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Financial Services (Implementation of Legislation) Bill 2017-19

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Summary

The *Financial Services (Implementation of Legislation) Bill 2017-19* enables the Treasury to make corresponding or similar provisions in UK law to upcoming EU financial services legislation in the event that the UK leaves the European Union without a deal.

Currently, most financial services regulation is made at EU level. It is either directly applicable or transposed into domestic law by secondary legislation. In preparation for leaving the EU, the *European Union (Withdrawal) Act 2018* (*EUWA*) incorporates all EU law on the day of exit into UK law so that existing regulation continues to have effect after Brexit. If the UK ratifies the Withdrawal Agreement, it will enter an implementation period until 31 December 2020, during which EU law will continue to apply. During this period the UK will continue to implement financial services regulation through secondary legislation. However, if the UK leaves the EU with no deal, there will be no mechanism through which financial services regulation can be updated without the need for primary legislation.

There are several items of EU financial services legislation which have either been adopted by the EU but will not be implemented by the time the UK leaves, or that are currently in negotiation and may be adopted shortly after. These items are referred to as "in-flight files". The Bill would give the Treasury the power to create corresponding or similar UK regulations, subject to any adjustments appropriate to the UK's new position outside the EU.

The power is subject to the same restrictions on scope as the correcting power in the *EUWA* and may only be used for up to two years after exit day. Statutory instruments made under the power in this Bill will be subject to the affirmative resolution procedure, which requires a vote in both Houses. The Treasury will be required to produce six-monthly reports on the use of the power.

The Bill completed its stages in the House of Lords on 6 February 2019, and had First Reading in the House of Commons on the same day. The Lords raised various issues at Committee Stage, which the Government took onboard at Report Stage, moving amendments with the following effects:

- To restrict the adjustments that the Treasury can make. The Treasury will only be able to make policy changes to those files that were not settled while the UK was an EU member, and as long as the changes are not "major". For those files that the UK fully negotiated as a Member State, the adjustments will be limited to fixing deficiencies arising from the UK's exit (as happens under the *EUWA*).
- To require more detailed and frequent reporting from the Treasury on its proposals and use of powers.
- To extend these reporting requirements to the financial regulators (Bank of England, PRA, FCA), where the powers are sub-delegated to them.
- To add proposed regulations to facilitate sustainable investment to the list of in-flight EU files that the Bill refers to.

The amendments were all accepted without a division.

The Bill received its Second Reading in the Commons on Monday 11 February 2019 and Committee Stage was on 26 February 2019. A number of opposition amendments were pressed to a vote at Committee Stage, but none passed.

Report and Third Reading are set for 4 March 2019. Andrew Mitchell and Margaret Hodge tabled a cross-party amendment (NC3) to reaffirm the end-of-2020 deadline for Overseas Territories to launch publicly accessible registers of the beneficial ownership of companies. The proposed new clause also extends that requirement to Crown Dependencies. There is more information about registers of beneficial ownership in our briefing, Registers of beneficial ownership.

All bill documents can be found on the bill page, here.

1. Background

Currently, most financial services regulation is made at EU level. It is either directly applicable or transposed into domestic law by secondary legislation. In preparation for leaving the EU, the *European Union (Withdrawal) Act 2018* (*EUWA*) incorporates all EU law on the day of exit into UK law so that existing regulation continues to have effect after Brexit. If the UK ratifies the Withdrawal Agreement, it will enter an implementation period until 31 December 2020, during which EU law will continue to apply. During this period the UK will continue to implement financial services regulation through secondary legislation.

However, if the UK leaves the EU with no deal, there will be no mechanism through which financial services regulation can be updated without the need for primary legislation. The *Financial Services (Implementation of Legislation) Bill 2017-19* enables the Treasury to make corresponding or similar provisions in UK law to upcoming EU financial services legislation in the event that the UK leaves the EU without a deal. Information on financial services if there is no deal can be found in section 3 of this paper.

1.1 Powers and restrictions under the *European Union (Withdrawal) Act 2018* and the Bill

The *EUWA* already provides Ministers with the power to modify domestic law to reflect deficiencies that would otherwise arise in the body of EU law that has been "retained" after exit day. The "correcting power" in section 8 and the consequential and transitional amendments power in section 23 of that Act are already being used by the Government in a range of fields, making pre-emptive changes to retained EU law before exit day.

Both of those powers are Henry VIII powers, meaning that they can modify primary legislation. Both powers to make regulations are time limited (to 2 and 10 years after exit day respectively) and are restricted as to the types of changes they can make to domestic law. Correcting regulations, for example, cannot have retrospective effect, create criminal offences carrying sentences greater than two years, or amend key constitutional statutes like the *Human Rights Act 1998* or the three main devolution statutes. In practice, neither of those two powers can give effect to major policy changes or developments over and above the fact of the UK leaving on 29 March 2019.

What distinguishes the delegated power (to the Treasury) in this Bill from those in the *EUWA* is that it allows changes to be made to domestic law with the explicit intention of "tracking" or "keeping pace with" EU law for up to two years after exit day. **Subsection 1(1)** of this Bill allows UK law to mirror new EU law provisions, so as to make regulatory alignment possible on the specific parts of EU financial services regulation identified in the Schedule.

For changes to EU law that (a) have been agreed before 29 March 2019, but (b) will not have been implemented by then, the Bill places broadly the same restrictions on this delegated power as *EUWA* does on the power to correct or prevent deficiencies in the operation of EU law. Subject only to "appropriate" modifications, the Treasury would have very limited scope to diverge from EU law when seeking to emulate changes entailed by it. Any subsequent divergence would require primary legislation.

Where this Bill provides greater flexibility for the Government is with regard to the in-flight files which will not have been agreed before the UK leaves (see 1.2 below). In those instances, "appropriate adjustments" can take into account "the United Kingdom's position outside of the EU". However, **Subsection 1(2)(b)** of the Bill does not permit the Treasury to make "major changes" from the EU legislation – these would still require an Act of Parliament.

In many cases under *EUWA,* draft "correcting" regulations would be made under the negative procedure. This means the instruments come into force unless time is made for debate and either House resolves against the instrument in question. This is not the case under the powers in this Bill: every delegated provision made by the Treasury would require the explicit approval of both Houses under the affirmative procedure.

1.2 The in-flight files in negotiation

There are a number of items of EU financial services legislation that are currently in negotiation and may be adopted shortly after the UK's exit. The Bill would give the Treasury the power to create corresponding or similar UK regulations, subject to adjustments appropriate to the UK's new position outside the EU.

The table below[1] lists all these in-flight files that the Treasury will have power to legislate for and make adjustments to under the Bill (listed in the Schedule), with a short summary of their aims.

Markets in Financial Instruments Regulation	This file facilitates the sharing of information on benchmarks, enabling pricing and clearing by Central Counterparties and Trading Venues. It will provide market participants with greater transparency of information.
Bank Recovery and Resolution Directive II	This proposal updates the existing approach to bank resolution. It will provide regulators with an updated resolution framework, and modifies several areas of the first BRRD to ensure flexibility and proportionality for resolution authorities and firms. It is primarily concerned with updating rules on available financial resources in resolution, which are derived from international Financial Stability Board standards.

1 Adapted from HMT's Memorandum to the Delegated Powers and Regulatory Reform Committee, 22 November 2018; the last row was added to reflect the Lords amendment

CCP Recovery and Resolution	The CCP R&R Regulation aims to ensure that both Central Counterparties (CCPs) and national authorities have the means to act decisively in a crisis scenario to maintain financial stability and ensure that CCPs can continue to function. It helps ensure that the costs associated with the resolution of failing CCPs do not fall on taxpayers.
Covered Bonds Regulation and Directive	The Covered Bonds file provides principles that ensure the quality of the product and protection for investments in covered bonds. This proposed new framework for covered bonds represents an improvement on the current regime, establishing common rules on the structure and supervision of such bonds.
Capital Requirements Regulation II (CRR II) & **Capital Requirements Directive V (CRD V)**	CRR II and CRD V are legislative revisions to the existing EU approach to bank capital and bank supervision. They are primarily concerned with updating rules on minimum capital requirements derived from international Basel standards. The files provide regulators with the regulatory framework they must apply, as well as updating their powers where necessary. They are crucial to maintaining a high standard of international financial services regulation.
Cross Border Distribution of Funds Regulation & Directive	This proposal aims to make it easier to market investment funds between EU member states. They will create greater transparency in the fees charged by regulators, make it easier for fund managers to test investor demand for different types of fund products and harmonise rules across the EU for firms that wish to withdraw marketing funds in a particular country. The file creates more transparency of regulatory fees, and makes it easier for fund managers to test investor appetite.
Central Securities Depositories Regulation	This regime was introduced as a measure to improve settlement efficiency and financial stability in the European markets. The proposals set out provisions for mandatory reporting if settlement fails, the imposing of penalties on failed trades and the requirement for failing participants to be subject to compulsory enforcement.
European Market Infrastructure Regulation 2.2	The EMIR 2.2 proposal updates the supervisory framework for third country CCPs, creating a broad set of tools to manage third country CCPs, which can have a significant impact on countries outside their home jurisdiction. The proposed regulation will increase our ability to manage financial stability risks posed by systemic third country CCPs.
EMIR REFIT **(Regulatory Fitness and Performance Programme)**	This proposal aims to bring in technical changes to EMIR that ensure the Regulation is more proportionate with regards to clearing and reporting. It looks to align EMIR with new international standards and update existing requirements. It also includes a pension scheme clearing exemption that will assist pensions schemes in accessing derivatives markets, allowing them to continue to pay UK pensioners.

European Supervisory Authorities Review	This proposal makes legislative changes to a number of EU files, including amendments to the current third country equivalence regimes for benchmarks, prospectuses, and date reporting services.
Investment Firms Review	The Investment Firms Review (IFR) reviews the prudential framework for investment firms and will deliver a new and more proportionate prudential regime tailored to investment firms.
Prospectus Regulation	This file simplifies the requirements of prospectus disclosures, lowering costs for businesses raising capital whilst maintaining a high standard of investor protection. Without it, UK businesses would face higher costs for producing a prospectus and additional regulatory burdens.
Securities Financing Transactions Regulation	This file helps to assess and mitigate risks posed by Securities Financing Transactions (SFTs) by requiring firms to report transactions to trade repositories. This increases market transparency and helps to mitigate risk.
SME Growth Markets Regulation	This proposal is aimed at improving growth in SME Growth Markets, focusing on reducing the administrative burden faced by SMEs in accessing public markets, diversifying financing options for SMEs and encouraging overall growth in SMEs use of public markets.
Sustainable Finance: Low Carbon Benchmarks	This proposal aims to enhance the transparency and comparability of low carbon benchmarks to enable investors to make more informed decisions. These proposals have resulted from targets agreed by the UK at the Paris Climate agreement and through the UN's Sustainable Development Goals.
Sustainable Investment Regulations [added by Lords]	These two proposals (and the one above) are part of a broader Commission initiative on sustainable development. The first of two proposals added by the Lords aims to establish a framework to facilitate sustainable investment by setting out uniform criteria for determining whether an economic activity is environmentally sustainable. The second proposal aims to increase disclosures relating to sustainable investments and sustainability risks.

There is more information on these proposals in the following reports of the European Scrutiny Committee:

- Banking reform: risk reduction measures (9 January 2019)
- Financial services regulatory framework: central counterparties (29 March 2017)
- Supervision of central counterparties (22 November 2017)
- Brexit: EU supervision of UK-based central counterparties (28 November 2018)
- Prudential requirements for investment firms (9 January 2019)
- Asset management: cross-border distribution of funds within the Single Market (11 July 2018)

- Regulation of covered bonds (25 April 2018)
- Green Finance: Low Carbon Benchmarks (16 January 2019)
- Green finance: sustainability disclosure requirements for investment advisors and asset managers (9 January 2019)
- European System of Financial Supervision (16 January 2019)

2. The Bill

The *Financial Services (Implementation of Legislation) Bill 2017-19* enables the Treasury to make corresponding or similar provisions in UK law to upcoming EU financial services legislation in the event that the UK leaves the European Union without a deal.

The Bill started on 22 November 2018 and moved through each of its stages in the House of Lords in a day. The Bill completed its Lords stages on 6 February 2019, and had First Reading in the House of Commons on the same day. Second Reading is set to be on Monday 11 February 2019.

The Bill is short, with only two clauses:

- Clause 1: Power in respect of EU financial services legislation with pre-exit origins
- Clause 2: Extent, commencement and short title

2.1 Clause 1

Subsection (1) sets out the nature of the Treasury's new power to implement post-exit changes to EU financial services legislation in UK domestic law. Provision may be made of an equivalent nature to that which the UK might otherwise have made as a Member State, but subject to "adjustments" which are considered to be "appropriate" in the view of the Treasury.

Subsection (2) narrows the meaning of "adjustments" so as to disallow adjustments that would create major policy divergence between the UK and EU. It restricts adjustments to changes of a like nature to the "correcting" power in *EUWA* where the substance of a new regulation has been agreed to by the UK before it left the EU. For those EU laws which were not finalised before the UK left, it allows wider "appropriate" adjustments to reflect or facilitate the UK's position outside the EU, but still prevents "major" divergence being enacted via Treasury regulation. Major policy divergence would need an Act of Parliament.

Subsection (3) lists the "Specified EU financial services legislation" referred to in the Bill.

Subsection (4) makes clear that, as with *EUWA*, this delegated power can be used to modify primary legislation (Henry VIII powers). However, it cannot be used to:

- impose or increase taxes or fees;
- make retrospective provision;
- create criminal offences for which an adult can be imprisoned for more than two years;
- establish a public authority;
- implement the withdrawal agreement;

- amend, repeal or revoke anything in or made under the *Human Rights Act 1998*; or
- amend or repeal the devolution statutes.

Subsection (5) allows regulations to make provision for the charging of fees in connection with the exercise of a function created under the powers in this Bill.

Subsection (6) imposes a sunset clause on the Treasury's power to make regulations. As with the *EUWA* correcting power, this is limited to the two years that follow exit day.

Subsection (7) requires the Treasury to exercise this power using a statutory instrument.

Subsection (8) makes clear that, unlike the correcting power in *EUWA*, all statutory instruments made under clause 1 would have to undergo the affirmative procedure. This means proactive approval will be needed from both Houses of Parliament before regulations can come into force.

Following amendments made in the Lords, the Treasury would also have to set out (more than a month before laying the instrument) what it would do and identify whether, how and why the instrument is expected to be "adjusted" and why that is "appropriate".

Subsection (9) and (10) set out the reporting requirements and frequency (every six months) that the Treasury will have to follow in relation to explaining their use of the power and the adjustments made to EU legislation.

Subsection (11) makes arrangements for accountability of sub-delegation of powers to make rules (i.e. where the Treasury confers rule-making powers upon the three financial regulators: the Bank of England, the Prudential Regulation Authority or the Financial Conduct Authority). It extends to those three bodies a reporting requirement that exists for other exercises of sub-delegated power under *EUWA*.

Under *EUWA* if a Minister has used the correcting power to "sub-delegate" to another person or body, that person or body must then report to Parliament and the Minister on an annual basis if and when they have used that power. This enables Parliament to scrutinise how that power has been used in a more public and accountable way.

2.2 Clause 2

Clause 2 specifies the extent (whole of UK) and commencement of the Act (the day on which it is passed).

2.3 Safeguards

The Bill gives the Government powers to create or change laws of a nature that would normally require an Act of Parliament. As such, the Government recognises the need for restrictions and time-limits on the power. It has provided for the following safeguards:

> The Government acknowledges that this proposal is a broad power, and recognises that it must be temporary and limited. The proposed limitations are:
>
> a) The power is strictly temporary. It is subject to a sunset provision in subsection (6), and cannot be used more than two years after the UK leaves the EU. This is in line with the sunset applied to the correcting power in the EU Withdrawal Act. There is no power in the Bill to extend the period of its application.
>
> b) The power can only be exercised in respect of proposals adopted by the European Commission before exit day and to the specified list of files on the face of the Bill. No power to add further files is included.
>
> c) The power is subject to limitations as in section 8(5) and (7) of the European Union (Withdrawal) Act 2018. The power cannot be used to impose taxation; make retrospective provision; create some criminal offences; establish a public authority; implement a withdrawal agreement; or amend the Human Rights Act or the devolution settlements.
>
> d) Similarly, any power to introduce fees is subject to the limitations in Schedule 4 to that Act (see subsection (4)).
>
> e) The Treasury must in April 2020 publish a report on how the powers have been used and how they are intended to be exercised, and in April 2021 must a publish a report on how they have been exercised.[2]

Safeguard (e) was amended by the Lords to increase reporting from two annual reports to four six-monthly reports. The Lords also added detailed requirements on the contents of these reports, and an obligation to publish a document explaining proposed regulations before laying them for approval. Lords amendments to the Bill are summarised below.

2.4 Lords amendments

The Lords raised various issues at Committee Stage, which the Government took onboard at Report Stage, moving amendments with the following effects:

- To restrict the adjustments that the Treasury can make. The Treasury will only be able to make policy changes to those files that were not settled while the UK was an EU member, and as long as the changes are not "major". For those files that the UK fully negotiated as a Member State, the adjustments will be limited to fixing deficiencies arising from the UK's exit (as happens under the *EUWA*).
- To require more detailed and frequent reporting from the Treasury on its proposals and use of powers.
- To extend these reporting requirements to the financial regulators (Bank of England, PRA, FCA), where the powers are sub-delegated to them.

2 HMT's Memorandum to the Delegated Powers and Regulatory Reform Committee, 22 November 2018, p5-6

- To add proposed regulations to facilitate sustainable investment to the list of in-flight EU files that the Bill refers to.

The amendments were all accepted without a division.

Amendment 1 distinguished between the two types of in-flight files – the files settled before the UK's departure and those not settled before the UK's departure. The amendment restricted the adjustments that the Treasury can make to the first type of files to fixing deficiencies arising from the UK's exit (as happens under the *EUWA*). The Treasury can make wider amendments to the second type of files as long as the changes are not "different in a major way" from the EU legislation. The Minister, Lord Bates, explained:

> Amendment 1 […] is in response to a recommendation by the Delegated Powers and Regulatory Reform Committee. […] In its report, the committee noted that, for those files listed in the Schedule which are still in negotiation, the justification for the power to adjust is that it is not now possible to know what the final form of that legislation will be. However, the DPRRC noted that the same justification could not be used for files already agreed, and it recommended that the power to adjust be limited only to the files in the Schedule to the Bill. I can now say that the Government are able to implement the DPRRC's recommendation. These files have been settled while the UK has been an EU member and has been around the negotiating table at all stages with a full voice. We accept the principle that this is settled law that has received UK sign-off and that, as such, an ability to fix deficiencies is more appropriate than one to make policy adjustments.[3]

Amendment 3, 4 and 5 increased reporting requirements. The Treasury will report not once but twice a year. The Lords also added detailed requirements on the contents of these reports, and an obligation to publish a document explaining proposed regulations before laying them for approval. They also extended reporting requirements to the financial regulators (Bank of England, PRA, FCA), where the powers are sub-delegated to them. The Minister, Lord Bates, explained:

> The Bill, as introduced, placed a duty on the Government to publish a report annually on their exercise of the power. It was clear in Committee, however, that there was some room for improvement. […]
>
> I turn to Amendments 3, 4 and 5. The noble Baroness, Lady Bowles, proposed that, where adjustments or omissions are needed when implementing the files, the Government should publish a report beforehand setting this out in detail to make sure that Parliament has sight of this, and can consider the merits of the proposals. Given the exceptional nature of the Bill and the powers being sought, it can only be right that the Government are clear with Parliament and the industry about how they intend to implement these files. The Government therefore propose introducing a new requirement, as set out in Amendments 3 and 4. These would ensure that, before laying any statutory instruments before Parliament under the affirmative procedure, the Government must first publish a document detailing the

3 HL Deb 29 January 2019 c1019

> proposed text of the regulation with an accompanying report. The report would have to outline what, if anything, has been omitted from the original EU legislation, where there had been any adjustments to the original EU legislation, and provide justification for these adjustments.
>
> As I noted in Committee, the three-month requirement could risk being too long. The essence of this Bill is the speed with which it will allow the UK to keep its regulation up to date and responsive to the uncertainty of a no-deal scenario. The amendment therefore proposes a one-month deadline. However, the Government will of course commit to publishing these documents earlier where possible.
>
> On Amendment 5, in Committee my noble friend Lord Hodgson suggested a more regular reporting cycle than the yearly proposal in the Bill as introduced, and that these reports should set out the Government's reasoning for why any adjustments might have been necessary. I again reassure noble Lords that it was always the Government's intention to set out such a justification. This underpins the spirit behind the proposed new subsections (8) and (9) in Amendment 5. This requires the introduction of a more regular requirement for the Treasury to report—now every six months. It requires the Government to specify both how the power has been exercised over the previous six-month period and how they intend to exercise it over the coming six-month period. […]
>
> Finally, proposed new subsection (9A) in Amendment 5 responds to the suggestion from the noble Lord, Lord Adonis, and the noble Baroness, Lady Bowles, in Committee. Here we propose to introduce the same requirement for the financial regulators—the Bank of England and the Financial Conduct Authority—to report on their exercise of any powers sub-delegated to them through the Bill. This follows the model established in the EU withdrawal Act. We agree that it is right that, as they will be implementing much of the legislation contained in this Bill, Parliament and the public should be kept informed of how their functions are being discharged.[4]

Amendment 6 added two items of proposed EU legislation to the "list of proposals for the purposes of section 1" in the Schedule of the Bill (the in-flight files in negotiation). Lord Bates explained:

> The noble Lord, Lord Sharkey, made a contribution in Committee in which he expressed concern about the omission of some files from the Schedule and Clause 1. At Second Reading and in Committee the omission of two sustainable finance files, which complete the EU's sustainable finance package, was raised. I am pleased to confirm to the noble Lord and the House in general, and to the sustainable finance industry, that the Government are happy to add these two files to the Schedule via this amendment.[5]

The Lords also debated the meaning of the words 'major' and 'significant' in **Amendment 2** (to Amendment 1). Lord Davies had wanted to tighten the prohibition in the Bill from the Treasury implementing "major" changes, but the amendment was withdrawn

4 HL Deb 29 January 2019 c1006
5 HL Deb 29 January 2019 c1020

after the Minister argued that "the word 'significant' would result in ambiguity and introduce a risk that the power could be given different interpretations".[6]

2.5 Commons amendments

The Bill received its Second Reading in the Commons on Monday 11 February 2019 and Committee Stage was on 26 February 2019. In Committee, Labour and the SNP moved various amendments that would increase the involvement of the House of Commons and decrease the Treasury's discretion in choosing whether, when and how to domesticate upcoming EU legislation. The amendments were pressed to a vote, but none passed.[7]

Report and Third Reading are set for 4 March 2019. Andrew Mitchell and Margaret Hodge tabled a cross-party amendment (NC3) to reaffirm the end-of-2020 deadline for Overseas Territories to launch publicly accessible registers of the beneficial ownership of companies. The proposed new clause also extends that requirement to Crown Dependencies. There is more information about registers of beneficial ownership in our briefing, Registers of beneficial ownership.

6 HL Deb 29 January 2019 c1014
7 HC Deb 26 February 2019 cc1-30

3. Financial services if there is no deal

The UK's financial services sector is the largest in Europe and is deeply connected with it. An estimated 10% of its revenues come directly from the EU, making it the third most-reliant sector on the EU market on that measure, after oil and gas at around 40% and manufacturing at around 20%.[8]

All the main European banks and insurance companies operate in London, as UK companies do in Europe, under a system of 'passports'. Any company authorised in any EU Member State can operate in any other EU Member State under its passport. It is the sudden loss of this passport without other arrangements in place that is the biggest potential problem arising out of 'no deal'.

A PwC study concluded that the loss of mutual market access in financial services would be detrimental to both sides, although it would hurt the UK more. It estimated that no access would make the UK economy 1.3% smaller than otherwise by 2030, and 0.3% smaller for the EU27.[9] The impact of no deal on financial services was estimated by the Government at around -9% of economic activity for the industry in the long run.[10]

The Government's no-deal notices and guidance for financial services are collated here. Key information from these notices and other sources is summarised below.

3.1 What happens?

HM Treasury's Approach to financial services legislation under the European Union (Withdrawal) Act (published 9 August 2018) explained what would happen if there is no deal (paras 1.17 – 1.20). As a third country, UK-based financial services would lose their automatic access to the EU. The Government said:

> In the unlikely scenario that the UK leaves the EU without a deal, the UK would be outside the EU's framework for financial services. The UK's position in relation to the EU would be determined by the default Member State and EU rules that apply to third countries at the relevant time. The European Commission has confirmed that this would be the case.
>
> In light of this, our approach in this scenario cannot and does not rely on any new, specific arrangements being in place between the UK and the EU. As a general principle, the UK would also need to default to treating EU Member States largely as it does other third countries, although there are instances where we would need to diverge from this approach, including to provide for a smooth transition to the new circumstances. The principles

8 See Library briefing, Importance of trade with the EU for UK industries, August 2017
9 PwC, Impact of loss of mutual market access in financial services across the EU27 and UK, February 2018, p4
10 HM Government, EU Exit: Long-term economic analysis, November 2018, p58

> that would lead to deviations from this approach are set out below.
>
> In some areas, correcting deficiencies to reflect this environment would be relatively straightforward. The UK's world-leading financial sector is overseen by HM Treasury and underpinned by a strong legislative framework with world-class regulators (the Bank of England/Prudential Regulation Authority and Financial Conduct Authority). This means that the responsibilities of EU bodies could be re-assigned efficiently and effectively, providing firms, funds and their customers with confidence after exit.
>
> In this scenario, EU financial services firms operating in the UK would broadly become subject to the same supervisory regime that the UK already applies to other third countries – a regime that is shaped by the highly global, cross-border nature of financial services and the UK's robust regulatory framework as set out in legislation, including in the Financial Services and Markets Act 2000 (FSMA), the Banking Act 2009 and the Bank of England Act 1998. This existing UK financial services legislative framework provides powers for extensive cooperation with global regulatory bodies. When the UK is no longer an EU Member State, and so the EU obligation of reciprocal cooperation no longer applies, this existing framework could be relied upon to ensure this important cooperation continues in this scenario.

The *European Union (Withdrawal) Act 2018* transfers EU law, including that relating to Financial Services, to the UK statute book on exit day.

In the event of no deal, the Government will create temporary permissions and recognition regimes (explained below) to allow EU firms to continue their activities in the UK for a time-limited period. Firms wishing to continue doing business in the UK in the longer term will be able to use this period to obtain full authorisation (or recognition) from UK regulators without disruption to their business.[11]

3.2 Who regulates?

In the event of no deal, regulatory functions carried out at an EU level will be transferred to UK bodies responsible for regulating financial services. The Government said:

> In leaving the EU without a deal, many functions currently carried out at an EU level would cease to apply to the UK and would need to be provided for in the UK's regulatory regime. HM Treasury's onshoring work involves allocating these EU functions to the appropriate UK bodies. In this scenario, HM Treasury proposes to follow the model outlined in FSMA and allocate functions to UK regulators in a way which is consistent with the responsibilities already conferred on them by Parliament, thus providing certainty and continuity for firms.
>
> Further information about how HM Treasury proposes to allocate responsibilities between HM Treasury and the financial services regulators in this scenario can be found in the draft Financial Regulators' Powers (Technical Standards) (Amendment etc.) (EU Exit) Regulations 2018 and accompanying explanatory note, published in April 2018.

[11] Bank of England, Bank of England's approach to financial services legislation under the European Union (Withdrawal) Act, 27 June 2018

> Additionally, HM Treasury has confirmed that in this scenario it intends to transfer supervisory powers to the FCA to regulate credit ratings agencies and trade repositories currently supervised at the European level by the European Securities and Markets Authority (ESMA), and it intends to give functions and powers in relation to non-UK central counterparties and non-UK central securities depositories, also currently exercised by ESMA, to the Bank of England.[12]

Regulation 2 of the *Financial Regulators' Powers (Technical Standards etc.) (Amendment etc.) (EU Exit) Regulations 2018* tells us who the "appropriate regulators" are in the UK that EU functions are assigned to: the Bank of England, the PRA, the FCA, and the Payment Systems Regulator. The SI's Schedule lists the precise EU powers and responsibilities that are transferred to these UK regulators.

HM Treasury's full programme of secondary legislation under the *EU (Withdrawal) Act 2018* to ensure that the UK continues to have a functioning financial services regulatory regime in all exit scenarios can be found here.

3.3 EEA firms in the UK – a new Temporary Permissions Regime (TPR)

In December 2017, the Government announced its intention to introduce a Temporary Permissions Regime (TPR) which would allow EEA firms to continue operating in the UK for a time-limited period after the UK has left the EU without a deal.

This temporary regime would be bolstered by the main regulators (the Financial Conduct Authority and Bank of England) being given the power to implement changes to their rulebooks to permit it to become effective in support of whatever legislation is passed.

The TPR will allow EEA firms currently passporting into the UK to continue operating in the UK for up to three years after exit. During that time, these firms can apply for full authorisation from UK regulators.

The government has published in draft the legislation that will deliver the TPR. The Financial Conduct Authority (FCA) has published its approach to implementing the TPR and the Prudential Regulation Authority (PRA) has set out its expectations for the TPR. The FCA and PRA are the key regulators in the sector.

The *Financial Times* reported (10 February 2019) that many European governments were preparing similar TPRs to allow UK asset managers to continue to serve customers in these countries:

> France, Germany, Italy and the Netherlands are among countries that have amended national laws to ensure UK investment companies can still serve foreign customers. […]
>
> "Each country is trying to implement something that will allow normal business to continue in the event of a no-deal Brexit," said

12 HM Treasury's Approach to financial services legislation under the European Union (Withdrawal) Act, 9 August 2018, paras 1.24 – 1.26

> Marco Boldini, head of the asset management legal team at PwC, the consultancy. "It is very welcome news that they are trying to put together a plan B.[13]

3.4 Financial stability risks related to derivatives

The derivatives market has been identified by the Governor of the Bank of England as the 'big issue' for the UK and EU to solve post Brexit day.[14] Derivatives are financial contracts used to manage risk (they are also used to speculate). For example, an interest rate swap is a derivative that allows a firm to fix the interest rate it pays on a variable loan.

Speaking to the Treasury Committee in July 2018 the Governor outlined the problem, saying that so-called 'life-cycle events' in derivative contracts such as rolling open positions or exercising options could no longer be executed:

> The crucial point here is that on the day of leaving, the contract can still be serviced; however, life-cycle events will start to accumulate and, arguably, they will accumulate quite rapidly in the event of a cliff-edge Brexit because one would reasonably expect the volatility in markets to go up. How big is that potential risk? We have done the due diligence on that. For a mid-size firm there are about 1,000 life-cycle events a month. For a large derivative counterparty, there are up to 250,000 a week. If you think about it in the world of derivatives hedging underlying positions, with the inability to conduct these life-cycle events and an environment where there is volatility, the risk—the inability to dynamically hedge—increases with time, and you see a financial stability risk developing fairly quickly, in our opinion. We shared that opinion publicly through the FSR and directly with our counterparts in the EU.[15]

He drew attention to how this problem affects cross-border clearing houses. A central counterparty (CCP) clearing house is a financial institution that facilitates the settling (i.e. clearance) of financial contracts such as derivatives. The clearing house stands between two clearing firms (also known as member firms or participants). Its purpose is to reduce the risk and consequences of participants defaulting on their obligations. Thus, CCPs make these transactions cheaper and safer for traders.

The Governor was warning that the consequences of 'no deal' for outstanding derivatives contracts cleared via UK CCPs would be financially destabilising, more so for the EU but also for the UK. There is an analysis of all these risks in the Bank of England's Financial Stability Report (June 2018):

> EEA clearing members and their clients currently rely heavily on CCPs based in the UK. The ECB estimates that UK CCPs clear

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[13] FT, "EU governments provide Brexit relief for asset managers", 10 February 2019

[14] For a more thorough examination of the derivatives market post Brexit see ISDA; Contractual Continuity in OTC Derivatives Challenges with Transfers, July 2018.

[15] Treasury Committee. Oral evidence: Bank of England Financial Stability Reports, HC 681, 17 July 2018

> approximately 90% of euro-denominated interest rate swaps used by euro-area customers. (p12)

The Governor explained that the EU had not come up with an equivalent temporary recognition regime for UK CCPs:

> … as it stands at present, the large, UK-based clearing houses would no longer be authorised clearing houses by the EU following the Brexit date. Therefore, the actions of European counterparties that had cleared in those clearing houses would be ultra vires; they would not be authorised to use those clearing houses. Those clearing houses would know that in advance and so the European counterparties would have to close out those positions in advance. The question is how rapidly that could be done. The orders of magnitude are much higher—it is a notional £60 trillion-plus of exposure—than they are in the uncleared space. That process, which the Bank of England oversees as the regulator of these clearing houses, would have to begin prior to the Brexit date.
>
> I want to make two final points. First, the UK Government have signalled their intention and developed statutory instruments, which they will lay before Parliament as soon as is practical. Given the timing of the summer recess, that is likely to be in the fall, but it will be done in a timely way. Those statutory instruments will solve the UK side of this issue—both authorisation of EU CCPs and authorisation of the EU counterparties. The European Union has not yet indicated a solution to this.

Four months after that, the EU announced they would do the same as the UK – give temporary authorisations to UK CCPs in the event of no deal. The EC said in November 2018 that they will continue to recognise for some time this systemically important area of UK financial services, central clearing.[16] The European Securities and Markets Authority (ESMA) explained:

> The European Securities and Markets Authority (ESMA) is publishing this Public Statement to address the risks of a no-deal Brexit scenario in the area of central clearing. The ESMA Board of Supervisors supports the continued access to UK CCPs to limit the risk of disruption in central clearing and to avoid negatively impacting EU financial market stability.[17]

They further published this statement (19 December 2018) clarifying their plans for recognising UK CPPs in the event of no deal. Whether arrangements for financial services would be more than bare minimum to safeguard financial stability would be a matter for negotiations.

The combination of the ‘no passport’ issue and the derivatives issue is particularly troublesome for the insurance industry. The Association of British Insurers (ABI) indicated that coordination between the UK and EU to avoid a ‘cliff edge’ would be ‘imperative’. A briefing from the ABI set out the problem:

> 1. When the UK leaves the Single Market, UK-based providers will no longer be able to rely on ‘passports’ and the right of

[16] EC, Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019: a Contingency Action Plan, 13 November 2018

[17] ESMA, Managing risks of a no-deal Brexit in the area of central clearing, 23 November 2018

establishment to service existing cross-border financial contracts throughout the European Economic Area (EEA). There will also be an identical impact on EEA providers who will be unable to service existing financial contracts with UK-based parties. This issue is often referred to as the contract continuity problem.

2. This will, for example, impact general insurance, long-term life insurance, pension schemes, medium and long-dated derivatives contracts, revolving credit facilities, and may also affect general customer terms of business, prime brokerage and custody arrangements.

3. The extent of this issue is significant and will affect both UK and EEA consumers. According to the Bank of England, approximately six million UK insurance policyholders, 30 million EEA insurance policyholders, and around £26trn of outstanding uncleared derivatives contracts could potentially be affected. The issue will also affect contracts relating to segregated mandate business under the Markets in Financial Instruments Directive (MiFID) II. In particular, failure to find a solution to derivatives contracts could potentially lead to significant financial stability risks.

4. Honouring existing obligations to customers is a key priority for the industry in the UK and the EU, and it is continuing to do all it can to address the issue. However, while service providers are preparing to take steps to mitigate the impact of the loss of passporting rights, it is highly unlikely that this will be adequate to fully address the contract continuity issue by March 2019.

5. As a result, it is imperative that action by service providers is coupled with action from policymakers and regulators in the UK and EU to mitigate this 'cliff edge risk'. The International Monetary Fund (IMF) flagged in its Article IV statement that a resolution would be "most efficiently achieved through coordinated EU and UK legislation".

- It is critical that the UK and EU implement the transitional period that was agreed at a political level at the European Council meeting in March 2018. Furthermore, it is also important for UK and EU regulators to issue commitments about the future treatment of these contracts to act as a regulatory 'back stop' in the event that the transitional period fails to materialise.
- Any UK/EU solution should also be underpinned by ongoing supervisory cooperation between UK and EU regulators. The new European Central Bank (ECB) and the Bank of England (BoE) technical working group on risk management, announced on 27 April 2018, would be an ideal forum to discuss solutions to this issue.
- The early announcement of grandfathering arrangements, either for a time-limited period or potentially until maturity, would allow for contract continuity which will deliver the best results for UK and EEA customers, as well as European competitiveness more broadly.[18]

Temporary Recognition Regime (TRR)

As explained above, the UK will establish a temporary recognition regime (TRR) for EU-based central counterparties (CCPs). This regime will allow these CCPs to continue to provide clearing services to UK

[18] TheCityUK/ABI briefing June 2018

firms for a period of up to three years while those CCPs apply for recognition in the UK. The Bank of England has published further details on the approach to recognising non-UK CCPs.

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