Bank of England and Prudential Regulation Authority (PRA) – Written evidence (FSB0013)

This is a written submission on behalf of the Bank of England and Prudential Regulation Authority (PRA) to the Lords' EU Services sub-Committee in response to the call for evidence on financial services after Brexit.

The Bank of England keeps the UK's financial system stable by keeping a close watch on any risks and taking action, if needed. The Prudential Regulation Authority regulates and supervises all the major banks, building societies, credit unions, insurers and investment firms in the UK.

Is the UK financial services sector well prepared for the end of the Brexit transition period? What are the main areas where arrangements are not yet in place?

The PRA and the Bank are responsible for the regulation of banks and insurers and financial market infrastructures respectively, and together with the FCA have continuously engaged with UK financial services firms on their operational readiness in our capacities as supervisors of these firms. The Financial Policy Committee (FPC) identifies, monitors and takes action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC has published its 'checklist'[1] of the risks of disruption to the provision of financial services after every meeting since November 2017. The FPC judges that most risks to UK financial stability that could arise from disruption to the provision of cross-border financial services at the end of transition period have been mitigated, reflecting extensive preparations by authorities and the private sector over a number of years. Examples of those preparations include:

- UK authorities have put in place temporary permission and recognition regimes which will allow UK households and businesses to continue to access financial services from EU providers for up to three years after the end of the transition period. Primary and secondary legislation has been used to 'onshore' existing EU legislation in order to ensure that the UK continues to have a fully functioning and effective legal and regulatory regime for financial services. This includes onshoring new EU legislation and technical standards that have come into force during the transition period. Onshoring is on track to be completed before the end of the transition period and, together with the temporary regimes, this has provided firms with certainty about the UK requirements that they will need to comply with after 1 January 2021. The Bank and the PRA intend to use their temporary transitional powers to provide broad transitional relief, with some key exceptions, for 15 months after the end of the transition period to facilitate the transition to onshored UK requirements for the financial services sector.

- Authorities have also taken action to reduce the risk of disruption in some key areas. The EU has adopted a decision to provide equivalence to the

[1] Financial Policy Committee, Checklist and other risks of disruption to the provision of financial services at the end of the transition period, October 2020 (link); An updated checklist will be published alongside the FPC Record on 9 December 2020.

future UK legal and supervisory framework for Central Counterparties (CCPs) until June 2022, and UK CCPs have been recognised by the European Securities and Markets Authority. This will allow EU financial firms to continue to use UK CCPs after the end of the transition period. When combined with the UK's temporary recognition regime for CCPs, which was already in place, it mitigates the financial stability risk in markets for cleared derivatives. On the UK side, the FCA has acted to preserve the ability of UK-based firms to execute their share trades at the venues where they can get the best outcomes for themselves and their customers.

- In parallel to the work done by UK authorities, UK-based firms have also over the past few years made substantial progress with their own preparations, which are now in their final stages. Most notably, as the EU has not followed the UK's approach of enabling access through temporary regimes, UK firms have established EU entities to continue servicing EU clients after the end of the transition period. All material subsidiaries of UK firms have now been authorised in the EU and are fully operational. Over two-thirds of clients of major UK-based banks have now completed the necessary documentation to enter into derivatives trades with EU entities. Many clients are also actively trading with the new EU entities.

The FPC has judged that most risks to UK financial stability that could arise from disruption to the provision of cross-border financial services at the end of the transition period have been mitigated. But financial stability is not the same as market stability or the avoidance of any disruption to users of financial services. Some market volatility and disruption to financial services, particularly to EU-based clients, could arise at the end of the transition period.

The FPC has identified areas where it has assessed that risks of such disruption remain, despite the good preparations already made. The PRA wrote to firms in October 2020, to encourage them to ensure their operational preparedness for the end of the transition period and assure themselves that they have done everything they can to minimise disruption:

- To facilitate the continuity of business and contracts, firms are well-advanced in repapering of EEA clients and are prioritising the novation of derivatives contracts where necessary. They are continuing to engage proactively with remaining affected clients to complete repapering and on-boarding, and novate existing trades where necessary to ensure clients can manage risks related to 'lifecycle' events in current financial contracts (e.g. amending the notional value of a trade). Some operational risks remain, including if many clients seek to migrate new business or existing contracts in a short period of time. These actions could also amplify any market volatility.

- UK firms and trading venues are taking action to ensure they can comply with UK and EU trading obligations after the end of the transition period. However, the process of adjustment might pose operational risks if participants have not put in place suitable arrangements by the end of the transition period, which could also amplify volatility. And the new arrangements will fragment liquidity across jurisdictions and venues.

- After the end of the transition period, processing some cross-border payments between the UK and EU — notably direct debits — will require additional information to be included for the payment instructions to meet regulatory requirements. Firms continue to put the necessary information in place where possible, but may not resolve all information gaps in time. This could result in disruption to both EEA and UK customers and businesses seeking to make and receive payments.

- The ability of UK banks and insurers to continue providing some services to retail customers resident in the EU will be determined by national regimes. Depending on the national regime in place, the ability of UK banks and insurers to provide certain services to EU-based customers may be impaired. Some UK banks have begun notifying EU-based customers that they will not continue to provide certain retail banking services in some jurisdictions.

<u>Could a lack of certainty prompt companies to move assets and personnel to the EU? How have these preparations shaped the UK financial services sector?</u>

It is known that some of the activity of UK-incorporated firms in relation to EU clients will not be able to continue following the loss of the passport and other access-related rights associated with EU membership. For example, this means that third country (including UK) firms cannot take deposits across the single market, only in those individual member states where local authorisation can be obtained. And the EU has said it will not provide equivalence decisions in some areas, such as the cross-border provision of investment services, in the short or medium term.

In some areas, such as the cross-border provision of certain investment services, this loss of access does not apply in reverse because of the overseas persons exclusion (OPE) – which can in certain circumstances enable EU firms to transact with firms in the UK without any equivalence in place.

To continue providing services to EU clients, major UK-based banks have, as noted above, set up EU subsidiaries and continue to build capacity in line with plans agreed with EU regulators. Those plans are well-established; all material subsidiaries are now authorised, fully operational and trading. As set out above, firms are well-advanced in repapering of EU clients with these subsidiaries. These subsidiaries allow UK firms to provide a full range of services to EU clients regardless of whether equivalence is given by the EU.

But it is also known that some activity with EU clients will be able to continue after 1 January, for example, through the use of access granted under the national regimes of EU Member States. And co-operation agreements between the FCA, ESMA and EU National Competent Authorities will, under current EU rules, enable EU asset managers to delegate the portfolio management of assets to firms in the UK and other third countries.

In the short term, PRA-supervised firms' estimates suggest up to 5,000 jobs in banks and insurance companies have moved or could move to the EU. This is relatively small given that over 500,000 people are employed in the banking and insurance sector, and over a million people are employed in UK financial services as a whole. And it is considerably less than some initial industry estimates published soon after the referendum in 2016.

Looking further ahead, both the UK and the EU's access arrangements for overseas financial services firms will continue to evolve alongside firms' business models. The longer-term impact may therefore be different from the short-term impact or firms' current plans. But the UK's open approach, as evidenced by the Government's recent decisions to provide equivalence to the EU, combined with the UK authorities' commitment to robust prudential standards in line with the best global approaches, will continue to facilitate cross-border activity into and out of the UK.

To provide some context, of an estimated UK financial services revenue of around £300bn about £30bn is estimated to come from EU clients.

<u>What would be the implications of a 'no agreement' scenario for financial services firms? What more can be done to help the financial services sector prepare for a 'no agreement' scenario?</u>

The FPC has been monitoring the risks of disruption to financial services and regularly updates and publishes its assessment of actions in what we refer to as the 'checklist'. The FPC's assessment reflects the risk of disruption to end-users including households and companies if no further arrangements are put in place for cross-border trade in financial services for the end of the transition period.

This means that a 'no agreement' scenario would not alter the FPC's assessment of cliff-edge risks. Our risk assessments are based on the disruption that could materialise if no further arrangements are put in place. Both the Bank's and firms' prudent planning assumption has been that equivalence would not be forthcoming, except in respect of UK-based CCPs. Based on this assessment, the FPC judges that most risks to UK financial stability have now been mitigated.

The mitigation of these risks reflected extensive preparations made by authorities and the private sector over a number of years. But, as has been noted above, financial stability is not the same as market stability and some market volatility and disruption to financial services could arise. Financial institutions continue to make preparations and engage with clients and customers to minimise any disruption. The PRA and the FCA wrote jointly to banks and insurers in October, encouraging UK firms to make final preparations to ensure that they are ready for a range of scenarios at the end of the transition period.

<u>What would be the consequences if the EU does not grant the UK positive equivalence determinations? In what areas are equivalence decisions particularly important?</u>

Equivalence can be an important tool in facilitating cross-border access between well-regulated open markets, but it is not the only one – for example the OPE also facilitates access to the UK. Equivalence is a substitute in respect of only a subset of the activities currently covered by passporting rights within the EEA, and even then only on less favourable terms – for example, equivalence under CRR would not permit the cross-border provision of deposit-taking or any other service and nor would it allow UK banks to have an automatic right to establish EEA branches. The same is largely true for UK insurers, although one form of equivalence under Solvency II does facilitate the reinsurance of EEA-situated risks with UK insurers, but only in certain jurisdictions due to differing interpretations across the EEA. Overall, equivalence provides considerably less cross-border market access than is provided under EU passporting arrangements.

From a financial stability perspective, the EU has already granted the UK temporary equivalence (until 30 June 2022) in the area where its absence would have created the greatest risks to financial stability – the provision of clearing services by UK CCPs to EU clearing members and venues. In line with this, the European Securities and Markets Authority (ESMA) announced that the three UK CCPs – ICE Clear Europe Limited, LCH Limited, and LME Clear Limited – will be recognised as third country CCPs eligible to provide their services in the EU for 18 months, after the end of the transition period. And the Bank of England and ESMA have agreed the necessary memorandum of understanding in respect of these CCPs. These equivalence and recognition determinations have mitigated the financial stability risk in markets for cleared derivatives.

In terms of facilitating market access for financial services, the most significant provision is equivalence under MIFIR Article 47. However, the European Commission stated in July it will not be assessing the UK for equivalence in the short or medium term under this or eight other provisions, including others in MiFID/R. Though less important, there remain some benefits in the remaining outstanding equivalence provisions. For example, more efficient intragroup management of risks by firms.

<u>How important is it that any positive equivalence determinations are underpinned by an agreed framework for the orderly withdrawal of equivalence?</u>

Under the equivalence arrangements proposed by the EU, equivalence decisions made by one jurisdiction, in respect of another, are taken autonomously and allow both Parties to develop their rulebooks independently over time. Such decisions are not generally underpinned by structured processes for withdrawal and can be withdrawn with very little notice. In certain circumstances, such an abrupt withdrawal of equivalence could have adverse effects on financial stability and lead to market disruption.

To provide greater stability for trade in financial services on the basis of equivalence, the Bank therefore supports the view that autonomous equivalence decisions should be accompanied by structured and transparent processes – in particular for the withdrawal of equivalence. This would provide confidence that any withdrawal of equivalence will be orderly. It would ensure that industry has time to adapt to any changes, thereby maintaining confidence in equivalence decisions as a reliable platform on which firms can conduct their business.

At the start of November, the Government published a guidance document outlining the principles and processes which will govern the UK’s equivalence framework from the end of the transition period. In particular, the document highlights the UK’s commitment to an outcomes-based model of equivalence, which operates in a transparent manner, providing predictability and stability

over time to UK industry, overseas jurisdictions and firms. With regards to the withdrawal of equivalence, this may include appropriate adaptation periods to allow firms time to prepare to the changing circumstances.
The guidance document also emphasises the importance of ongoing cooperation and dialogue to build understanding, encourage cooperation and resolve material issues early in the policy development process.

<u>How could the absence of a positive data adequacy decision from the EU impact the sector?</u>

The UK Government has passed legislation to continue to allow the free flow of personal data from the UK to the EU when the transition period ends on 31 December 2020.

Because the UK will be a third country and not subject to the European General Data Protection Regulation (GDPR) when the transition period ends, the European Commission is undertaking an assessment of the adequacy of the UK's data protection standards. If the EU does not deem the UK's data protection regime adequate, both UK and EU households and businesses may be affected due to the EU to UK data transfers required for them to access certain financial services.

In the absence of an adequacy decision of the EU, personal data transfers from the EU to the UK must be made in accordance with other GDPR-complaint mechanisms, for example standard contractual clauses and binding corporate rules. UK firms are generally well advanced in implementing these mechanisms to allow for the continued flow of data from the EU to the UK after the end of the transition period in the absence of an adequacy decision. Third party vendors and EU firms will also be required to take similar steps in order to continue servicing UK customers.

EU data protection requirements and guidance continue to evolve. For example, the European Data Protection Board has issued a consultation on recommendations for supplementary measures that EU data exporters can take to be able to transfer data outside the EEA in accordance with EU law in the absence of an adequacy decision. The consultation period expires on 30 November. Firms are considering whether their standard contractual clauses and binding corporate rules need to be updated to comply with EU requirements, and whether further appropriate measures need to be taken where personal data transfers from the EEA into the UK are necessary to ensure the continuity of services.

<u>How should future UK-EU regulatory dialogue be structured? How should divergence be managed?</u>

As host to a large international financial centre, the UK has a global responsibility to maintain regulation and supervision to the highest international standards. The Bank therefore welcomed the statements by the Chancellor to the House of Commons on 9 November re-emphasising the UK's goal to deliver open, well–regulated markets.

Being open enhances the efficiency and risk-sharing of the financial system, but it also necessitates the effective management of cross-border risks. The best way to oversee an open financial centre is through a combination of internationally agreed high prudential standards, close international supervisory cooperation, and a shared assessment of global systemic risks.
Whatever the particular form of the relationship with the EU, the Bank and its committees will remain committed to the implementation of robust prudential standards. Over time, regulation in both the UK and the EU can be expected to continue to evolve in order to be able to flexibly manage financial stability risks, and to be tailored to the different characteristics of each market. Rulebooks will not remain static. But both jurisdictions should be expected to continue to adhere closely to international standards, and we will expect to see evidence that the EU is doing this.

The Bank and the PRA, like the other UK authorities, will remain committed to transparency in the development of the UK regulatory framework and rulebooks. That will continue to include public consultations and regular engagement with counterparts in other jurisdictions through ongoing dialogue.

The PRA will also continue to be accountable to Parliament for the exercise of rule-making powers, in this and other respects. And we are ready to comply with the proposed requirement under the Financial Services Bill to consider and consult HMT on the implications for equivalence for rules made under that Act, and any comparable requirements under any subsequent legislation following the Government's consultation on the future regulatory framework.

Similarly, while financial regulation is constantly developing as financial services change, effective supervisory cooperation in all areas of cross-border financial activity will continue to be needed. We coordinate with other financial regulators around the world to tackle the issues we all face, like climate change, cyber and operational resilience. The Bank seeks to achieve common solutions as far as possible through agreements on international standards at the Financial Stability Board, the Basel Committee, the Committee on Payment and Market Infrastructures, and the International Association of Insurance Supervisors. The Bank's commitment to these mechanisms of international coordination, including working closely and cooperatively with its European colleagues, will not diminish with Brexit – indeed we will endeavour to make them stronger. The Bank of England (including the PRA) has signed MoUs with EU and member state supervisory authorities, which will provide the basis for continued supervisory co-operation and information sharing.

<u>The Government has now published the Financial Services Bill and Financial Services Future Regulatory Framework Review consultation paper. What are the strengths and weaknesses of these proposals?</u>

<u>What impact could a greater delegation of powers to financial regulators have? What oversight should there be of these bodies?</u>

<u>The Bank's views on the future framework for regulation</u>

The Bank of England (including the Prudential Regulation Authority) is committed to the implementation of robust prudential standards in the

UK. The Bank's Financial Policy Committee has stated that this will require "maintaining a level of resilience that is at least as great as that currently planned, which itself exceeds that required by international baseline standards, as well as maintaining UK authorities' ability to manage UK financial stability risks".[2]
In that context, **senior Bank policymakers have previously set out[3] the benefits of a regulatory framework in which the high-level objectives, responsibilities and powers of regulators are set out by Parliament and Government, while the technical detail of requirements to achieve those objectives is designed and maintained by operationally independent regulators** accountable to Parliament. Such a system has a number of benefits:

- **Dynamism**: Regulatory rules can be more easily updated than primary or secondary legislation. Having the technical detail of rules in regulators' rulebooks means regulation can be more agile and tailored. The rulebook can be adapted in response to new risks such as from cyber and climate, unintended consequences, and opportunities including from technology. It allows for the timely implementation of international standards, and the better tailoring of rules to business models.[4]

- **Expertise**: Regulators have the expertise needed to develop rules. This is because of the synergies between rulemaking and our other functions: prudential regulators (including the Bank/PRA) participate in the international negotiations where global standards are developed, and are responsible for implementing and enforcing the regulations in practice, through supervision.

- **Time Consistency**: There is substantial empirical evidence that politically independent regulators are associated with better outcomes for financial stability.[5] This is because insulation from short-term political pressures allows regulators to focus on achieving the long-term goals of prudential policy – a similar argument to the case for operational independence in the setting of monetary policy. The Basel Committee on Banking Supervision recognises this, and sets "operational independence" as one of its core principles for effective banking supervision.[6]

- **Reduced Fragmentation**: At the end of the Brexit implementation period, some highly technical regulatory material will be 'locked' in primary and secondary legislation, while other material will sit in regulators' rules, guidance and on-shored European technical standards. Transferring all firm-facing requirements into the regulators' rulebooks would reduce this fragmentation. This would ultimately allow for the delivery of a simpler more coherent rulebook. Regulated entities would then be able to access and navigate prudential standards more easily.

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[2] Record of Financial Policy Committee meetings, August 2020 (link).
[3] See e.g. Saporta V (2020), The ideal post-EU regulatory framework (link) and Woods S (2019), Stylish Regulation (link).
[4] Woods S (2020), Strong and Simple (link).
[5] See Antoniades, A and Calomiris, C W (2018), 'Mortgage market credit conditions and US presidential elections', NBER Working Paper 24459 (link) and Dagher, J (2018), 'Regulatory cycles: revisiting the political economy of financial crises', IMF Working Paper WP/18/8 (link)
[6] Basel Core Principles for effective Banking Supervision (link).

Delegation of detailed standard-setting to regulators would be a return to a 'UK style' of regulation. Before the advent of enhanced EU regulatory harmonisation, the UK approach was to set rules in regulators' rulebooks rather than in primary or secondary legislation. This was the model enacted by Parliament in the Financial Services and Markets Act (FSMA) 2000. It is also the model that the UK has continued to follow in areas not constrained by EU regulation, such as the Senior Managers and Certification Regime.

This approach would also reflect international best practice. Major jurisdictions outside of the EU such as the United States, Japan and Singapore have delegated broad rulemaking powers to their prudential authorities. The European Union is an international outlier in this respect, with detailed technical requirements sitting in the equivalent of primary or secondary legislation, to promote harmonisation across the single market.

<u>HM Treasury's proposed approach</u>

HM Treasury's proposals in the Future Regulatory Framework (FRF) consultation and Financial Services Bill are consistent with this approach. The Bank was consulted in the preparation of both documents and supports the proposals.

The FRF consultation sets out HMT's proposed long-term approach to the UK financial services regulatory framework.[7] HMT are proposing an approach where Parliament and Government set the high-level framework and specify the outcomes that regulators should be aiming to achieve. Regulators are granted discretion over the technical means by which the outcomes are achieved. Subject to the outcome of the consultation, including the views of Parliament, we look forward to working with HMT to develop and implement this framework so that its benefits for the UK can be realised as soon as practicable.

The proposed Financial Services Bill[8] provides for the implementation of international reforms, including the remaining Basel III standards (often referred to as 'Basel 3.1') that need to be delivered before the long-term framework is fully implemented. The proposed model for Basel 3.1 implementation is intended to be consistent with the long-run approach set out in the FRF consultation. HMT would be granted a power to delete from primary legislation those elements of the on-shored European capital requirements that are affected by Basel 3.1. The PRA would then be responsible for implementing those standards through rules, under an enhanced accountability framework.

<u>Oversight, accountability and transparency</u>

We agree that now is an appropriate time to review how the regulatory framework can ensure accountability, stakeholder engagement, and transparency. These are crucial to the legitimacy and sustainability of the

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[7] HM Treasury, Financial Services Future Regulatory Framework Review Phase II Consultation, October 2020 (link).

[8] Financial Services Bill 2019-21, as introduced to the House of Commons on 21/10/2020 (link)

regime. FSMA put in place a series of governance and accountability arrangements for the UK's operationally independent regulators, with a view to ensuring that their broad rule-making power was exercised in a transparent and proportionate way. As the FSMA model will form the foundation of the future regulatory framework, it makes sense to assess whether those mechanisms remain fit for purpose.
Accountability mechanisms for the PRA include regular evidence to parliamentary committees and remit letters from the Government. Transparency mechanisms include consultation and cost-benefit analysis requirements, and more recently the Regulatory Initiatives Grid, which lays out the forward work programme of financial regulators, including the PRA.[9] **The design of any new accountability and transparency mechanisms is ultimately a matter for Parliament and Government. We stand ready to provide any information or assistance required to support that process.**

In considering these mechanisms, we would note that there is a careful judgement to be made about ensuring sufficient regulatory accountability and transparency while also preserving regulatory independence, dynamism and clarity of objectives. Accountability mechanisms, particularly through Parliament, are crucial to effective democratic oversight. Transparency mechanisms allow the public to effectively scrutinise and input into the regulatory process. To realise the benefits of a FSMA-style model, we should ensure that the regulatory rule-making process remains nimble, and that technical decisions are subject to political scrutiny but not politicised. The regulator's objectives should also be clear and focused, to ensure a transparent division of responsibilities between different policymaking institutions. This avoids diluting regulatory effectiveness and blurring accountability.

We welcome HMT's approach to striking this balance in the Financial Services Bill. The Bill sets out new matters to which the PRA must 'have regard' if relevant, when making policy decisions. The PRA will be required to publicly explain and consult on how these matters have been taken into account in its proposed policies. These 'have regards' cover: international standards; finance to the real economy; the relative standing of financial services in the UK; and any other matter specified by HMT via regulations. The PRA would also have to consider, and consult with HMT about, the likely effect of the rules on relevant equivalence decisions. **Subject to Parliament's approval of the Bill, we will consider carefully these 'have regards', and explain transparently how they have been taken into account in our policymaking.**

November 2020

[9] This initiative was launched following HM Treasury's October 2019 Call for Evidence on Regulatory Coordination and responses to it, which are available here. The September 2020 version of the Regulatory Initiatives Grid is available here.