Government response to the House of Lords European Union Committee Report, 'Brexit: financial services'

Introduction

The House of Lords European Union Committee published its Report, 'Brexit: financial services', on 15 December 2016. This document sets out the government response to the conclusions and recommendations in that report.

The government welcomes the Financial Affairs Sub-committee's vital work on this key area of UK economic policy, and for their final report, which is an extremely helpful contribution to the debate on financial services; the analysis and commentary will inform the government's strategy. The government thanks the wide array of individuals who have provided evidence and expertise to assist the committee's preparation of this report. The government is keen to hear from as diverse a group of stakeholders as possible in its preparations for the forthcoming negotiations, and this report and the evidence it draws upon is a welcome opportunity to do so.

Financial services are a significant area of comparative advantage for the UK. This sector employs 1.1 million people and generates approximately 60-67 billion pounds of tax to the UK per year. The UK is a global leader in complex insurance, wholesale / investment banking, market infrastructure, portfolio management - associated with asset management - and other areas of financial services activity. As a result, global financial services firms will typically headquarter their European operations in the UK and branch into other markets from here.

As the UK leaves the EU, it will seek to establish a close, new, relationship with its European partners, including the greatest possible access to the single market. The government will aim to reach this agreement within the next two years and thereafter will aim to secure a phased process of implementation to avoid a disruptive "cliff-edge" and ensure that businesses and institutions have enough time to prepare for the new arrangements.

The government's vision is a positive one for the financial services sector. The UK's future relationship with the EU will, of course, be subject to negotiation, but the ambition is to construct a future relationship based on reciprocal market access and cooperation, underpinned by a high-quality regime reflecting international standards. This outcome is in the economic interests of the UK and the EU from both a financial stability and economic competitiveness perspective.

The government recognises the recommendations made in this report as sensible suggestions. The sub-committee should be reassured that, in general, suggestions for further analytical work align with analysis undertaken by the government since the referendum.

The recommendations fall under the following **five** categories:

1. **The government's vision for financial services, industry engagement and EU exit processes**. The financial services sector is incredibly important for the UK economy. The Prime Minister has set out the government's vision for the future UK/ EU partnership in the recent White Paper: the UK will be leaving the EU and seeking to establish a close, new, relationship. The future relationship should allow for the freest possible trade in goods and services, including financial services, between Britain and the EU's member states. It should give British companies the maximum freedom to trade with and operate within European markets – and let European businesses do the same in Britain.

2. **The Sub-committee's proposals for a future work programme**. The government welcomes the sub-committee's clear-sighted recommendations for its future work programme in this vital area of policy, and will integrate these into its ongoing preparations.

3. **The government's approach to market access.** The government welcomes this Report's analysis and recommendations. The Committee should be assured that the government's priority is to secure market access where it matters, basing this judgement on robust and comprehensive analysis.

4. **Transitional arrangements and business certainty as the UK leaves the EU**. The Prime Minister has made a clear commitment to avoiding a disruptive cliff-edge and associated risks to UK and EU financial stability and business certainty.

5. **Continued industry engagement.** The government has met with a wide range of stakeholders from across the Financial Services industry. It is important that the government continues to engage with businesses in order to understand their assessments of the risks and opportunities of leaving the EU, and to unlock their knowledge and expertise.

The individual recommendations are addressed in turn, below.

Recommendations and responses

1. The government's vision for financial services, industry engagement and EU exit processes

UK as a financial services hub

Recommendation: The UK has a number of advantages as a financial services hub. The concentration of activity allows for economies of scale and a depth of capital market activity that cannot be easily replicated, except possibly in an existing major centre such as New York. Our evidence suggested that it would be to the EU's advantage that such a system should remain intact. (Paragraph 38)

Response: The government agrees with this assessment of the UK as a global financial services hub, and its resultant strategic importance to the European Union. Citizens, businesses and public sector bodies across the continent rely on UK-based firms to access the services that they need. Over 75 per cent of the EU27 capital market business is conducted through the UK and the UK industry manages £1.2trillion of pension and other assets on behalf of EU clients. The government therefore believes that an agreement that secures deep market access, on a reciprocal basis, is in both the EU and the UK's interests.

Risk of regulatory divergence

Recommendation: While the UK might be deemed equivalent at the point of withdrawal, there is no guarantee that it will remain so. Regulation must adapt to changes in the financial services system, raising the risk of regulatory divergence between the UK and the EU, and indeed between the UK and the US. The UK's influence on international standard-setting bodies, such as the Basel Committee and the Financial Stability Board, will be crucial to ensuring that changes to regulation are consistent internationally. But it is in the UK's and EU's mutual interest that the UK should maintain direct influence within the EU, especially in areas such as certain types of insurance, where there are less well-developed international standards. The government should encourage direct regulatory cooperation between UK and EU authorities and, as part of its negotiation, should seek UK input to EU regulation-setting upstream. (Paragraph 59)

Response: While we are leaving the EU, we will remain close partners with our neighbours in Europe and will continue taking a leadership role in international regulatory forums. This is in line with the government's vision for a global Britain.

The report is correct in noting the close relationship between UK and EU markets and regulators. The government is looking for a sensible discussion in negotiations about how UK and EU financial markets can continue to serve one another, and what is needed to support that. This is very much in the interests of both parties.

Access to highly qualified staff

Recommendation: The ability to continue to access highly qualified staff and the ability to transfer them between the UK and the EU is a key issue for the financial services industry. While we welcome the Chancellor's reassurance that highly skilled migrants will not be prevented from coming to the UK, as far as it goes, we note that maintaining appropriate labour market flexibility will be critical to the UK's long-term economic prosperity. (Paragraph 82)

Response: As in other sectors, the government is very clear that the UK remains open to the talent we need from Europe and the rest of the world, but managed properly so that our immigration system serves the national interest. Openness to international talent, in the financial services sector and beyond, must remain one of this country's most distinctive assets.

The government understands the needs of financial services employers to engage people with the requisite skills. High-skilled immigration will always be desirable to the UK and we will always welcome individual migrants arriving lawfully in the UK. But in future we must ensure we can control the number of people coming to the UK from the EU. We are considering various immigration options and will ensure that businesses and communities have the opportunity to contribute their views.

FinTech Industry

Recommendation: The FinTech industry has thrived in London, but could potentially move elsewhere. We note the concerns of the industry over future adherence to the EU data protection regime, and over its ability to recruit adequately qualified staff, and to attract the entrepreneurial talent needed for innovative startups. The government should be particularly mindful of the opportunities for FinTech to develop further in the UK and of the effects of Brexit on a promising industry. (Paragraph 89)

Response: The government has been engaging with firms from across the FinTech industry and is aware of these concerns and opportunities.

The government and financial services regulators have created a world-leading environment to support the growth of FinTech in the UK. The addition of a competition objective for the Financial Conduct Authority in 2013 has led to a focus on encouraging innovation. Through the Innovation Hub and the Regulatory Sandbox, the Financial Conduct Authority are lowering the barriers to entry across all areas of financial services.

The government is supporting the development of an Open Banking Standard, which we believe is a key intervention to allow customers to safely use their own data, held by their banks, in powerful ways. We are also legislating to allow non-bank payment firms to directly access payment systems, lowering this barrier to entry and supporting a more competitive payments ecosystem. These actions and many others undertaken by government and the financial services regulators have led to the UK being ranked as the best location for FinTech in two separate studies last year, and we are committed to building on the this position as a world-leader in FinTech.

Division of responsibility between departments

Recommendation: In the interests of stakeholders across all sectors, the government should provide clarity on the division of responsibility for the negotiations between departments. While the negotiating strategy must be agreed as a whole across government, we are clear that HM Treasury is best placed to lead on financial services. (Paragraph 114)

Response: The Government agrees. HM Treasury has responsibility for financial services, including ongoing business-as-usual EU negotiations as well as leading on financial stability policy for the government. The Department for Exiting the European Union (DExEU) has responsibility for overseeing negotiations to leave the EU and establishing the future relationship between the UK and the EU.

Other government priorities

Recommendation: We were concerned to hear that Brexit might already be having an effect, through diversion of resources, on the quality of legislation produced by the government. Brexit is rightly the government's top priority, but not to the exclusion of other important responsibilities. (Paragraph 116)

Response: The government has an ambitious domestic agenda of social and economic reform, including the launch of a new Industrial Strategy. Our exit from the EU is a substantive body of work and it is important that we get it right, but it will not preclude the government from pursuing an ambitious wider agenda.

2. The Sub-committee's proposals for a future work programme.

Evidence for the regulatory impact on firms

Recommendation: The legislation underpinning access to the EU market is based largely on the regulation of activities, and does not map easily onto the business structures of many firms. A better evidence-base is needed, and it is imperative that the government gains a detailed understanding of how firms are likely to be affected by changes to their rights of access to EU markets, building where possible on the work undertaken by the firms themselves. (Paragraph 27)

Response: This is a welcome suggestion on how the government can better understand the regulatory impact on firms. The government has been undertaking analysis since the referendum and has had comprehensive engagement with the financial services industry on a regular basis.

Analysing the impact of third country status

Recommendation: We endorse the government's work in analysing the difference between the opportunities afforded by passporting and third-country equivalence. That analysis will be problematic, thanks to the complexity and newness of the regimes, but it will be crucial in determining the true impact of third country status on the financial services industry. The priority should be to establish at an early stage the extent of the lacunae in the regimes, the likely restructuring that will have to be undertaken by businesses to adapt to changed circumstances, and the consequent effects of such adaptations on the financial services sector and the wider UK economy. (Paragraph 57)

Response: The government has been undertaking analysis since the referendum. The results of this work will play a crucial role in informing the government's negotiating priorities. The priorities identified by the committee are recognised as important issues by the government.

Modelling possible scenarios

Recommendation: A main purpose of any bespoke agreement, so far as financial services is concerned, will be to supplement the current equivalence regimes to mitigate any loss of access, and to ensure the continuation of equivalence decisions in order to maintain that access. The government has acknowledged the complexity of predicting the impact of a bespoke deal. Nonetheless, we urge the government, as a priority, to model the effect of different scenarios as accurately as is possible in order to achieve the most appropriate bespoke deal. (Paragraph 96)

Response: The government has been undertaking this analysis since the referendum, and is working towards delivering the most effective bespoke agreement.

Potential attempt by EU to relocate UK financial services

Recommendation: The UK currently has a significant trade surplus in financial services with the EU, and it is to be expected that EU governments may wish to attract some of that business to their own territories. The efficiencies provided by the UK financial services industry, the reliance of EU firms on the services it provides, and the interdependencies between financial services and other EU businesses, mean that such efforts could be as harmful to the wider EU economy as to the UK economy. The government should go into the negotiations armed with robust analysis of the economic impact on the EU of an attempt to dismantle and relocate UK financial services. (Paragraph 124)

Response: The UK's financial services industry plays a vital role in the UK, European and global economies, benefitting customers and businesses around the world. It is a hub for money, trading and investment and is one of only two global, full service financial centres – and the only one in Europe. The government is clear that an agreement that preserves the greatest possible market access is in the best economic interests of both the UK and the EU.

3. The government's approach to market access.

Third-country equivalence as a substitute for the financial passport

Recommendation: The existing third-country equivalence regimes in certain pieces of EU legislation are an inadequate substitute for the financial passport. They do not cover the full range of financial services activities, excluding in particular deposit-taking and lending, retail asset management and payment services. As they are agreed at a point in time, and are static, they may also be vulnerable should regulation change to respond to the development of the financial system. The process of updating them as EU-wide regulation changes would be laborious and time-consuming. (Paragraph 56)

Response: The sub-Committee's assessment is noted. This concurs with other published analysis and the drawbacks of existing equivalence regimes are well understood. The government is committed to pursuing the freest possible market access within our future relationship with the EU.

Risk of relocating Eurozone clearing

Recommendation: The current clearing regime provides benefits to the wider economy by aiding financial stability through the compression of risk and therefore of the collateral required to support trades. These benefits, which depend in large part on the ability to conduct multi-currency clearing, are felt in Europe as well as the UK and internationally. The possibility of a new attempt to require euro clearing to be conducted within the eurozone thus presents significant risk to both the UK and EU economies. Nonetheless, the ECB has attempted to do so once before and the risk of its doing so again should not be taken lightly, particularly in view of the jobs at risk. (Paragraph 75)

Response: Euro-clearing is an important part of the overall financial structure in London that cannot easily be separated from clearing in other currencies. This is largely due to the economic efficiencies of multicurrency clearing noted in the report. These efficiencies can be very significant and benefit firms in Europe as well as the UK and internationally. However, when Britain leaves the European Union, there will still be a number of countries who do not use the euro currency who are inside the European Union and thus entitled to the protections afforded by the single market. It is not clear that the rules of the single market even after Britain has left would permit the ECB to require euro denominated instruments to be cleared inside the Eurozone.

Politically-driven attempt to repatriate euro-clearing

Recommendation: New York has been suggested as a plausible alternative to London for clearing activity, but a move to 'repatriate' euro-denominated clearing to the Eurozone would appear to rule out New York as well as London, notwithstanding the positive equivalence decision already granted to the US. The question is whether any

eurozone location could provide the same benefits to the wider economy as London and New York, and whether a politically-driven attempt to repatriate euro clearing to the eurozone would invite retaliation by other non-eurozone states, leading to the breakdown of the system of multi-currency clearing. (Paragraph 76)

Response: Many firms in the UK, in Europe and internationally benefit from multi-currency structures as identified by the report. Any changes to this structure are likely to significantly increase the cost of clearing for users, thereby increasing the costs for many firms and corporate companies to hedge their liabilities.

4. Transitional arrangements and business certainty as the UK leaves the EU.

Transitional arrangement

Recommendation 1: The interconnectedness of the UK financial system presents serious difficulties for firms and the government in determining the impact of changes to the relationship between the EU and the UK. Unless it is extended, the two-year period of the Article 50 negotiations would appear to be insufficient to resolve the uncertainty. We therefore recommend, both for the business environment and for financial stability, a considered and orderly transition to any new relationship. The earlier any aspects of this new relationship can be agreed the easier it will be to determine the impact on each sector of the industry. (Paragraph 39)

Recommendation 2: Negotiations on the UK's new relationship with the EU are likely to take longer than the withdrawal negotiations under Article 50. A transitional period will therefore be needed in relation to financial services following the completion of the Article 50 process, when the UK leaves the EU. This may need to be adapted and extended in the light of subsequent negotiations on a new long-term relationship with the EU. This will enable firms and others such as regulators to adapt to any new business conditions. (Paragraph 108)

Recommendation 3: An orderly transition to a new relationship, whatever it may be, would ensure continuity of service to clients and the wider economy and would provide time for regulators and supervisors to adapt to changes in business practices adopted by firms. Avoiding a cliff-edge when the UK leaves the EU will benefit financial stability, and should be in the interests of the EU as well as the UK (Paragraph 111)

Response: The government's vision is that an agreement about our future partnership will have been reached by the time the 2-year Article 50 process has concluded. The government is clear that it will seek to avoid a disruptive cliff-edge as the UK exits the EU and will aim to agree a phased process of implementation which will provide time for businesses and regulators to adapt to the terms of the new relationship.

Business certainty

Recommendation 1: It will be vital, in the interests of all parties, to provide certainty as early as possible in the process. Negotiations on financial services should commence as early as possible after notification under Article 50 and the government should pursue an early announcement on a transitional period. This period should extend through the negotiations on the new relationship and continue thereafter for a period sufficient to provide stability after that relationship is agreed. The more the new relationship departs from the status quo the longer any further transitional period may need to be. (Paragraph 109)

Recommendation 2: We are concerned that, in the absence of clarity over the future relationship, firms may pre-empt uncertainty by relocating or restructuring, for instance by establishing subsidiaries or transferring staff, even though such changes may

ultimately prove to be unnecessary. This would not be in the interests of the industry or the UK. (Paragraph 110)

Response: We agree that financial services is an important, complex topic that will play a very important role in the upcoming negotiations. The government notes the risk of relocating and restructuring, and will seek to address it by providing as much certainty as possible through the negotiation process.

It is clear that it will seek to avoid a disruptive cliff-edge as the UK exits the EU and will aim to agree a phased process of implementation which will provide time for businesses and regulators to adapt to the terms of the new relationship.

5. Continued Industry Engagement

Engaging the financial services industry

Recommendation: It is striking that some firms do not themselves appear to be aware of their reliance on the current passporting arrangements. It would be in the interests of the firms themselves, as well as in the national interest, if they were to cooperate with the government and the regulators to determine the true extent of such reliance, so as to inform the government's negotiating position. (Paragraph 28)

Response: The government has already engaged and consulted widely with the financial services industry. This constructive engagement is crucial in helping the government to deliver the most effective agreement. Moreover, ongoing dialogue with industry will be invaluable in helping firms advance their understanding and planning, as the UK prepares to leave the EU. The government will continue to meet with industry stakeholders at ministerial and official level throughout the process of the UK leaving the European Union, and beyond.