Brexit: financial services

Oral and written evidence

Contents
Abundance Investment, Innovate Finance and Zopa – Oral evidence (QQ75-80) 3
Allianz Global Investors, Bank of America Merrill Lynch and HSBC – Oral evidence (QQ18-26) ................................................................. 18
Association of Foreign Banks – Written Evidence (BFS0004) ..................... 35
Association of British Insurers, Swiss Bankers’ Association and TheCityUK – Oral evidence (QQ48-56) ......................................................... 42
Bank of America Merrill Lynch, Allianz Global Investors and HSBC – Oral evidence (QQ18-26) ................................................................. 59
Bank of England – Oral evidence (QQ38-47) .............................................. 60
Professor Sir Charles Bean, London School of Economics and Political Science and Professor Eilís Ferran, University of Cambridge – Oral evidence (QQ1-9) ....... 76
British Bankers’ Association, PricewaterhouseCoopers (PwC) and Reuters – Oral evidence (QQ10-17) ............................................................... 90
Bruegel – Written evidence (BFS0001) ....................................................... 107
Clifford Chance and Norton Rose Fulbright – Oral evidence (QQ27-37) ......... 110
Professor Eilís Ferran, University of Cambridge and Professor Sir Charles Bean, London School of Economics and Political Science – Oral evidence (QQ1-9) ....... 123
Financial Conduct Authority – Written evidence (BFS0003) ...................... 124
HSBC, Allianz Global Investors and Bank of America Merrill Lynch – Oral evidence (QQ18-26) ................................................................. 131
Innovate Finance, Abundance Investment and Zopa – Oral evidence (QQ75-80) ................................................................. 132
London Stock Exchange Group – Oral evidence (QQ66-74) ......................... 133
London Stock Exchange Group – Supplementary Written evidence (BFS0006) 147
Norton Rose Fulbright and Clifford Chance – Oral evidence (QQ27-37) ............ 148
PricewaterhouseCoopers (PwC), British Bankers’ Association and Reuters – Oral evidence (QQ10-17) ............................................................... 149
Reuters, British Bankers’ Association and PricewaterhouseCoopers – Oral evidence (QQ10-17) ................................................................. 150
Abundance Investment, Innovate Finance and Zopa – Oral evidence (QQ75-80)

Scottish Financial Enterprise – Written evidence (BFS0002)..........................151
Swiss Bankers’ Association, Association of British Insurers and TheCityUK – Oral evidence (QQ48-56) ....................................................................................................................153
TheCityUK, Association of British Insurers and Swiss Bankers’ Association – Oral evidence (QQ48-56) ....................................................................................................................154
HM Treasury – Oral Evidence (QQ57-65).................................................................155
HM Treasury – Supplementary written evidence (BFS0005) ..............................169
Zopa, Abundance Investment and Innovate Finance – Oral evidence (QQ75-80) ..............................................................................................................................171
Abundance Investment, Innovate Finance and Zopa – Oral evidence (QQ75-80)

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Wednesday 2 November 2016

Members present: Baroness Falkner of Margravine (The Chairman); Lord Callanan; Lord De Mauley; Earl of Lindsay; Lord Shutt of Greetland; Lord Skidelsky; Lord Woolmer of Leeds.

Examination of witnesses

Mr Bruce Davis, Managing Director, Abundance Investment, Mr Daniel Morgan, Head of Policy and Regulation, Innovate Finance and Mr Giles Andrews, Chairman, Zopa.

Q75  **The Chairman:** Good morning. Welcome to the Committee’s inquiry on the implications of Brexit for the financial services sector, Mr Daniel Morgan from Innovate Finance, Mr Bruce Davis from Abundance Investment, and Mr Giles Andrews from Zopa. Before I kick off, I will read you some housekeeping points. You have a list of interests that have been declared by the Members of the Committee. This is a formal evidence-taking session of the Committee and a full transcript will be taken. This will be put on the public record in printed form and will be on the Parliament website. You will be sent a copy of the transcript and you will be able to revise any minor errors. The session is on the record. It is being webcast live and will be accessible subsequently via the Parliament website.

Do you have opening statements or shall we go immediately into our discussion? I take it that we can go immediately into the discussion. Perhaps you could briefly tell us the main ways that you think the Brexit vote will impact your industry and what you think the Government’s negotiating priorities should be in respect of the UK FinTech industry, given how it is being wooed across the world, it sometimes seems. Mr Andrews, would you like to kick off?

**Giles Andrews:** We are in the credit business: we lend money. Credit businesses tend to suffer in periods of economic downturn: the performance of credit businesses is linked to economic prosperity generally. If the prevailing view is that Brexit is likely to lead to less economic activity in the UK that is bad for credit businesses, at a very general level. There is a specific point in financial services around passporting, which I know is one of the questions, so perhaps you want me to come back to that at the right time, and there is also a specific point around talent. Again, I do not know whether you want to come back to that in the question on talent.

**The Chairman:** We will.
**Giles Andrews:** Then there is a third point, which is pretty unique to my industry, the peer-to-peer lending industry. It has the benefit of its own regulatory order—RAO 36H—which is a marvellous thing and very good for the industry, and something we worked hard with both the Treasury and the regulator to enact. There is a piece of misdrafting in it, which is acknowledged as a piece of misdrafting, and it is the first sign we have seen of a lack of bandwidth, if I may use that word, in the Treasury and the FCA in resolving something. We found, before Brexit, that considerable time and energy was put into working with our industry and we have noticed a fall-off in that, which is perhaps not surprising given the stretch in resources that is being taken up by activities such as this.

**The Chairman:** Are there direct implications that you are facing?

**Giles Andrews:** There are. It is just a piece of misdrafting that could be resolved. I think all parties acknowledge that it is not as intended. The Treasury is on record as saying, “Yes, we acknowledge that that is not what we meant”, and of course the FCA is bound to take some words on a form and say, “Well, that is what it says so that is what we have to do”. For the first time in our experience of working with the regulator and the Treasury, we have found a logjam, where everyone acknowledges that there is a problem to be solved, which is actually not trivial to resolve because the redrafting will require some thought. It is not just a question of crossing a “t” or dotting an “i”. It is that lack of time to put the thought into it that is stopping it happening.

**The Chairman:** That is very interesting. Mr Morgan?

**Daniel Morgan:** You use the term “industry”; we represent FinTech as a whole. There is no industry code or SIC code for FinTech so it is quite an amorphous space and Brexit will hit each sector differently. There has been FinTech a lot longer than the term has been widely used and it has arisen around the same time as the disruptor or particularly B2C—business to consumer—propositions. Most of the investment in the US and the UK, particularly on what has been described as the last mile—payments, peer-to-peer, crowdfunding—in areas where there are high margins is increasingly underserved or there is light regulatory friction. The vast bulk of the activity in this area in the UK over the past few years has been on the consumer side but increasingly there is activity in FinTech, cap markets, regtech and other areas, which again will have different implications.

The areas that have already been touched on are still important. Obviously, talent is hugely important. Of our start-up member base—non-institutional—30% of the founders of those companies were born overseas. It is inherently an international sector so access to that talent is really important. The Government commissioned EY to do a report on FinTech, which identified three types of talent within FinTech: technical talent—STEM, et cetera—financial services talent and entrepreneurial talent. That third one is quite difficult to define within a visa system. In a very large labour market of 500 million people, it is easy for people to come here and start a business.

Obviously, there are single market issues, including passporting. Some sectors, such as peer-to-peer, do not benefit from passporting. Others do,
especially in the payments area, regulated under SEPA or the PSD. There is a huge sector of growth in payments, which will be directly impacted. Of our start-up members, 20% are authorised to passport but not all of them do so at this stage. It is very much seen as a growth potential for future activity for investors.

Obviously, access to capital is an issue—the attractiveness of the UK as a place to invest but also European funds are important. The European Investment Fund is a key cornerstone investor in a lot of venture capital in the UK, so the role of the British Business Bank will be critical in stepping in to fill that void.

Another key area, which has been a huge success for the UK, has been progressive regulation—some of the stuff the FCA did. The bespoke regime in both P2P and crowdfunding had been widely recognised as a global success and a world-leading sector. Other areas, such as the sandbox approach, Project Innovate and the competition mandate, have been widely seen as positive—something that is obviously in domestic hands and can be taken forward.

**Bruce Davis:** I can speak both as a platform that is regulated under MiFID as a crowdfunding platform and as a director of the UK Crowdfunding Association, so there are another 40 or so platforms that all have different regulations. The first thing to say is that there is no single market in financial services. What we are working with is basically a series of overlapping agreements that are incredibly complex and quite often rub up against each other in interesting ways that make our lives difficult. There is no harmonisation; it is not feasible in certain areas. You have many national interests represented in the way that legislation works. What we have found immediately, particularly since Lord Hill’s departure from his role in the Commission, is that we have been shut out of those discussions, particularly around the development of the prospectus directive. That will have a direct impact on the way that our businesses run, specifically looking at raising the cap on the exemption from the prospectus directive, which will allow small and medium enterprises to raise money more cost-effectively from investors. That was an immediate impact within a week of the vote.

More broadly, as Giles said, we have had very strong support for our industry across a number of different areas, including the development of a tax system that incentivises investment, incentivises people to take risks and gives rewards for doing that. There are two sides to it, one of which is how we respond to the negotiations, but we must not take our eye off the ball. The UK market still needs that development to carry on. Each time we do something, we have an impact.

On the third area, which is around skills, it is not just about bringing people into businesses; it is also about how we fund research into both the development and the impact of our innovations, and helping to guide policy in that way. We welcome the fact that the FCA is using the Cambridge Centre for Alternative Finance to improve its evidence base for making policy, but that will need to be supported more strongly if we are going to grow it; the more we do, the better we do.

**The Chairman:** It has been suggested that prior to Brexit the FinTech
industry was living in its own comfort zone because out of all the EU countries the United Kingdom was the most innovative in that regard. Do you think that one positive that may come out of this move is that you might go out and look at other markets where the future growth potential really lies? The next billion internet users are expected not to use bank accounts and to be far away from London.

**Bruce Davis:** The EU market is underdeveloped in terms of financial services and has huge potential. It delivers different opportunities from the emerging markets. I think that the emerging markets are really about what might be considered to be leapfrog technologies. We have seen that in mobile phones and solar generation, and we will see it in financial services. I do not think that the emerging markets are going to go down the same cul-de-sacs that we did in terms of financial institutions and developing them when there are new technologies available to them. Yes, it is an opportunity, but I would say that it needs support. It comes with a huge amount of risk. We are a growing industry but we are not huge, so the question then is how we are being supported into those markets.

**The Chairman:** Could any of you put a number on the size of the industry?

**Daniel Morgan:** Obviously there is no industry code, so it depends on how you cut it. In revenues, according to the HM Treasury report it is worth around £6.6 billion, but if we take the larger figure, which is institutional investment in FinTech, it is around £20 billion. But again, because there is no industry code it is very hard to define the broader FinTech industry.

**Bruce Davis:** In terms of the EU, I would say that we are seen as the leader, but the catch-up rate is remarkably swift. Before the Brexit vote we had Ministers coming to the UK to talk directly to FinTech firms—I am talking about Finance Ministers from Ireland and from Germany in particular, and that was not just a sort of sales pitch for Berlin. They really wanted to understand not only how they could develop their regulations to attract businesses but also how to keep them. So they were slightly bemused when they were met by three or four German entrepreneurs who had set up in London and told them why they had not stayed in Germany. They were given a very clear reason why. I think that they will set about making themselves attractive.

**Giles Andrews:** In terms of scale, my industry piloted this because we were the first people in the world to do it. That gave us an advantage in terms of time. The industry will lend approximately £2 billion this year, which represents probably about 75% of all European activity. The rest of Europe is a fraction of our size but, as Bruce says, they are catching up fast and probably growing more quickly than the market here.

**Lord Shutt of Greetland:** Mr Davis, you said that you had been shut out of discussions in the EU. How did that come to pass? As I understand it, we are in until we are out. Did you think, “Oh well, we are on our way out so we won’t bother troubling them” or have you been pushing?

**Bruce Davis:** We are still in discussions because we happen to have strong allies in Germany. The MEPs were shut out of the conversation in the trilogue process.
Earl of Lindsay: Mr Morgan, in your earlier comments you referred to the relative importance of passporting to some parts of your FinTech membership. Can I ask all three of you to be a little more specific about exactly how important, and where that importance may be, in terms of achieving passporting post-Brexit? Also, do you have any comments to make about whether the third-country equivalence arrangements, which are already defined and designed, and to an extent operating in some EU directives and regimes, are also, as it were, a desirable objective in terms of what the post-Brexit landscape might look like?

Daniel Morgan: As I said, it is quite a diverse sector so it impacts on different parts of FinTech quite distinctly. The largest sector is around the payments under the PSD and e-money directive in terms of operating and utilising the passport in terms of FinTech and the 1,500 registered PSPs in the UK. They will be directly impacted. Again, with money transfer you are outside the single European payments area, so you will be impacted directly and there will be an extra layer of friction. In terms of MiFID and things like crowdfunding and robo-advice, I hear that it does not work as well in practice. There are many different national regulations around prospecting and so on. Like Bruce, I do not think that it is necessarily the best example and it is not fully utilised. The important thing to take away in terms of what is happening in the sector at the moment is that many who are passported, which is not all of FinTech, are not all utilising it yet. It was seen very much to be a part of something of a term sheet for investors, an opportunity to scale with relatively less friction up to a much larger consumer market at some future point. So many are utilising it, particularly in payments or money transfer, but others are not utilising it yet.

Bruce Davis: I run a passport business and I passport to the EEA. I know that other businesses trying to do that have found that responses from the local jurisdictions have become tortoise-like. We are at the bottom of the pile. An FCA request will not now be dealt with at the same speed as it was before. We can definitely see that as an impact right now. Even in the next two years, if we are still trying to establish businesses that we may then want to deal with post negotiation and post some form of resolution of what is happening, we are already seeing a slowdown in the engagement of bureaucracy on that side because it is not seen as a priority for them. That is being communicated strongly. There are an awful lot of other things that we touch on—the unfair terms directives and the alternative investment fund managers directive. Payments is a particularly important issue. A lot of us are on payment systems that are regulated out of Europe and based in Europe. The last one, which is perhaps the biggest one, is data.

The Chairman: We will come to data a bit later

Giles Andrews: For us, passporting is a desirable hypothetical because you cannot passport an activity unless it is similarly recognised as an activity in the other member state. Peer-to-peer lending is uniquely regulated in the UK and therefore we cannot passport it to a jurisdiction where there is no regulatory activity called peer-to-peer lending. I was hopeful that over time, as the European states catch up in terms of their volumes, they would inevitably be regulated. I have spoken to a number
of country regulators who have all said that they admire the approach of the FCA to regulating our industry. It appeared that the direction of travel was that other European states would regulate similarly to the FCA, so I was looking forward to being able to passport as and when they did. But I cannot grieve the loss of something I never had other than as an opportunity that I perceived I would have in the future.

**Daniel Morgan:** Earl Lindsay, you raised one more point about third-country regimes. Currently, as it stands, it would take payments and PSD; there is no third-country regime for that, so anything we moved for would be a bespoke option.

**Earl of Lindsay:** I want to pick up on the point Mr Andrews made. Some of the witnesses have commented on the merits and possible drawbacks of seeking third-country equivalence within the EU definition of how that process works. They have expressed a concern that the requirement to maintain regulatory equivalence could be unhelpful to the innovation of the financial services sector—of course FinTech is a good example—the UK’s leading role with regard to innovating within the financial services and, equally, its reputation for seeking to innovate regulation alongside new products. Do any of you have any views as to why FinTech might suffer if we ended up with a Brexit deal that was heavily committed to retaining a regulatory equivalence to achieve that third-country equivalence in EU terms?

**Bruce Davis:** Obviously, the key areas are now hugely important for the business model, and payments is one. If you are outside the European Union, you do not have any say in how the regulation impacts on you as a nation. Given the size of the UK’s financial services sector, I find it difficult to see how that situation would be palatable for long. On freedom to innovate, key things will have to be compliant with data. If you have a 500 million person block on your doorstep and you want to interact with that, you will have to be compliant with how you process that data and be equivalent. In other areas, there are opportunities as regards how we are looking at regtech now, especially capital markets; for example, blockchain, KYC and so on. There are huge opportunities, but at this stage it is a bit further down the line and it is not where our members are currently looking.

**The Chairman:** Mr Andrews, do you want to add to that?

**Giles Andrews:** Forgive me, but I do not entirely understand the question. If you are asking whether third-country equivalence would be a similar result to passporting, I feel that it would be more difficult. The regulation has to be identically matched, whereas under the passporting regime, if there is deemed to be sufficient overlap that allows for more compromise, it allows for individual countries to have subtly different regulations that broadly get to the same place, and that allows for passing. That feels like an easier solution than—if I understand you correctly—the more bureaucratic one you discussed.

**Daniel Morgan:** On FinTech regulation, the UK has already exported a model. The US, for instance—all eight federal regulators—is looking at a sandboxing approach, as are places such as Singapore, Australia, and so on. Therefore the approach to regulating innovation in financial services is
Abundance Investment, Innovate Finance and Zopa – Oral evidence (QQ75-80)

a model which is being taken on around the world. For instance, Australia has a very similar code of conduct handbook and it has taken a similar approach. We must not forget that the UK within the European Union has already started to set the agenda with regard to regulating FinTech.

**Bruce Davis:** It is really about the direction of travel. We had a direction of travel that was around encouraging cross-border retail money in particular, because that does not really happen at the moment in Europe, for lots of political reasons, which relate to some of the issues around the Brexit vote that also occur in other countries: a desire to protect the capital inside your own economy and not to have it flow somewhere else. Therefore we have to look at some of the political motivations behind the way the financial services market works within Europe and be realistic about that. It is not a small task to renegotiate commercial terms with large providers of services which are in a different regulatory environment. I am thinking specifically about data, which we can pick up later, but there are a lot of different places where that process will become more complex. Culturally we will be on a divergent path again, when previously we were on a convergent path as regards the way people thought about how financial services worked and the best way to operate at a European level. We are going back in time, and that has reduced opportunities for expanding businesses.

Q77 **Lord Woolmer of Leeds:** The use of and access to regulation of data is clearly very important to you. What use does the FinTech industry make of UK data-sharing arrangements and EU-US arrangements and agreements on those matters? How do you think those issues might be affected by the Brexit scenarios?

**Bruce Davis:** The EU-US question is interesting. Personally, I do not do business with the US, for that reason. Data is important, and there are two issues here: where it is stored and how it is shared. Currently, you will find that a lot of the industry uses certain providers. We had a long conversation with the FCA about how providing access to those facilities would work; that has to be looked at again, as lot of those facilities are in Ireland. It is therefore not straightforward to unravel all those different commercial agreements and what commercial providers are prepared to take in terms of risk within those agreements, as well as the political ones. You therefore have two levels of complexity: what the companies are prepared to do and what someone might have agreed at a policy level. I would not like to unpick that at this point, as we are still trying to work it out.

**Daniel Morgan:** The UK will implement GDPR—that was confirmed by DCLG very recently—and once we leave the European Union it is essential that we that we comply with the third-country equivalence regime. Given the size of the market and the business models involved, any extra layer of friction will have an impact on investment and business models, so it is critical that we do not go down our own path in terms of data processing given the size of the neighbour next to us. Obviously, a huge amount of business models in FinTech are based in the Cloud and so will be impacted disproportionately. PSD2 will also be important as a driver for FinTech in the coming years which opens up consumers’ data to third parties across Europe, supporting the FinTech industry. Again, open
banking and open APIs in the UK will be critical to see who can operate within that market, which will all interact with GDPR. So it is essential to maintain a little less friction and that we try to aim for equivalence within GDPR.

**Giles Andrews:** EU data sharing and things like PSD2 have been long negotiated, and we urge a commitment to continuing with those. If there is a difference in approach, it is more between Europe and the UK together, and America. We are better off aligning ourselves with a big entity if we are going to have disagreements about data sharing with the US.

**The Chairman:** To align ourselves with the US, or with the EU?

**Giles Andrews:** With the EU.

**The Chairman:** Because we are closer to them?

**Giles Andrews:** We are closer to them philosophically and geographically on the matter of data sharing, therefore if we have a disagreement with the US, it is better to have that disagreement together.

**Lord Woolmer of Leeds:** As I understand it, the European Union’s data protection directive is likely to be replaced by a more stringent directive in 2018. In that event, in or out of the EU, presumably you would want the UK to ensure that the way it protects data is very much in line with the way the EU has devised, which, as I understand it, will be more stringent.

**Giles Andrews:** Correct.

**Lord Woolmer of Leeds:** I could put that simply: it means that the idea that freedom to do what we want if we are not in the EU does not mean that we can ignore what the EU is doing, from your point of view. You would still want the UK, even with Brexit, to make sure that we are in line with European directives.

**Giles Andrews:** Correct, particularly in the area of data.

**Daniel Morgan:** It is not even just the UK being on the doorstep of the European Union; other countries are undertaking a third-country regime through the current EU rules and will do on a GDPR so that they can do business with the European Union and be seen as equivalent, so it is essential for business to do that.

**Lord Woolmer of Leeds:** How confident are you, going forward, that out of the EU, the Government on your behalf will be able to negotiate, and you yourselves with your relationship with Europe will be able to maintain, sufficient equivalence so that you find ease of access to the EU markets?

**Daniel Morgan:** I do not know.

**Lord Woolmer of Leeds:** So really it is up in the air and you will wait and see what happens.

**Lord Callanan:** I want to ask you about the potential impact on your business of any post-Brexit immigration controls. How might that affect the ability of the FinTech industry to attract and retain talent?
**Giles Andrews:** Just under half our workforce is non-UK, and they come from a wide variety of sources.

**Lord Callanan:** EU or non-EU?

**Giles Andrews:** Mainly EU—not exclusively, but mainly EU. I happen to think that unfortunately the UK is underdeveloped in terms of its STEM education. That is something that successive Governments have tried to address, and perhaps we are on the route to addressing it, but as of today our graduates are underrepresented in those subjects, and therefore there is a need to look elsewhere. I also think there is a benefit culturally within our businesses from having the melting pot of a variety of different nationalities and attitudes. We met with our workforce the day after the referendum. There were a number of people who were very confused—adults saying, “Do I have to leave now?” We were able to give a degree of reassurance but we cannot give the ultimate reassurance. We could give our opinion that it is highly likely they will be able to stay, but we could not guarantee that. We are continually recruiting technical talent—I am particularly focused on that—but we are already finding less desire among bright eastern Europeans, Germans and French people to come and work in the UK.

**Daniel Morgan:** We have institutions and start-ups in our membership base. The start-up section goes up to quite large companies, and 30% of the founders of these companies were born overseas. It is an inherently international market, and that is not unique to the UK: this is a global sector and a globally competitive sector. It is a similar story around the world. The Government’s own figures, from a report commissioned from EY on the FinTech sector, highlight that 40% of all tech workers in Silicon Valley were born overseas, and the US has a large domestic labour force—larger obviously than the UK’s. There are three elements to it: technical, FS talent and entrepreneurial. As we said, the flexibility around technical is still difficult. The definitions and the hoops which start-ups have to go through are quite tough. The wage level that is set does not always fit, although sometimes, obviously, equity is offered in lieu of a wage. How long it takes to hire new workers is potentially going to be an issue—you may want to hire someone quite quickly, maybe after a funding round, and obviously some of the criteria on a tech nation visa can be quite stringent, and not many people qualify for it. The numbers and awareness are not great.

One of the key things with technical, FS and entrepreneurial talent is that entrepreneurial talent does not have a definition—you cannot define someone who wants to come here and set up a business. Obviously there is an entrepreneurial visa, but you have to have a huge amount of capital already in place behind you or prove that you are about to set up a business. Many of our founders came here just with an idea, and with a smaller labour pool that talent will no longer gravitate here. I might also add that many of our members have not been enthused by some of the language around immigration and skills. This is a highly international sector. Investment was the number one concern immediately following the vote, and this has shifted somewhat to attractiveness to international talent and skills, before we even try and attract them.
Bruce Davis: I would just add two things. First, I think it is about looking beyond recruitment into the companies and into the universities that we then recruit from. Similarly, about one-third to one-half of my workforce comes mainly from the EU, but for lots of different skills, not just tech. A lot of them came through our university system, so it is turning out good people, but we need more of them.

The other thing is that one of the reasons why those entrepreneurs come here is because of a positive circle: we have an effective crowdfunding system, so we can raise money for companies more easily, and so if you have a good idea, we are a good place to come and create it and then export it to the world. There are later questions about being a FinTech hub; part of being a hub is about being connected to spokes. At the moment those spokes have to be two-way, and people have to feel they can come and go within that environment because that is what creates new ideas. These things do not come out of thin air, but out of the interactions that we have with industry. We are very collaborative, and that is what is producing the good stuff that is happening. Maintaining that momentum is very important, and it can disappear quite quickly—as quickly as people’s confidence. We really need to work to ask what we are doing to support that ecosystem.

Lord Callanan: Do you think there is a good opportunity post-Brexit, if we frame immigration policy properly, to increase the supply of talent from across the world rather than just concentrating on the EU? The consequence of free movement has effectively been that the Government have imposed much stricter immigration controls on non-EU nationals, so it is much more difficult to hire people from outside the EU, as a consequence of it being relatively easy from within it. If we structure immigration controls properly we could attract talent from the EU and outside it, while possibly restricting non-skilled immigration.

Bruce Davis: I could not comment on that as it is something of a hypothetical as to what graduates are bringing in. When you look at the numbers of foreign students who are using our universities, the biggest number is Chinese—90,000, I think. What we do not know, and what would be a good thing for the Government to find out, is exactly what they are studying.

Giles Andrews: And whether they stay.

Bruce Davis: And whether they stay. Within the European area, there is a degree to which the idea is you come here and stay. There are different views elsewhere, more about acquiring those skills and then taking them back. Some of that is a cultural desire to deliver your success in an environment where you are recognised for that success. It is a more complex cultural problem than simply turning off a tap and then turning on a different one. I do not think that would be the case.

Daniel Morgan: What is clear is that if you take away the access to a labour pool of more than 500 million people, there will have to be a radical overhaul and assessment of all levels of visas and what we are looking to achieve through that. Obviously, at the SME, entrepreneurial start-up level, they do not often fit into the boxes or definitions of what would fall within certain skill sets or qualifications or within certain access
to capital around the entrepreneurial side of the well. We would need to drastically increase the numbers, or keep them open to review on a constant basis. We would have to be a lot more flexible in trying to address some of the skills shortages if we were going to do that.

**The Chairman:** Mr Morgan, would you be able to provide us with a line of vision—a list of the things that, when recruiting from outside the EU, a company in FinTech would have to go through, for example to get a visa for an Indian, an Australian or one of the other nationalities to come to the United Kingdom? Would you be able to give us a short list of what your company would have to do? We want to get a picture, or brief overview, of the bureaucracy involved and the timelines.

**Daniel Morgan:** I have never been involved in the process, because I am in a trade body, but—

**The Chairman:** Would any of you be able to provide that?

**Daniel Morgan:** I can attempt to run through what I understand to be the process. Obviously there would have to be a period where the role has to be out internally, under a number of guises. There is often a certain salary level which needs to be achieved at tier 2, which is obviously not exceptional.

**The Chairman:** Would you be able to send this to us?

**Daniel Morgan:** Absolutely.

**The Chairman:** That is great. It will help us to illuminate the extent of the issue if they do not negotiate the kind of deal that Lord Callanan just referred to.

**Giles Andrews:** To pick up on your point, in a pre-Brexit environment we are naturally competitive within Europe as a place where people want to come and work. It is not impossible but it is harder to imagine that competitive advantage being extended greatly geographically. The US is seen as a very appealing prospect for people who are prepared to travel half-way round the world, and it would be hard for us to compete with that.

**Q79 Lord Skidelsky:** I want to get an idea of what FinTech really is. It is always quite useful to have that in one’s head before talking too much about it. Is it simply a supplementary electronic form of intermediation, such as traditional banking provides, with services to retail services and investment services? Is it regarded as a sort of supplementary electronic form of intermediation, or do you have in mind the potential to replace traditional banking in some sense? To finish that question, you have talked about credit creation. To what extent is this a source of credit? Can it be a source of credit creation? If so, it will obviously impinge on monetary policy. There are huge implications for this industry, so how do you see its development?

**Giles Andrews:** We do not create credit. Banks create credit. We intermediate directly between providers of credit—who, in our case, are predominantly retail consumers—and the people who want to borrow it. So we provide a different sort of electronic intermediation.
I would characterise FinTech as being not about technology per se but about the use of technology. Innovations in FinTech are seldom innovations in technology. They are usually innovations in business models that are enabled by the use of technology. Although we are technology-rich and employ lots of technology specialists, those specialists are more involved in implementing technologies that already exist so as to do a different form of intermediation.

**Lord Skidelsky:** So you are in the interstices of an intermediation system, and you are not thinking of replacing banks as sources of credit.

**Giles Andrews:** No, but we could replace banks as intermediaries of certain types of credit, if that is clear.

**Lord Skidelsky:** No.

**Giles Andrews:** We take a source of capital—which in many cases is not very different from a bank’s source of capital in that banks take retail deposits and we take investment from our lenders—and we do a different type of intermediation that does not involve the creation of money; it simply involves transferring money from one place to another. Banks do the same intermediation, plus they have the ability to create money.

**Lord Skidelsky:** In so far as you grow, the regulatory environment will have to change to accommodate that growth.

**Giles Andrews:** It would have to change were we to seek to create money, but I do not think there is any fundamental need to create money. The UK economy is not short of money, so I would postulate that the money does not need to be created.

**Lord Skidelsky:** One last thing: one of the triggers of the development of FinTech was disappointment at the failure of banks to create enough credit in the aftermath of the 2008 crash.

**Giles Andrews:** I think that that was coincidental, not causal. In our company’s case, we have never lent money to consumers to whom banks would not lend money. So we were not responding to a funding gap; we were responding to a disenchantment with the industry. We were introducing some efficiency and a better service that meant that people were happy to use the new, alternative service, but we were not stepping into a gap.

**Daniel Morgan:** Fintech is pretty broad and it is evolving all the time, along with technology and the regulatory and policy environments. Obviously the vast bulk of the investment has gone in in the last mile—the consumer experience on top of the rails of the existing financial system. How you experience payments is ultimately still administered by the banks. The PSR—the new Payment Systems Regulator—is obviously working towards opening up the access of real-time gross settlement to electronic challenges, which could potentially change some of that relationship.

Another area is robo-advice, which is delivering automated investment based around algorithms. It offers automated execution, only cheaper than an investment manager would do it, the average cost of advice being about £140 an hour. It enables people to step into an underserved area.
For example, the Retail Distribution Review created an underserved area with the advice gap, and technology can deliver it in a cheaper and more transparent fashion. It is a changing and emerging area of activity, which so far has been primarily on the consumer side, but a whole new range of technologies are looking to change the way that capital markets and regulation work, based on the better use of data. It is a moveable feast, so to speak.

Then there is the rise of neo-banks and challenger banks with full banking licences. You can have a digital-only bank based on an app on your phone, but they are fully licensed banks and can create credit. So FinTech is a pretty broad spectrum.

Bruce Davis: There is also the investment side. My main competitors are not the high-street banks; they are the international merchant banks on the local infrastructure projects that I fund. We are looking at introducing the opportunity to take risks again with people’s money, which had largely been taken away. On the other side, when I have talked to the larger high-street banks, I have been told that their regulation is driving them towards very high-volume, very low-risk and low-margin business. That is vital in the economy—they need to provide that extremely liquid credit to very low-risk businesses and individuals—but we need to maintain the momentum of rebuilding the financial system that was largely wiped out in 2008 and, post that, with the unwinding of those businesses. That needs to be replaced. At the moment, it is not so much about replacing banks as about replacing a vacuum. If we lose focus on that, in some respects it will have a bigger impact on some of the detailed negotiations around our relationship with the EU.

We also need to look at the resilience of our own financial system. The fact that we have an alternative finance industry, as opposed to just a blip, will support us in maintaining our economy. On your point about why people voted in the way that they did, interestingly people voted against the EU because they did not feel that they had a stake in it. One thing that alternative finance does through this mechanism is that it gives people a stake in the way that these financial institutions work. They are part of the system: it is not done to them; they are it—we are networks. That enablement and engagement is incredibly important.

Swindon has today launched its own ISA. Why has it done that? It is because it a pretty self-starting kind of town and they want to do it for themselves. Now, you can invest in stuff that is happening in Swindon through an ISA. That is the innovation. There is a load of technology and thinking behind it but, in that case, the innovation is self-reliance. I think you will see that coming through in lots of places, whether in alternative currencies, new forms of lending or new forms of investment. That is where we can generate innovation

The missed opportunity is our ability to export those ideas easily to new markets. We are going to keep innovating in the UK and we need support. We have had good support but more can be done, particularly around social investment. Once you go beyond that, we can take it out to new places, but that is risky for us. We would have to raise capital and we have to have confidence that we can operate in those sectors. We would
need a lot of legal advice and there would be a lot of cost in doing things, and help would be needed with that. The more we create barriers to that, the harder it is to do. That does not mean that it is impossible but it is harder.

Q80 Lord De Mauley: You mentioned Berlin. We have heard in the course of our inquiry that Amsterdam, Frankfurt and Paris are also busily trying to persuade companies and services to relocate. We have also heard how important the financial and related professional services ecosystem—a word you recently mentioned—is in London, and it has been suggested that it would be difficult to replicate this elsewhere. So could the close proximity of regulation, legislation, funding, research and advice contribute to supporting London’s continued position as a leading FinTech hub?

Giles Andrews: Yes, it could help. It is why London is the leading FinTech hub, for all the reasons that you mentioned. What we are concerned about is the diminution of that leading status. The ecosystem you described is the reason why the hub is as strong as it is.

Lord De Mauley: It is difficult to get a feeling for the relative importance of that against some of the other issues that you have been raising.

Giles Andrews: It is very difficult to give you a detailed answer on its exact importance, but it comes from an emotional perspective. Mr Morgan made the point that where entrepreneurs choose to set up businesses is for a wide variety of reasons. That is the central decision: it is the entrepreneur who has an idea deciding where to go. We are concerned that they are less likely to pick London. The point I made earlier about the regulator having less time and attention may be relevant as well. Having the proximity of the regulator in London is a great thing, as is the fact that it has been forward-thinking to date. The fact that they may have less time to devote because they are otherwise engaged is a bad thing.

Daniel Morgan: We are really at early doors in the FinTech story. It obviously gets a lot of headlines but I think that only 1% of banking revenues in the US have been disrupted, according to a report from Citi. This is the start of the journey; it is not that we have a well-established industry. It is early in this fledgling industry, so let us not forget there is a long way to go. We have used the term “ecosystem”, which is very popular in FinTech more broadly, but it is the same as a natural ecosystem. If you take one vital part out of it, you do not know what the effect will be. Taking one part of the food chain out could be benign. It could readapt or it could crumble. We are in a place now where we will see how it reacts and what we need to do to respond to that.

In terms of other centres in Europe, London is a FinTech centre more broadly because of its huge financial services base. Berlin is a huge tech centre but at the moment it does not have what we would describe as a FinTech sector, primarily because there are not the banks investing huge amounts in accelerators, et cetera. There is a venture capital community that fed off a wider and older financial services ecosystem, which has meant that London is more of a natural home. But that does not mean to say that it will stay; they are obviously under pressure as well. Even if we look to the US, where a lot of the big B2C FinTechs grew out of California
and the venture capital there, they are increasingly located in a huge base in New York, because that is the financial centre. That is the reason why it is a FinTech hub.

_Giles Andrews:_ I would argue that New York is the dominant FinTech hub in the US, not California.

_Bruce Davis:_ I have experience of both the FSA and the FCA. I caught the dying embers of the FSA and, in the space of two years, you had significant cultural change.

_The Chairman:_ For better or worse?

_Bruce Davis:_ For better. In other words, it is not difficult. The FSA was a horrible place to deal with. Trying to get a new thing done was like dealing with something from a Kafka novel. It took two years of my life to get through that process; that is why we have things such as Project Innovate. Abundance and Seedrs were the two which broke the ground, if you like. They bear the scars and the risk, and I think that the FCA responded to that. It is not beyond the wit of man for the BaFin in Germany to do the same.

One barrier to innovation in the European markets is their regulators being slow to wake up to their role. Regulation should promote innovation and protect consumers. That is not a big philosophical shift but it has huge ramifications. Austria did it in six months; I think that Finland did it in under a year. Do not underestimate how quickly they can change the environment in which we could innovate. That is probably a bigger thing than whether or not law firms have offices in certain places or are able to recruit, for example, German-speaking lawyers to produce German documents. I cannot sell my products in Germany under full passport unless I am able to operate fully in that local language, to make sure that consumers understand the risks. We are slowing down that process. Every barrier that you create in that adds in costs. Cost ultimately stops us doing things; that is why we are pushing for the exemption cap to go up on prospectus directives to €10 million or €20 million. It is because money is not being raised not because of regulatory or consumer risk, but just because it is not economical. It is those sort of barriers that we are sitting against. Placing economic barriers when we need to bring growth back into an economy seems counterintuitive.

_The Chairman:_ Thank you very much. Are there any other questions that members of the Committee might have? Thank you, it was a really illuminating discussion and we are very glad that we had you in. Thank you very much for coming at such short notice. This concludes today’s public evidence session and the Committee will now continue its meeting in private.
Q18  **The Chairman**: Good morning. I welcome you to the inquiry of the EU Financial Affairs Sub-Committee into the impact of Brexit on the financial services sector. You have a list of interests that have been declared by the Members of the Committee. This is a formal evidence session of the Committee. A transcript will be taken which will be put on the public record both in printed form and on the parliamentary website. You will be sent a copy of the transcript to revise any minor errors. This session is being webcast live and subsequently will be accessible via the parliamentary website for those of you who make that your late-night viewing. I warmly welcome Elizabeth Corley, the vice-chair of Allianz Global Investors Great Britain, Mr Douglas Flint, the group chairman of HSBC Holdings and Alex Wilmot-Sitwell, President, EMEA, Bank of America Merrill Lynch. We are very pleased to have you with us and you have indicated that you can stay on if our session runs for a little more than an hour.

Perhaps I may kick off by asking each of you to give a brief response to the overall question of how your particular firms and others that you know of—we recognise that you represent different sectors—are planning for the outcome of Brexit and how the political uncertainty that that has created is affecting your day-to-day operations. How are you planning for the new and existing challenges in the areas you operate in?

**Elizabeth Corley**: Thank you very much, and I am grateful for the opportunity to speak to the Committee. As an asset management company, essentially we do what our clients need us to do. On planning, following on what I would say was a rather shocked and surprised reaction, which was short lived, many of our clients are calm. They are waiting to see what the process, the timetable and the outcome might be. So in terms of how we are looking after their portfolios and how we are
talking to them about services, it is business as usual. Many asset management firms have well-developed structures globally; it is a global business. Europe is obviously an important part of that, but as I say it is a global business. So the specifics of how one plans vary depending on how well established one already is between the UK, the rest of Europe and the rest of the world.

For us specifically, many years ago we took steps to create what is a well-established legal structure in Europe that provides us with tremendous versatility to locate people and services wherever we want. The most important thing is that the global conventions which apply to asset management that allow you to run money quite freely do not change because you can delegate portfolio management around the world. If it were to change as a result of the negotiations on exit, that would be a change to the global convention, not necessarily just between the UK and the EU. At the moment, we are treating that as a lower probability. If there were any indication that that might change, we would have to make significant changes to how we plan for the future.

Douglas Flint: Thank you very much for this opportunity. The response is multifaceted. The initial reaction was around reassuring our staff in terms of their position and what we would say about the importance of being able to attract and retain talent. It was about working with customers to help them understand how their business models and operations might change depending on the variety of arrangements that could be negotiated in the future. Then in relation to banking services, again the dimensions are multiple. We are very international so we are present in most of the major countries of the world. In terms of our own ability to do business, we have choices. The critical thing for us is trying to understand what a change in arrangements in the world’s most international financial centre and ecosystem might have on the aggregate ecosystem of finance around the world. If we think about the last seven years post-crisis, the principal priorities of our regulators and public policymakers has been to eliminate risk through consolidation, central counterparties and more transparent arrangements. That has led to an ever greater concentration of financial activity into the major centres of the world. What takes place in the ecosystem, the cluster that operates in London as one of the world’s greatest financial ecosystems—it happens to be in the UK as opposed to being a UK asset; it is an international asset based here—means that our biggest concern is to understand whether financial stability in the ecosystem can be preserved if you start playing with the range of activities that can be conducted from a single location.

On a day-to-day basis, there is a huge amount of planning around what could be disruptions to the activities that we make available to our clients and how they might affect our own model in terms of where we do business. As I say, a huge amount of planning is involved in going through the options, but our biggest area of focus is on what happens to the ecosystem, because it is incredibly broad and deep with tremendous elements in it in terms of the supply chain that supports a huge number of multinational, domestic and regional companies which have consolidated their financial affairs into the time zone financial system that exists in the United Kingdom today and which services the world.
Alex Wilmot-Sitwell: I will try not to be too repetitive because I agree wholeheartedly with the comments made by Douglas and Elizabeth. The initial reaction for us to was ensure that our staff were reassured that we were open for business and to reassure our clients that we remain open for business. Regaining a sense of “business as usual” was the immediate priority. I would say that the preparation undertaken by regulators here and by market operators meant that the market did return to normality extraordinarily quickly and behaved effectively through what had been a difficult period which could have led to great volatility. As the head of an American bank based in London which is entirely focused on the wholesale markets, I would echo the comments made by Douglas in terms of what we are looking at now. We are trying to ensure that client activity is maintained in a way that supports clients’ needs, that financial stability is protected because that is absolutely critical, and that we are able to explain the complex nature of the interconnected ecosystem. It is not a Lego set in which little pieces can be built up and put somewhere else. The interconnectedness is very significant and therefore the complexity of the ecosystem is something that we need to be assured that whatever happens from this point forward, the consequences and implications of any steps are understood.

The Chairman: You are almost directing me to think about chaos theory, but I will not go there. Have you found that there has been a chilling effect? Last night I spoke to someone from a major US investment banking firm who said that depending on the sector, they do think there is a chilling effect. Have you detected that across the different sectors? For example, has there been a reduction in M&A activity?

Alex Wilmot-Sitwell: No, I do not think there has been a fundamental chilling effect from our point of view. In fact, market activity has recovered to the levels that would be consistent with a normal market environment. There are clearly a lot of factors at the geopolitical and macro level that are of concern—a lot of political processes on the horizon that are of concern—and of course the Brexit process is a matter of concern because it is uncertain. Until we know what the direction of travel and the destination are going to be, it is difficult for us to position ourselves from a strategic point of view. But I would not say that I have seen any fundamental change in market activity.

Douglas Flint: I pretty much echo that. Clearly, a huge amount of work is being done across all sectors to understand what the changes might mean. There might be projects that are taking more time to get off the drawing board and execute, mostly in the commercial property space. In other activity the comparative advantages of a weaker sterling are promoting investment into this country for those who see it as better value than it was before, and supporting the export sector. There are businesses that are winning from that. I think there will be a lag effect and those that are faced with higher import costs on whatever they bring in from outside will start to see that towards the second half of the year. I agree with Alex that so far there has not been a dramatic impact on activity, but a huge amount of preparation work is being done.

Elizabeth Corley: I would just add that there is a difference between capital market activity, which, as you say, is around M&A or capital raising
and the use of existing cash flow. Anecdotally—because it is still very early—we find in some sectors a hesitation to commit capital expenditure to inward investment in capital that is already there and a caution in deploying free cash flow, which would not come through in the activities of the capital markets per se. As we roll forward and start to see company announcements, we will see the extent to which major investments, innovations and R&D are continuing at that level. I am sure it is something that the CBI will be tracking closely. Anecdotally, when we speak to some of the companies in which we invest, there is definitely more caution.

Q19 Lord Desai: You referred to different players: the UK, the EU 27 and non-EU players. There are different sectors: asset managers, investment banks and retail banks. How will they be affected differentially by the passporting rights? How much do they depend on passporting rights for their operations?

Douglas Flint: Everyone is affected by passporting rights to a greater or lesser degree. The system has two major priorities. Some businesses rely on passporting rights in order to sell their services to or attract business from the EU 27. But it is also hugely important that the ecosystem that exists in the UK is largely because of the quality of regulation, the legal system, historical reputation, and so on, and the fact that the system built up to serve a global community. London dominates foreign exchange trading, including in the US dollar and the RMB. That has nothing to do with Europe but the cluster has attracted those services because they want a single point of contact to cover the world in terms of financial needs, currencies, and so on.

There are two aspects. For those who sell on their reliance on the passport, that is a challenge. But more important to the global financial system is the possibility that if the benefits that come from consolidation allowing people to bring all the risk into one place and get the compression effects of risk management and offsets were fragmented, we would risk an element of financial stability as it adjusts, we would make the system more expensive and we probably do not know where the system ends up if it gets fragmented. Does it get split over a number of centres or does it find some other place in the world that can offer the consolidated benefits that come from the system that exists today in the UK?

It is relevant to say that what we have today is not because we built it and then said to people, “Look how clever we are”. We built it because our clients wanted the services and therefore they were added piece by piece to create this huge network of international and domestic firms that offer international services through London. The thing we are trying to work out, along with everyone else, is not so much how it impacts us but where our clients will want to do business and how those who compete with the UK ecosystem will seek to attract business away by promoting the fact that they can offer a greater degree of certainty as to how they will transact, as Europe and the UK transition to a different model of co-operation.
Elizabeth Corley: In the asset management sector, passporting is only part of the equation. I am sure we will get on to equivalence and other things in a moment. Obviously, it is very varied, as you rightly say, by different sectors even within asset management. This is a simplistic answer and the devil is a bit in the detail but simplistically, if one is dealing with professional, institutional clients the ability to do that is far greater than if one is dealing with retail clients. Europe has been one of the innovators in creating a single market for retail asset management—the UCITS directive. That is a very rare phenomenon in the world. Certainly, the ability of individual European retail savers to buy product from the best supplier in the market—which might be British, American or from somewhere else—is controlled through that UCITS regulation. Therefore, it will be a question of how that gets promulgated in the separation arrangements.

Alex Wilmot-Sitwell: Again, we are in danger of repeating ourselves but passporting is a bit of a simplistic way of looking at the challenge. The challenge is actually ease of access to markets more broadly in order to provide clients with the solutions, capital support and strategic support that they are looking for. It is around efficiencies of scale, market infrastructure and the ecosystem that exists. You pull pieces out and it is difficult to know how that will impair or affect the efficiency of scale. But we do not operate in a world where there are very significant margins of doing business. Adding complexity and capital charges makes that ecosystem less healthy. That is the risk that we need to focus on.

Lord Haskins: You are putting a difficult proposition to Mr Davis. On the one hand you say, understandably, that the London ecosystem must not be messed around with or fragmented; on the other hand, Mr Davis has his political people behind him saying that that does not matter, the issues are much more important than how London fits in. How will he reconcile these two very different positions?

Alex Wilmot-Sitwell: I absolutely understand how difficult it is. We must be very clear that there is no one size fits all; we all have slightly different business models and we all represent slightly different aspects of the industry. We all benefit from being able to operate in an environment where you get real scale of capital, skills and infrastructure. That has real benefits as an ecosystem. To the extent that that cannot remain together for political reasons, we will obviously need to adjust to those different circumstances; and we will because that is our job—we need to service our clients. The important thing then is to ensure that a sufficient period of time and transitioning is put in place to allow that process to be undertaken safely. Financial stability, the efficient working of markets and the ability to provide access to capital and services to those clients are of fundamental importance. Even if there is a short-term interruption or damage is done to the system that could have very wide ramifications for the whole economy, not just the UK but the EU and indeed the global economy. My greatest concern is to ensure that financial stability is maintained, that market access and infrastructure can operate effectively and efficiently, and that any process of change requires an appropriate period of transition so that it can be managed safely. We will adapt our business models to whatever that outcome is. We are not here—I am
certainly not here—to preach or to influence the political process but rather to make sure that there is an understanding of the consequences of market efficiency and effectiveness if that process is managed poorly, hastily or in a way that is not well co-ordinated.

**Douglas Flint:** It is not just European businesses that benefit from the ecosystem; global businesses do so as well. For reasons of efficiency, European businesses have chosen to consolidate their capital raising, cash management, equity market activities and risk management activities within a single ecosystem that happens to be based in the UK along with, as I said, a whole bunch of international as well as domestic firms. I am sure that part of the discussion will be that you probably could not ever replicate that in one place. You could not replicate the individual pieces in multiple places other than in a fragmented way over a long period of time. How does Europe ensure that the economy continues to receive the financial support it needs during a period of transition to a new model? I am sure that that will be just as important to our European counterparts as it will be to the UK. We need to do more on capital markets union, but that is based on what happens in the ecosystem that is based in the UK. There is nothing that immediately replaces it. Can we envisage a time when there might be? That is possible, but it will take a very long time to build up, license and operate. If it is critically important to ensure that employment and economic activity in Europe, and in a broader sense the world, is maintained and not disrupted; and to ensure that we do not have events that contribute to financial instability, there has to be an open conversation about maintaining economic activity and avoiding financial instability during a transition.

**Lord Desai:** I have a supplementary question. As an economist, I understand that the City has certain advantages over anywhere else in terms of efficiency. Anything that happens with or without equivalence will add to transaction costs. Have you been working on what extra transaction costs you can bear and remain ahead of the competition?

**The Chairman:** Not all three of you need to answer. I am keeping an eye on the clock.

**Elizabeth Corley:** Perhaps I may add something in response to the previous question. One of the things that we have not been very good at—I say this from my own sector—is that we are actually one of the leading international centres of the world. Two-fifths of the assets and the activity we run here are for external clients, half of which is with Europe and half with the rest of the world. We have created a sort of national champion industry that we do not talk about much. We are also a critically important crossroads for capital flowing into investment in companies. What we need to think about as we move forward as an international trading centre is where we have an international and competitive advantage and where we wish to see that growing our businesses and our imprint on the world. Asset management is undoubtedly one of the leading international centres. The money that we run here is greater than the three largest European asset management centres and we are second only to the United States in terms of scale. Even more important is the fact that we are a significant contributor to equity issuance, equity risk capital which is obviously essential for growth.
We need to work closely on what we need to see as the seeds of future international expansion when moving forward.

**The Chairman:** I think that we can pick up on those points later. Perhaps Mr Flint would like to deal with Lord Desai’s question.

**Douglas Flint:** Very briefly, the question is not the competitiveness or the profitability of the industry, it is what our customers choose to do. First, at the moment they derive huge benefits from consolidating in one place because they get all the offsets. If you start to dismantle and fragment, it becomes less efficient for them. They then have the choice either to accept a less-efficient system or to go somewhere else where they can get everything in one place. The most obvious place would be the United States. Secondly, partly because of low interest rates and a weak economy, the European banking system is not recovering its costs of capital at the moment. It trades at less than 50% of book, so can it absorb more costs? Not without making itself less attractive as an investment proposition. Having folk going back to their head offices saying, “We are going to have to restructure and take our returns to a level even lower than they are today when the sector is trading at roughly half book”, is not an attractive proposition.

**Lord Butler of Brockwell:** You have emphasised that London is a unique ecosystem which, taking Mr Flint’s words, cannot be replicated. It sounds to me, and indeed it has been suggested by others, that in this negotiation as far as business is concerned, the EU partners will be demandeurs; in other words, they are going to want very much their access to London not to be inhibited by any outcome of the negotiations. Is that your view, and is there a possibility that business in Europe will be putting pressure on one way whereas the politicians may be putting pressure on in a different direction?

**Alex Wilmot-Sitwell:** I would say that there is a very real risk of that, and indeed there is some evidence that it is already happening. It is quite clear that corporate clients, institutional clients and other market participants want the most efficient access to products and services at the most effective cost. At the moment, having that hubbed substantially in one place, which happens to be London, is a great benefit to those clients and the users of such services. Clearly there is a potentially different political agenda. It is important that as the political agenda develops, there is an understanding of the consequences of certain outcomes. The consequences of those outcomes could well be that the cost of doing business goes up or indeed that the breadth and diversity of products and services that are made available to the markets shrink. As Douglas has just said, currently the European banking sector does not cover its costs of capital, so it is difficult to see how creating additional complexity and adding costs is going to be of benefit to the broader economy. I am talking about the whole European economy, not just that of the UK. That political agenda and the business imperatives could potentially drift apart. We should be careful about that and monitor it because it could have a significant negative impact on the broader macro environment.

**Douglas Flint:** If I could just add one thing to that. It is worth recognising that for the largest part of the financial infrastructure the major players in all the sectors are already responding to the Financial
Stability Board, Basel, IOSCO and Dodd-Frank given that we all have interests in the United States. To a large extent, regulation of the sector has gone beyond national boundaries in any event. We are globally regulated although it is implemented by national regulators. The framework of regulation is a globally negotiated one.

Lord Butler of Brockwell: Do you think that you and your clients can play a useful part that is helpful to the British Government in putting pressure on for the maintenance of the stability of this ecosystem and try to prevent politicians complicating it or putting obstacles in its way? I mean this as a serious question. Great institutions such as the ones you lead could well be very important in this negotiation.

Douglas Flint: The most important voices are those of our clients, not us. We exist to give them what they want and I hope that they will speak up. I hope also that those who make the decisions understand the implications of what those clients say.

The Chairman: You are being quite modest. I think your announcement about HSBC’s location was relevant to the argumentation.

Elizabeth Corley: It is about the benefit to all the underlying clients, and to an extent asset managers are clients of the large banks here. We are very respectful of the democratic and political process and frankly would not wish to do something that goes beyond our brief. But if suggestions were to come through that would be seriously damaging to employment, to the stability of the markets and to growth, we would undoubtedly make sure that we commented on them. But it would be on those points of substance rather than on the process itself, which we have to be very respectful of.

The Chairman: Thank you. I will bring in Lord Shutt on the legal and organisational structures.

Q21 Lord Shutt of Greetland: Can I get a greater understanding of the legal and organisational structures and how Brexit might affect them? You can speak from your own personal experiences, but it seems to me that you may have branches in different parts of Europe or you may even now have subsidiaries in various parts of Europe. Under passporting, perhaps regulation is simpler if you have branches rather than subsidiaries, because the subsidiaries may then be involved in other forms of regulation. How important is all this? Indeed, do any of you have neither, because you do not need a branch or a subsidiary?

Elizabeth Corley: We are a relatively lowly capitalised business versus the banking sector, which will be very different. You are absolutely right. At the moment, choices driven by client and cultural preferences, country by country, are being made as to whether one has a subsidiary, a branch or nothing at all and just flies in. I anticipate that institutional and professional business could well continue unless deliberately protectionist elements were introduced in a negotiation. For retail business, at the moment we are clearly benefiting from a harmonisation of client protection and marketing rules, which undoubtedly helps the retail customer. At the moment, the UK is equivalent to that in a full sense. In
that area it would really depend on the detail of the legislation that came through after any exit.

Where we would certainly start to struggle would be if there were a physical restriction on what could be done outside the European market. For example, on the delegation point, if someone tried to say that you could not run European money if you sat in London that would be quite an extraordinary reversal of the last 40 years of a global trend. It would certainly cause us a lot of thinking and would be very difficult. In the United Kingdom we look after about £630 billion of European equities on behalf of global, not just European and UK, clients. So you would be talking about a reversal of the way that capital markets have evolved in the last 30 years since exchange controls were removed.

**Douglas Flint:** First, no free trade agreement outside what exists in Europe today allows free access to services, and particularly financial services. Therefore, even on a simple basis, whether it is a branch or a subsidiary, it is important to be part of a single payments system and to be able to sell risk management or foreign exchange services into a global market through a consolidated hub, as you will have heard in other testimonies. The UK does 90% of the world’s OTC derivatives markets and it is the largest foreign exchange centre in the world. It has everything to do with being able to consolidate everything in one place, including the dollar, the renminbi, the Swiss franc, the Saudi riyal and everything else—it is the fact that people can do things in one place. If you say, “Euro activities cannot be done from a base outside Europe, and the UK is now outside Europe”, then the benefit of being able to do everything in one place is fragmented. Could the business be done? Yes, it could, in the same way in which we deal with other countries through correspondent banks and the like or set up subsidiaries, but it adds another layer of engagement, which adds to cost and complexity and potentially to risk.

There is a whole ecosystem in terms of our customers, our regulators and our policymakers, and we have to ask how we can bring as much as possible together in a place that is transparent and well-regulated so that we can eliminate risk. Dismantling that is completely counterintuitive to everything that people have tried to do over the last eight years post-crisis.

**The Chairman:** Mr Wilmot, did you want to say anything on that?

**Alex Wilmot-Sitwell:** The trouble is that I keep agreeing with Douglas.

**The Chairman:** That is perfectly fine and excellent.

**Alex Wilmot-Sitwell:** And I do not intend to disagree with him now. I will add one point, because we are all slightly different. As I said, we are a US bank and we service only the wholesale markets. There is an advantage in doing that in London for all the reasons that Douglas has just very well-articulated. To the extent that we need to access the markets in the EU from within the EU that will just add to the cost and complexity of how we run our business. The chances are that that cost and complexity will be passed on to clients to a certain extent, and the complexity will add to the risk. Eight years post the financial crisis that is not a very good outcome from creating a much safer environment where
capitalisation is clearly hubbed around operating subsidiaries that carry the appropriate liquidity. If you start dismantling that, it will create inefficiencies and add to risk and complexity, and that is not good for any of our clients.

The Chairman: I think that Lord Butler wanted to come in on this.

Lord Butler of Brockwell: To take a specific example, in evidence to us last week, Professor Charlie Bean said that he was certain that we would lose the capacity to do euro clearing in London. I do not know whether you agree with that view, but would that be a serious blow to London’s financial services?

Alex Wilmot-Sitwell: I am not going to give a view on the political debate around what comes out of what will be a complex series of negotiations and discussions, but foreign exchange clearing is an ecosystem in itself; it is not something that you can dismantle and pull pieces out of without the risk of it increasing costs and complexities. Of course you can clear euros—you can clear any currency from any trading venue you choose. To the extent that it is all packaged together and interconnected and enjoys the benefits of efficiencies of scale, it is the supermarket effect, if I can call it that. Foreign exchange is essentially like Walmart; it is a question of pushing as much product through pipes as cheaply and efficiently as possible. If you move those pipes somewhere else, you will probably create some additional frictional costs and lose some of the benefits of compression that you get from having it all sitting on a single trading venue. But that may well be what we are faced with and it will obviously need to be factored into the strategy of CCPs and other trading venues.

Douglas Flint: I think it would be very bad for the ecosystem. Effectively, you would create the need for collateral in more than one place. It would become less efficient. The infrastructure is at the heart of the financial system, and you can get the compression benefits by offsetting all the pluses and minuses across every currency. As I said, we have Saudi riyals, dollars and renminbi, as well as euros, but to take every one of the major currencies from that offset arrangement would have a seriously damaging effect. It is inefficient, but you also invite people to ask where they can do it all in one place. No doubt other jurisdictions would leap at the opportunity to try to create something that competed with the ecosystem that dominated.

Earl of Lindsay: I turn to equivalence. Do you think it is very important that we establish equivalency rights going forward and maintain them thereafter? Is this going to be the vital means by which UK financial services or UK-based financial services retain access to the EU single market? Or do you see equivalence of disciplines and requirements of establishing and maintaining equivalence rights acting perhaps as a constraint, stifling new opportunities and perhaps introducing new risks?

Elizabeth Corley: As Douglas said very well, we are in an international world. It is a global world. There have definitely been a lot of attempts in the last eight years to see more convergence of regulation and standards. When we talk about equivalence with Europe, we are also talking about the way in which we work with other jurisdictions, particularly the United
States and parts of Asia. There is no doubt that in financial services one needs a dynamic and agile means of regulation and supervision. The challenge with straightforward equivalence is that it is static. You are given an equivalent status at a certain point in time, and then, as you say, markets change and innovate, and regulation might shift. So anything that assumes a static status quo will not work in practice. Something that is beyond equivalence in regulatory co-operation and joint working and is consistent with an international framework of convergence on regulation will probably be key.

**Douglas Flint:** I completely agree. The great thing about equivalence for the UK is that we start off on day one as equivalent because we have EU law. The challenge then is the process to agree that equivalence remains, and whether it is absolute equivalence or you get an equivalent outcome from slightly different regulation. Are you a follower of someone else who says, “You have to be equivalent to us and therefore if we change, you have to change”? It is quite challenging to see what the arrangements would be in order to adjudicate on continuing equivalence and whether a business model could accommodate the risk of someone saying, “Sorry, I do not think that you are equivalent anymore.” That would mean that you are out of business. It is a challenging concept without some line of sight on how changes would be accommodated, negotiated and agreed.

**Earl of Lindsay:** So if equivalence as a means of maintaining access for UK-based financial services in the European markets is not the most satisfactory or desirable pathway to go down in terms of the disciplines and constraints it might introduce, how else do you think that the access could be negotiated or created to provide some certainty going forward for the UK financial services sector?

**Elizabeth Corley:** Obviously this is something that from a regulatory and public authority point of view should be front and centre of the thinking. However, from the practitioner point of view, there is no doubt that the United Kingdom has in many instances worked very co-operatively with the rest of Europe on raising standards of regulation and supervision. We have been very influential on many of the financial services regulations. That in turn has helped Europe to have a degree more influence and status in global discussions around regulatory convergence. It would seem to be very sensible for both sides to view this not as a tit-for-tat negotiation but more about how to continue on the pathway that has been set out for the past eight years of raising standards, improving market stability and protecting customers without it becoming a political counter. This goes to the heart of looking after clients’ interests. I do not know how the process will work, but as a pure practitioner I would love to feel that certain elements are viewed more in terms of market stability and consumer protection than they are as political counters in part of the negotiation.

**Alex Wilmot-Sitwell:** I think that equivalency can work, but it would need to be a different form of equivalency from what currently exists. That is because in its current form it can be withdrawn at very short notice, which does not give anyone the ability to look forward or to have any long-term confidence that it would remain. Some form of equivalence regime potentially could work, but it needs to go hand in hand with some
form of shared regulatory response and harmonisation. That can be achieved, but it will take time and will require a lot of thought. This again goes back to a point I made earlier, which is that equivalency is quite possibly the right framework to be thinking about, but it needs to be long term and must be embedded and aligned with a harmonised approach to regulation. By the way, that is also achievable in the context of regulators from the UK and the EU that have worked completely hand in glove. We are equivalent today. We start this process being completely equivalent, so we are starting with the right perspective and from the right departure point. Equivalency is a regime that could possibly work, but as I say, it needs to be aligned with regulatory harmonisation and to be thought through on a long-term basis.

**The Chairman**: Do you take comfort from the Trade in Services Agreement for 23 member states? It is the new agreement that has been negotiated. Are you optimistic about it?

**Alex Wilmot-Sitwell**: I cannot comment; I do not know the details of the agreement so I would not want to jump into an area that I do not know.

**The Chairman**: Do either of the others know anything about it?

**Elizabeth Corley**: No, I am afraid not.

**Q23**

**Lord Desai**: One merit of a place like London is that you can always find new markets. The Brexisters are asking us why we should get stuck in the EU area. Is there any scope for the City to go into non-EU markets?

**Elizabeth Corley**: We may be the wrong people to ask because we are already global firms. I am sure that there are many opportunities given the reputation of the United Kingdom for its regulatory and legislative basis as well as the innovations that are happening here in fintech and other areas. I am absolutely sure that there are markets that have yet to be opened up. Purely in asset management we tend to roam the global stage already. Here in the United Kingdom, two-fifths of our asset management activity is for international clients, half of whom are in Europe and half elsewhere. I am sure that it will grow, but one thing that will help it is a better line of sight on what the transitional arrangements will be and on the process for getting us from A to B and then to the ultimate destination. It is a very competitive world and the more certainty we can give to our clients, the better that will improve our competitiveness.

**Douglas Flint**: We are already subject to global roles. We absolutely agree that there can be no backtracking on the very high standards that have been put in place; the UK is clear on that. There is no desire to loosen and lessen the regulatory. If anything, one wants to make it even more internationally respected in order to retain business in the ecosystem. There may be bits and pieces we can do where the EU is unable to agree a deal with a foreign country that the UK might have less concern about, but for the major firms the regulation that we face and the standards we apply are global rather than regional or national.

**Alex Wilmot-Sitwell**: I am definitely the wrong person to ask because as the head of a global firm we look at the business on a global basis.
Allianz Global Investors, Bank of America Merrill Lynch and HSBC – Oral evidence (QQ18-26)

This is one of the big challenges that Europe faces. We are competing with other global markets, so creating and maintaining market efficiency, capacity and attractiveness are obviously critical. Whether it is in the UK or the EU, we operate close together. We are competing with Shanghai, New York and other big centres of commerce, although within our industry it is primarily those two centres. Business can move very easily if the framework for doing business becomes more expensive or less attractive.

**Douglas Flint:** We should not lose sight of the fact that over the last 40 years we have attracted many international firms into the ecosystem that has been built up by offering them not only fantastic rule of law and access to the cluster, but also access to the European markets. The Japanese among others are very cogently around. We have built up our infrastructure in the UK because it has given us access as well. There is a flipside to the question of whether other markets are more available because we have brought people in on the basis of giving them access to a bigger market than may be available in the future.

**The Chairman:** Am I correct in inferring that the regulatory fragmentation that will come out of this is not something that you would welcome? Do you see it as a challenge even though it might improve the competitive environment for some players in the marketplace?

**Elizabeth Corley:** For the international and wholesale markets, that is undoubtedly true. Douglas is better placed to talk about this, but where there is potentially some scope is in purely domestic opportunities and in retail. One could argue that a one-size-fits-all approach could possibly be rethought. But internationally and for wholesale reasons, we are going to be dependent on international standards.

**Douglas Flint:** It is possible that there is an opportunity at the middle and lower level of financial firms which are purely domestic. The one size fits all of international regulation which is articulated through European directives could be moderated for challenger banks and smaller institutions to improve competition. It is something that I am sure people will look at, and it could be a good thing. But at the wholesale level, as we have all said, we are subject to global standards and global rules.

**Q24 Lord Haskins:** We have come to the nub of the thing. David Davis MP is coming this afternoon to talk to Cross-Benchers. One thing that we know is that we will learn nothing from him. He has explicitly said that everything will be done confidentially and Parliament will not be aware of what is happening. But we must try. Despite knowing nothing, we are getting the feeling that the Norwegian option is not on the table and that the Swiss option is not on the table. In the view of Lord Lawson, Mr Fox and Patrick Minford, there is the WTO option of just walking away and everything will be okay. But we come back to the bespoke deal, which is almost a clean-sheet-of-paper approach. It seems that a tension is developing between the political aspirations on the one hand and the economic realities on the other. At the end of it, how will it work out? What sort of deal will be remotely acceptable to the financial services? I should add that my background is in Yorkshire manufacturing. I am very concerned that the manufacturing problems take second place to the
problems of the financial services and that there may be a deal where Minford would say, “Let manufacturing go to hell and we’ll let the financial services run”. You probably will not say anything about it, but how is that all going to work through?

Elizabeth Corley: The challenge that we face is that trade deals for services are a substantially underdeveloped area globally. There is no WTO option for services. I do not think that it detracts from the importance of trade deals. The challenge is that there is a clean sheet of paper on how one would do a services negotiation. Given the United Kingdom’s location as a centre for a huge amount of financial services, we probably have no choice but to think about it carefully. This is again practitioner naivety, but one would hope that certain elements of financial stability, such as capital flowing round the world and looking after customers, are not viewed as tokens and do not get in the way of the more substantial conversations about manufacturing and other areas. One would hope that they could somehow be dealt with in a way that reflects the importance of capital markets to our jobs and growth. But that is me being very logical and practical and I completely understand that that is why I would never make a politician. I could not argue it fully.

Douglas Flint: You explained the uncertainty very well. In and of itself, it is another challenge. Firms today, particularly international firms based in London, are faced with the challenge that in two, three or however many years’ time the UK could have left the European Union and they will have to make a decision as to how they configure themselves to be able to do what they need to do for their customers at that point of exit. That means that, in an ideal world, they need two pieces of information: where are the Government aiming to get to in their fresh relationship with Europe and what is the bridge arrangement between leaving and getting to that arrangement—how long will it be and what will it encompass? Without knowing where you are trying to get to and what happens from the point of exit to that point, if anything, how do you make a decision? Given the time that it would take to establish a different model and to set up subsidiaries or branches elsewhere or to repatriate activities back to your home location, these things need to be known sooner rather than later. It is taking us three years to move 1,000 people to Birmingham. Contemplating as a firm moving any number of people outside your own country, setting up arrangements and getting licensed is a non-trivial task.

Alex Wilmot-Sitwell: The bridge to the ultimate destination is absolutely fundamental. If that bridge is not long enough or, indeed, if it is not even built in time, it is impossible to make that journey without incurring huge risks and harm to the participants. That does not mean us; it means the markets and our clients. These are very complex processes. Migrating huge businesses from one jurisdiction to another requires an enormous amount of work. It requires a huge amount of regulatory approvals; it requires an enormous amount of co-ordination with other participants, clients, counterparties and clearing houses. That process is very dangerous; it is fraught with risks. The materials that are being moved are risky. You do not move nuclear waste in a race; you do it in a carefully co-ordinated and managed process. The materials are perfectly safe so long as they are properly handled and the period of time in which...
to move them is suitable. So the bridge—both the building of it and its length—is critically important. An important factor in this process goes back to your point: we are probably not going to know the destination for some time. There is clearly a lot of uncertainty and a lack of clarity in that approach and it is quite clear that the Government are not going to let us know the destination until they are ready. But then we have to be careful that, once the approach and the destination are understood, the time for completing the journey is long enough. That transitioning period is critical.

Q25  **The Chairman**: That bridge analogy is quite compelling. From where you sit, looking at your own sectors but also at the UK interest—it is in your interest that the UK should do well, as your business is located in the UK—what sort of transitional arrangements would you wish to see? You must have given quite a lot of thought to planning for that. How do you see the architecture of that bridge, Mr Wilmot-Sitwell?

**Alex Wilmot-Sitwell**: It is difficult to be definitive at this stage because this will obviously depend on the detail of the outcome, but it is multiyear. The danger of this potential two-year window from the point of triggering Article 50 to the point of completing negotiations and implementing the outcome is that it is simply not long enough. If you wind the clock 24 months from a period probably in the first part of next year, we need to start those plans now, because the process is multiyear. That is the danger. It has to be a multiyear process from whenever the point of destination is understood if it is going to be completed safely, done in a way that will not risk financial instability and done in a highly co-ordinated fashion. It is a multiyear process, but it is difficult to be precise, because the devil is in the detail.

**The Chairman**: But once negotiations are concluded and we know what they are, you would like to see a reasonable period—would you like to put a figure on it?—for transitional arrangements on both sides to bed in.

**Alex Wilmot-Sitwell**: Yes, I would. I suspect the period is two to three years.

**Elizabeth Corley**: Perhaps I could add that it is a bridge but it is a bridge with spans, as we have periods of transition. We have from now until we trigger Article 50. We then have the period during the process of negotiation. We then have the concluded negotiation and a transition to the end state. So we have spans on this bridge and multiple transition periods. Alex is absolutely right. It is very complicated and you cannot detail it, but one theme will clearly be around continuity of service and continuity of risk management and controls. That is vital. What does it take to be able to continue to service clients in a way that gives you risk management and controls? That, for me, would be the first test. In the second span of the bridge, we are talking about passporting, future business growth and growing from the status quo, but the first part of the bridge has to be around looking after client interests so that they are not harmed or fractured.

**The Chairman**: I was more interested in the end state. How long do you think you need between when you know what is on offer and the end state?
Douglas Flint: This is going to be the big challenge. Defining and agreeing at the point of departure with our European partners where we all think we are trying to get to will dictate how long the bridge is. How long will it take to set up infrastructure somewhere else and to license the institutions to do business in a different way? Transitioning the licensing, the supervision and the regulation of an ecosystem that today exists in one place and is regulated and supervised by the regulatory authorities of the UK to somewhere else, piecemeal or in whatever way, is an enormous task. Likewise, the UK will have to relicense the 76 European institutions that are here. The more ambitious people are about taking things away from where they are today, the longer the bridge will be because it will take a very long time to build it. If we go to our clients and say that we will not know for seven years or whatever what it is going to look like, they will say, “Well, good luck. We’ll go somewhere where we can do it all today because we can’t run our business by waiting to see what it looks like in that period of time”. So there is a trade-off, which I think will be a political discussion.

Lord Haskins: In a way, is that not a strength for the British negotiation? We can say to the other parts of Europe, “Don’t rush this because it’s not in your interests to rush it”. Mr Juncker made some rather emotive comments yesterday about wanting this all to be tied up very quickly. It is very important to get the pace of this agreed but we do not even have that. If the pace were agreed, we could start dealing with it, and I think that that has to be done.

Elizabeth Corley: That is a very good point. Is it one race that we are running or are there multiple races? Certain parts could perhaps be done more quickly than others. Certainly, it is not just about our own competence in relicensing. If things moved into the European jurisdiction for regulatory purposes, there would be a need to build up regulatory and supervisory resources, which, in turn, would also take time.

Douglas Flint: There is an analogy that I like to make. Everyone talks about financial services being difficult and automobiles being easy, but automobiles are sold on a finance basis. You do not sell a bit of metal; you sell a financial contract which is secured by cars. So the auto manufacturers of Europe and the heavy equipment manufacturers are all going to require financial service access to the UK. There is a huge mutuality of interest in preserving access to finance to make the underlying business work.

Earl of Lindsay: I want to ask a question flowing on from that. Clearly the design of the endpoint will be critical for you—the design of the bridge and the spans within that bridge. I assume that that design being based on the realities of your sector, rather than on the politics that are flowing around the whole Brexit agenda, will be a key issue. You were somewhat reticent earlier when you were asked whether you were engaging directly with the senior Minister and officials involved. You rather sidestepped that question, saying, I think, that you rather hoped that your clients were doing that. Are you confident that in this process there will be the right quantity and quality of dialogue between the financial services sector and the Ministers and officials who will be taking forward the negotiations? Do you already have reason to believe that that dialogue will be there and
that you will be listened to, or are you yet to be convinced that that opportunity will be properly created?

**Elizabeth Corley:** I would say that we have no reason not to believe that. I think there is a genuine recognition that this is a very important part of the economy—both directly and what it supports. These are very early days but—again, perhaps I am looking naive and optimistic—there is no reason not to believe that that should be the case.

**Douglas Flint:** I think that our role is not to lobby but to inform. We have had very good engagement so far in helping us to understand what the implications are. I think that that is our role. We have set up a number of groups that have interfaced with the political system to make it aware of the issues that are on our mind. It is going to be a political challenge to accommodate them all against all the competing interests but I think that our job is to inform.

**Alex Wilmot-Sitwell:** I agree. I would also point out that the industry as a whole is working together closely to try to create an environment of providing good information and access to advice. It is very important that we continue to work together, despite the fact that we all have slightly differing business models and interests.

**Lord Butler of Brockwell:** Do you have any confidence that similar links are in place on the other side of the channel?

**Douglas Flint:** Yes, they are.

**The Chairman:** That concludes today’s first public evidence session. The Committee will now adjourn for a few moments while we bring in the second panel. Again, I thank you, Ms Elizabeth Corley, Mr Douglas Flint and Mr Wilmot-Sitwell, for giving us your time today. Thank you.
The House of Lords EU Financial Affairs Sub-Committee, chaired by Baroness Falkner of Margravine, has decided to conduct a short inquiry exploring the future of financial services in the UK following the vote to leave the European Union.

In this inquiry the Sub-Committee is seeking, against the backdrop of Brexit, to identify the key UK interests in financial services, and to explore the opportunities and constraints that will affect the Government’s ability to secure those interests in negotiating the UK’s future relationship with the EU.

The Sub-Committee will conduct a small number of oral evidence sessions, and is soliciting written evidence from selected witnesses. This written evidence is sought by 12 October 2016. The Committee seeks evidence on any or all of the following questions:

Following the EU referendum on 23 June 2016, in which the United Kingdom voted to leave the European Union (i.e. “Brexit”), the AFB formulated a position statement which highlighted what the Association felt were the key issues of the foreign banking sector in the UK in respect of Brexit.

The statement also included a number of questions, effectively a short survey, designed to gauge the sentiment of foreign banks on the key issues and it was distributed to the membership for their comments. The AFB’s position statement and the feedback received from AFB members, which has been anonymised, is attached separately to this written evidence for the reader’s reference.

The AFB’s position statement and anonymised feedback from its membership was, separately, submitted to the House of Lords EU Financial Affairs Sub-Committee on 9 September 2016. The AFB’s responses to the questions, below, will draw heavily from the feedback its members shared in response to the AFB’s position statement over the course of August 2016.

1. What are the main concerns of foreign banks when considering the possible effects of Brexit?

From the AFB’s survey of its membership, undertaken in August 2016, it would appear that the concerns from the possible effects of Brexit are:

- Loss of Passporting;
- Business Confidence; and
- Political Stability in the EU

Across all firms and structures, the issue of Immigration is important for the substantial population of EU nationals working in foreign banks within the UK. In the immediate aftermath of the Brexit vote, respondents to the survey reported significant concerns from their EU staff members over their residence rights and ability to work in the UK going forward. Firms have issued supportive communications to staff and feel, broadly, it is unlikely there will be any immediate effects on recruitment levels.
Furthermore, there is a general apprehension over the plans of corporates following the Brexit outcome. Given that most foreign banks in the UK follow the international business needs of their corporate clients, many originally from their home state, there is a possibility that retrenchment by foreign manufacturers, service providers etc. will drive a similar retreat in the foreign banks that support their financing needs. Anecdotal evidence would suggest that foreign banks are surveying the tentative plans of their clients into their own post-Brexit strategy.

HM Government’s strategy towards subsidies and other forms of support for large-scale project finance deals will also factor into the strategy of some member banks that provide financing in this sector. Project finance is a very capital intensive form of banking, by its very nature requiring significant assurances for foreign banks to agree on long-term commitments.

Assessing the feedback from member banks by geography (EEA domiciled banks vs. Non-EEA domiciled banks in the UK) and by structure (branches vs. UK-incorporated subsidiaries), the response would suggest that concerns in the sector can be categorised as follows:

UK branches of EEA banks

- Respondents’ most critical issue is passporting. This is material for the vast majority of wholesale banks, but most acute for the small numbers of retail banks in which the loss of passporting may completely disrupt their current business model.
- The key concern centered on whether branches will be required to capitalise as standalone UK banks, costing firms a substantial amount of resources.
- The AFB recognizes, however, that such a requirement would very likely apply if the PRA felt that a firm engaged in Critical Economic Functions connected with the UK’s real economy (for example, retail and SME banking).

UK branches of non-EEA banks

- For most respondents to the survey, it would appear that passporting is not a central issue.
- Some respondents felt that the sudden depreciation in Sterling was good for business, as overseas demand for UK property increased following the vote.
- The AFB noted that such depreciation could also potentially cause some challenges for financial reporting, notably capital reporting, given the negative impact it could have on capital ratios, and subsequent budgetary issues.
- Respondents also expressed concern over the potential loss of London as a major global financial centre, especially because many non-European firms base their European hubs in London as a “bridge head” into the rest of Europe.

UK Incorporated Subsidiaries of overseas banks
• For respondents, passporting was not fundamentally a key issue for their business, as responses suggest that they mainly service the UK needs of customers from their home state.
• Like branches of non-EEA banks, respondents have been affected by the depreciation in Sterling; however, some firms have reported an uptake in demand for commercial property in the UK as a result.
• Respondents also flagged the amount of investment they felt was still being held back following the vote’s outcome. They saw that there is still much demand in the economy, but firms and consumers are holding back on expenditure until greater clarity emerges on the Government’s plans for Brexit.

2. What types of issues or legal adjustments are being discussed or may be necessary for foreign banks should the UK lose access to the single market?

The central issue of Access to the Single Market has, according to responses to the AFB’s survey, impacted foreign firms differently based on their structure in the UK and business activities and, therefore, likely to drive different planning processes in readiness for Brexit. Segmenting feedback by geography and structure, we have the following views from respondents:

UK branches of EEA banks
• Passporting into the UK is essential for business and EU citizens working in firms
• UK presence for Euro clearing business, however, is not a necessity, as it can move to other Member States

UK branches of non-EEA banks
• Mixed view on passporting - for some respondents it’s important, but for many others it’s either inapplicable or immaterial as the group already has a footprint in EU member states, i.e. can transfer activities, including Euro clearing, into other EU entities already in existence within the banking group

UK Incorporated Subsidiaries of overseas banks
• Generally, passporting and location of Euro clearing does not seem to have a significant impact; it’s either inapplicable to the business model (minimal exposure to EU market) or alternative options are being considered to maintain permissions, e.g. acquiring an EU entity to continue business with European clients following Brexit

3. Where do the priorities of foreign banks based in the UK align and where do interests diverge?

Where priorities align
• Immigration for EU nationals working in the financial services sector
• Continuing “business as usual” until further clarity emerges on HM
  Government’s plans for Brexit
• Contingency planning for the continuation (or discontinuation) of
  activities post-Brexit in the UK

Where priorities diverge

• Larger firms would prioritise continuity of investment activity without
  the need for subsidiaries to be established across the EU, hence Article
  46 of MiFIR is of critical importance; smaller firms, particularly UK-
  incorporated subsidiaries, would prioritise stability in Sterling given its
  impact on their capital requirements (e.g. Large Exposures and Net
  Stable Funding Ratios)
• EEA firms in the UK would prioritise their ability to remain as a branch
  of their parent bank (i.e. avoid subsidiarisation if the UK becomes a
  Third Country); whereas Non-EEA firms are most concerned with the
  potential loss of London as a major financial centre and/or a magnet for
  wealthy foreigners.
• Market volatility - EEA firms that responded have managed currency
  volatility without significant issue and, therefore, it is not a priority for
  their business; however, Non-EEA firms have expressed mixed
  outcomes on their business activities from Sterling’s volatility and,
  particularly UK-incorporated subsidiaries which almost wholly have Non-
  EEA parent groups, have prioritised it following its impact on their
  regulatory requirements.

4. How important is a foreign bank’s legal and organisational structure when
   evaluating how Brexit may affect it? What are the legal, operational and
   regulatory differences associated with branches and subsidiaries for
   financial firms operating in and outside of the EU?

From responses to the AFB’s survey, it would appear that the legal and
organisational structure for UK branches of EEA firms is of critical
importance for their operations as they passport into the UK from their
home state in the EEA. The potential loss of this passporting right into the
UK would have a substantial impact on their business model, particularly
for a number of EEA firms that engage in retail activities as a branch of
their parent bank, as the alternative could potentially require
subsidiarisation to become a standalone bank with its own, separate,
capital and liquidity to continue operations in the UK. Where such firms do
not engage in Critical Economic Functions, it is hoped that UK branches of
EEA firms would not need to subsidiarise.

Non-EEA firms, either present in the UK as a branch or a UK-incorporated
subsidiary of their parent bank, may typically have offices in other EU
member states and use the UK entity as a hub for European operations
(and usually Middle East and African operations, i.e. EMEA). Non-EEA firms
with a branch in the UK often have a UK-incorporated subsidiary of the
parent operating alongside it - this may be used as a booking entity
and/or a vehicle to passport into other Member States from the UK. Therefore, current discussions about contingency planning will very likely include exploration of what processes may be involved in moving certain operations out of the UK and into other European offices to maintain access to the Single Market.

While the focus of Brexit has been on banks resident in the UK, post-Brexit strategies will undoubtedly have an impact on group entities across the remaining Member States, e.g. a Non-EEA bank may have a branch and UK-incorporated subsidiary in the UK, as well as a Dutch-incorporated entity in the Netherlands whereby transactions may move between entities for tax purposes - Brexit could potentially render some aspects of the group structure across the EEA less useful.

5. What factors determine the importance of the EU financial services ‘passport’ for the business model of foreign banks?

Norton Rose Fulbright LLP, which engages with the AFB’s Compliance Committee, has produced a helpful analysis of Passporting which the AFB has already shared with HM Treasury (specific contact is Katharine Braddick) and is attached separately to this written evidence.

The key factors which determine the importance of the EU financial services passport for foreign banks are:
- Origin - EEA domiciled firms use the passport to come into the UK; Non-EEA domiciled firms based in the UK typically use the passport to enter other Member States (the UK being their bridge head into 27 other nations);
- Business activities - the passport would be vital for cross-border regulated activities (and the appended analysis from Norton Rose Fulbright helps clarify this);

6. What complications, if any, could arise for foreign banks should euro denominated trading and clearing activities relocate from the UK? Would a relocation of these services disrupt the market chain of activities in the UK and the rest of the EU?

Respondents to the survey did report that transfer of activities, such as Euro clearing, could move into other Member States without significant issues where the banking group already had a presence in other states.

7. What key arrangements need to be preserved so that market infrastructure providers (e.g CCPs or trading venues) in the UK can continue to provide their services to foreign banks and their clients?

Timely and transparent equivalence determinations, together with clear plans for which entities, venues or infrastructure providers are working towards equivalence, would be very useful. For our comments on how the various equivalence regimes have largely failed to deliver to date, please see our response to Q10 below.
For both existing rules and incoming rules, the ability to do the following (non-exhaustive and illustrative list) is vital:

(a) Submit reports to trade repositories (EMIR);
(b) Clear prescribed OTC derivatives via approved CCPs (EMIR);
(c) Trade prescribed instruments on EU trading venues or equivalent third country venues (MiFID II); and
(d) Refer to LIBOR and other UK based benchmarks in agreements (Benchmarks Regulation)

UK-based institutions will need to have access to EU or EU-equivalent venues/services providers who can provide all of the above or face not being able to service European or multinational clients. While institutions have European service provider options should they be forced to move away from UK-based infrastructure providers, this would be very disruptive and costly for no apparent market or client benefit.

8. What transitional arrangements, if any, will be needed to provide regulatory stability and certainty to financial services and markets, in the period between the UK’s withdrawal and confirmation of its future relationship with the EU?

US banks have commented that a longer transition period would be required to help adjust operations following the changes that, potentially, Brexit could have on access to the single market through offices in the UK.

9. For the purposes of equivalence, is it in the UK’s best interest to keep the majority of EU laws intact over the short to medium term?

From the perspective of the financial services industry, EU financial services laws should certainly remain intact for now. Any selective (e.g. remuneration rules) or wholesale (e.g. of AIFMD) repeals should only be contemplated once the Brexit dust has started to settle. Further uncertainty would be highly undesirable.

In addition, not to maintain EU laws over the medium term would create additional work for institutions already grappling with a huge volume of regulatory change. Given that UK institutions are familiar with the EU regimes and have invested heavily in project teams to ensure compliance, there would seem to be very little justification to move away from EU and EU-based regimes in the short/medium terms.

10. What is your assessment of the EU’s regulatory equivalence regime? What operational intricacies are involved in the EU’s assessment of a third country’s supervisory and enforcement regime? What lessons can the UK learn from non-EU countries that have met or have failed the EU’s regulatory ‘equivalence’ provisions?

From experience of engaging with the European Commission on the subject of CRR equivalence for a number of nations represented in the AFB’s membership, it would appear the equivalence process is opaque and difficult to forecast as to which nations and infrastructure providers may
soon become equivalent. Due to the “outcomes based” equivalence regime, regimes which on the face of it appear to bear little resemblance to the EU regime in question (e.g. Japan in some cases) have nevertheless been determined to be ‘equivalent’.

The AFB would welcome any support from HMT and the Government to ensure that the equivalence regimes (across multiple pieces of EU legislation) start to work better. That so few equivalence determinations have been made would suggest that there has been little impetus to grant jurisdictions and service providers equivalent status. Brexit changes all of this. As part of the withdrawal agreement to be negotiated, we would strongly encourage HMT to seek to secure a commitment to a ‘fast track’ process for determining equivalence of UK market infrastructure providers. Indeed, on paper, we believe UK institutions are ‘equivalent’, and that to delay UK equivalence determinations would seem to be unjustifiable from a legal perspective.

1 November 2016
Evidence Session No. 6  Heard in Public  Questions 48 – 56

Wednesday 12 October 2016

Members present: Baroness Falkner of Margravine (The Chairman); Lord Butler of Brockwell; Lord Callanan; Lord De Mauley; Lord Desai; Lord Haskins; Earl of Lindsay; Lord Shutt of Greetland; Lord Skidelsky; Lord Woolmer of Leeds.

Examination of witnesses

Huw Evans, Director General, Association of British Insurers, Stefan Hoffmann, Head of European Affairs, Swiss Bankers’ Association and Miles Celic, Chief Executive, TheCityUK.

Q48  The Chairman: I welcome our second set of witnesses, Huw Evans, Stefan Hoffmann, and Miles Celic. You are very welcome to our inquiry into the implications of Brexit on financial services. I have to go through some administrative points. You have a list of interests that have been declared by Committee members. This is a formal evidence-taking session of the Committee and a full transcript will be taken. It will be put on the public record in printed form and on the parliamentary website. You will be sent a copy of the transcript and you will be able to revise minor errors. The session is on the record. It is being webcast and broadcast live and will be subsequently accessible via the parliamentary website.

Some of you were in the room while we were speaking to Sir Jon Cunliffe and will have heard his responses. We touched on bespoke agreements, because the indications from the Prime Minister last week are that immigration is a serious consideration and therefore a single market with full freedom of movement of people will probably not be a runner. In light of that, there seems to be a tendency to say that the UK will not fit any of the existing arrangements and that we should go for something bespoke to the UK. Briefly, in that kind of arrangement what would it be important to preserve in the UK’s financial sector from where you sit, and would there be any protectionist measures that could harm cross-border access—the stuff you do not want to see as well as the stuff you want to see? Could we kick off with you, Mr Evans?

Huw Evans: Certainly. We would accept the assumption that the announcements made by the Prime Minister and other Ministers last week point to the need for a bespoke trade agreement, and therefore the need for quite considerable transitional arrangements, which Sir Jon referred to. There is no easy model to look at, not least because no country has
left the European Union before, but, in brief, we consider that important aspects to look at would be: to preserve some form of access to the single market, but with it an understanding of how you would arbitrate disputes, given that that is the current role of the ECJ; something which preserved a high level of agreement around how regulatory frameworks would work, including from the insurance and long-term savings industry, it being absolutely critical that the UK has a say in ensuring that those regulatory frameworks are appropriate for the UK market, which is the largest in Europe; measures relating to access to labour, in particular the skilled labour market for the insurance industry; and a means of having equivalence of agreement on the use of data. Data is absolutely critical to the insurance and long-term savings industry. It is not the most glamorous industry, but given how the current data framework is entirely driven by the EU, and indeed has been in the process of being revised over recent years, it is a critical area for any future bespoke deal for the UK insurance and long-term savings sector.

**The Chairman:** Mr Hoffmann, what would you say from the Swiss Bankers’ Association?

**Stefan Hoffmann:** In our assessment, once the UK has exited, is out, the EU equivalence rules will probably be applicable¹, but probably that will not be enough for a bespoke arrangement. You could try to arrange a sort of EU equivalence and, on top of that, at least part of EU passporting². It is probably not realistic to say there would be the full passport rights that you enjoy at the moment, but I think it would be feasible to negotiate at least partially the passport rights that are in place at the moment, because there are certain passport rights that are applicable to third countries in the EU.

**The Chairman:** As in MiFID.

**Stefan Hoffmann:** As in MiFID yes³. That could be a way to reach a position between EU equivalence for general third-country applicability and EU passporting, which is in most cases restricted to member states, but there is a wide range in between. That is something you could try to negotiate in a bespoke arrangement.

**The Chairman:** Mr Celic.

**Miles Celic:** I agree that I do not think any of the existing models or networks of agreements would fit the UK, but equally there is no template, as has been said, for leaving the EU. The Norwegian model is different from the Swiss model and is different from the relations that exist with Turkey and so on. By necessity, there would have to be some form of bespoke British model that reflected the close and integrated

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¹ Note by witness: The rules would be equivalent for the time being (deviating future UK law could however jeopardise equivalence).

² Note by witness: e.g. mutual recognition-based market access rights in areas currently covered by passporting.

³ Note by witness: more precisely, in the associated EU regulation MiFIR (for professional clients).
nature of our relationship economically—beyond economically—with the European Union. That is particularly the case in financial services.

I very much agree with what my colleagues have already said. I will briefly set out a number of principles that TheCityUK has identified for the final shape of any relationship: the process needs to deliver clarity and stability during that time; it needs to be done in an orderly and cordial manner; the relationship and the talks need to begin in a manner that very much has in mind the end state of where we want the relationship to be; we need to defend the pre-eminent position of UK financial and related professional services as an asset not just for the UK but for the European Union—we represent 40% of the capital markets in the European Union, so this is a European asset and has been for a time that predates the European Union; and when we map out the exit, it needs to retain access that is as close as possible to the current situation and safeguards the future relationships that we have talked about, such as similar trading conditions and preserving the ecosystem.

There are two items that are more UK-specific. One is that we move quickly to design and implement an independent UK trade and investment policy, which bolsters pre-existing links but builds on the new ones that we will build in the years ahead, and a deeper relationship between government, the regulators and the industry. If you look at the major public policy challenges that the UK faces, and indeed that many other developed and developing economies face, over the next 20 years, financial services have a role to play in helping to address those and in enabling economic growth in other parts of the economy.

The Chairman: We will move to transitional arrangements and Lord Haskins.

Q49 Lord Haskins: Martin Wolf in today’s Financial Times says that a bespoke arrangement is not feasible to negotiate if the timetable the Government have set out is to be met; in other words, that the deed is going to be done in two and a half years’ time, and therefore one might have to face something more drastic at the moment. He would argue that it goes towards a WTO arrangement. Whatever happens, your industries have to face enormous degrees of uncertainty—uncertainty while the negotiations are taking place and, if a bespoke deal comes through, which I think we all hope will happen, the uncertainty that will arise between the time a deal is done and the time it is completed, which could take several years, perhaps less so in the insurance area than in other areas. What reactions or proposals would you like to put to government, to the banks, to the Bank of England, et cetera, to mitigate the damage that that uncertainty may cause to your businesses?

Miles Celic: As regards transitionals, it is difficult to say exactly where we are going to be, because it will depend on the nature of the final relationship and how it is negotiated. Sir Jon’s evidence, and that of some of your previous witnesses, used the analogy, which I think is quite apt, of a bridge that takes us from the end of the Article 50 process through to the final state of the relationship between the UK and the European Union. It is difficult to start building any bridge—to have a sense of how long it will take to build or how it is designed and developed—without
knowing, if I can labour the parallel a little, what the bank on the other side is like: is it firm ground, soft ground, how far is it and how fast is the river moving? Those are all engineering factors and there is a similarity in what we are looking for. Clearly, the value of having a worked-through, agreed and orderly transitional process is that you avoid what has been termed the cliff-edge effect and a discontinuity of service that is not in the interest of clients, customers, corporates and indeed the countries themselves. There is a variety of factors that I would put in, and I do not think there is an immediate answer that we could give at this stage. A lot will depend on how the shape of the negotiations works out over the coming months.

**Huw Evans:** The key challenge around transitionals is not to wait until the end of the two years to start talking about them. It has to be part of the conversation now, for the reasons that you outlined, if we are to avoid a position where we default to WTO and then have what could be a very long time to negotiate a decent, effective and mutually beneficial bespoke treaty, which would of course then have to be ratified and agreed by the 27 EU member states plus several Belgian Parliaments. Such a process is inevitably very time-consuming. It is important that the Government focus on transitionals from the beginning of their Article 50 negotiations, but, as Miles said, it is difficult to know where the end point is so early in the process.

There are a few general points for us. It is important that the timeframes are as generous as possible, for the reasons I outlined. As much clarity as we can muster on existing customer relationships would clearly help as well, as would clarity over the regulatory structure of the relationships and how jurisdiction matters would work during the period that the transitionals covered. All those are important components of a transitional package, but it is very difficult to be more precise at this stage about the order they should go in and how they should be calibrated.

You asked about mitigation, Lord Haskins. There are several areas that are worth considering for mitigating any impacts. The first is the ongoing regulatory environment. Notwithstanding the Bank’s correct focus on the fact that its first priority is financial stability, the signals it sends about how open it is and how much it wants businesses to come and set themselves up in the UK are important, as are the wider tools at the Government’s disposal for their tax framework; their welcome for talent from around the world; their general positioning around how much they want the UK—London, Edinburgh and the other significant parts of the UK in financial services—to have new business coming in, including from Europe; and the value they place publicly on their relationship with the states of the European Union. All those things have an impact in the signals they send to boardrooms considering what options they might take and whether they would still want to view the UK as an interesting and useful place to invest in people, businesses and products.

**The Chairman:** Mr Hoffmann, did you want to add to that?

**Stefan Hoffmann:** No, I do not think it is up to a Swiss to advise on transitional arrangements.

**The Chairman:** We will move directly to something that does concern
Lord Callanan: Mr Hoffmann, would you like to comment on the specific reaction of the major Swiss financial players to the outcome of the referendum? Then I have a question for Mr Evans: would you like to comment on the specific risks that you think the process offers to insurers?

Stefan Hoffmann: First, we do not have an overview of what each of our members is doing, but as far as we are informed there have been no decisions taken concerning the UK after the Brexit decision. The reason is simple. For the moment, there is just not enough secure information around. The transition has not started. Nothing is yet decided, so there is no ground for taking decisions, certainly not about relocation or anything like that. What is certain is that at the moment the process is being observed carefully and assessed constantly, but so far, to my knowledge and to our knowledge, no decisions have yet been taken. It will probably take quite some time before useful decisions can be taken, given that the process will be rather lengthy and complicated, as we all know. For the moment, there is not much to say on that. Of course, the range of comments is varied and broad. Some are concerned, and others are more enthusiastic about the future. You can hear all kinds of voices at the moment, but as far as decisions are concerned, none is known to me.

Huw Evans: I welcome the question about specific risks to the insurance sector, because it is sometimes easy for debates about financial services to be entirely refracted through the prism of our colleagues in the banking sector. There are a couple of points I would flag. Obviously, London is the insurance capital of the world and the UK is the largest market in the European Union, and indeed the fourth largest in the world, so we have a very wide and deep insurance and long-term savings sector. Therefore, to a certain extent, we have more to lose. It is none the less important to have some perspective, and, as was noted in the previous session, large sections of the UK insurance and long-term savings industry are entirely domestic and retail and are therefore relatively unaffected by Brexit. It is important to have that perspective. If I look across the ABI, which, as I say, covers a very widespread area, I see some members who are barely affected at all and others who are profoundly affected. Probably a better way to think about how it affects the insurance sector is that the parts that are affected are affected pretty significantly.

There are some very specific risks for the insurance sector that I would draw attention to. Probably the most relevant, particularly given the focus of the previous session, is that there is a much less well-developed international architecture for insurance than there is for banking. With banking, obviously, you have the Basel standards. With insurance, that framework does not really exist. A putative insurance capital standard is being developed by the IAIS, but it is at very early stages. It is not very UK friendly in the way it has been developed so far, and there are very significant challenges in how such a standard could ever be adopted, given the very different positions of the US and the European authorities, who have very different views about how insurance should be regulated and supervised. That is probably the single most significant issue. There is not the same international framework that you can fall back on in the way
that Sir Jon eloquently described for the banking sector. By extension, that has relevance to passporting, because if passporting is lost, either in whole or in part, there is not the same option to fall back on MiFID II, as has been described for some parts of the banking sector. The same framework is not there for insurance.

Another area I would flag, again, is data. Because data is so central to the insurance industry, it is absolutely critical that, however the future relationship with the EU is evolved, it is done on the basis of full equivalence with the European data regime. The new European data regulation will come into force in the UK in May 2018, and will then become part of British law; obviously we welcome the Great Repeal Bill announcement that it will therefore remain part of British law going forward. It is very important that data does not become a political football, with people saying that we should have a UK system just for the sake of it. That would cause very significant challenges for a wide range of insurance and long-term savings providers, including those who otherwise would not really be much affected by Brexit.

The Chairman: Lord Butler, do you want to come in on the passporting issue?

Q51 Lord Butler of Brockwell: May we pursue the issue of passports for a moment? Mr Evans has just mentioned that the loss of passporting would be serious for UK insurance companies. We know that a very large number of firms depend on passporting. How serious would the loss of passporting be for the companies that you know—Mr Evans referred to it in the case of the insurance industry—and to what extent is there a mutual interest such that EU companies will similarly want to retain passporting into the UK, and therefore the basis for a deal, perhaps after a transitional period maintaining the present passport arrangements? Can I ask for your comments on those aspects of passporting?

Miles Celic: Three things immediately strike me in response to that. The first is that the sort of ecosystem that we have depends on passporting, but it is more than just passporting. There is an important financial and related professional services ecosystem, and I agree with Huw’s point that sometimes insurance—I say this as a former insurer—gets a little forgotten. Sometimes we forget that there are about 1 million or so jobs in financial services, but there are about another 1 million in related professional services that rely on the financial services industry in the UK, so there are 2.2 million in total. Two-thirds of those are outside the M25.

Passporting is an important part of the way the industry and the ecosystem around the industry has evolved over recent years, but, as Sir Jon made clear, passporting is a complex set of relationships, directives and so on. There is more than just a single passport. One of the things that has characterised the debate since the referendum is the unpacking of some of these terms. I was very conscious that passporting was thrown around as a generic term, and I welcome the fact that it is now being looked at in slightly more detail. It is a case of going through those things and making sure that, where possible, we continue with them, and certainly that would be the consistent view among the members of TheCityUK, while recognising that many of the elements in passporting
are untried and untested and will need to be tracked and worked on very carefully both in the run-up to the UK’s departure and subsequently.

On your point about the importance of passporting in the EU, again it goes broader. The London and UK financial and related professional services sector is more than just a UK asset. We would argue very strongly that it is a strategic asset for the whole of Europe. It has an international centre—one of arguably only two genuinely international financial centres—off the channel, which has been a driver for European growth, for innovation. To give an example of what that means, a company in Düsseldorf may go to the local branch of their Sparkassen, or whatever, or they may go to Deutsche Bank or whoever, and ask for a loan or funding, however they choose to cut it, to extend their offices or to build a new production line, and as far as they are concerned that money comes from the bank at the end of the road. The likelihood, or a good possibility, is that a lot of that, if not all of it, is done in London and then goes back to the branch of the bank in Germany and then to the manufacturer. We would argue that, as the negotiations move forward, there needs to be recognition on both sides that the UK financial services sector is mutually beneficial to elements of both the UK and the EU27.

The Chairman: Mr Evans, do you want to add to that?

Huw Evans: Briefly. I agree with Miles. The honest answer is that we are still working it out because, as Sir Jon alluded to in the previous session, it is not something we have ever had to know before, or overanalyse. Even then I think there is a danger that, when figures are produced to try to give some estimate of the value of passporting, they are either rubbish as too low or viewed as not specific enough in what they can actually relate to. The wider ecosystem point is important, but it is worth noting that in Lloyd’s of London’s recent results its chief executive said that Lloyd’s viewed about 11% of its revenues as being at risk from the loss of passporting and a so-called hard Brexit. It may not sound that much, but Lloyd’s annual revenues are £27 billion, so it is 11% of a very big number. However, it is still worth emphasising that this is a very big deal for the firms it affects and does not have that big an impact on others. It is important not to generalise but to recognise how vital it is for the firms that are affected.

Finally, it is true that there is mutual benefit, but, as has been reflected on already, it comes back to the tension of whether economics or politics wins out at the end of the day. To go back to my earlier point, it reinforces the importance of our Government and our Parliament signalling to our continental partners that they value the reciprocity of the current relationships and the mutual economic benefit that goes forward. If negotiations begin in that spirit, it is more likely that we can preserve something of that kind, rather than perhaps implying, maybe inadvertently, that we view these things as of limited or no value to the UK or to our European partners. That is demonstrably not the case.

The Chairman: Mr Hoffmann, your clients are directly affected by this.

Stefan Hoffmann: Many global financial institutions have more than one passport under one roof, depending on the range of products they sell
and the countries they work in\(^4\) In general, one can say that passporting is a crucial cornerstone for the set-up of international global firms because it allows efficient and effective labour sharing; you specialise in one area and you are allowed to distribute that all over the EU. Without that, we could all—not only the UK but EU member states as well—lose potential benefits from the effective specialisation and labour sharing that is possible under the EU passporting regime. Efficiencies in capital allocation, netting, margming and risk management will get lost. We are all aware of that, but it comes back to policy versus economics, and that is the really tricky thing, I guess, but I am repeating what my colleagues have said. I would not add much more.

**The Chairman:** Lord Desai, do you want to come in on that point?

**Q52 Lord Desai:** From the numbers I have, UK firms have 60 passports per firm and the EU side comes in at three passports per firm, so there is a huge asymmetry in our interests in passporting. Do you think the Government recognise that and will in negotiations give proper importance to how much our interest is involved in this matter? It is not simple reciprocity. It is asymmetrical reciprocity.

**Miles Celic:** I cannot comment on the Government’s negotiating strategy at this stage. As I said, I certainly hope that they would look at the UK and London’s financial and related professional services sector as something that we can present as a point of constructive continued engagement with the European Union. Certainly from the conversations that I have had in Brussels—I have been there twice in the last three weeks—there is a real desire among the people I have spoken to in the Commission, the Council, the Parliament, the permanent representations and elsewhere to understand what all this means. There is a real sense in Brussels of information gathering. The word that kept coming up in the discussions that I had was pedagogical. They see this as a pedagogical exercise, the word they consistently used, so there is a real desire for them to grasp what the potential consequences are. What the Government then choose to do with that in negotiating terms is clearly a matter for them, but as I have said, and as I think my colleagues have said, there is an understanding that the politics of this is very important. It may or may not trump the economics, and I cannot comment on that, or indeed the processology, but if there is a sense of being able to grasp the economic prize that is on offer, if we get a mutually beneficial outcome, yes, passporting may play a part.

**The Chairman:** Can I take you back to what you said about the pedagogical exercise for your interlocutors in Brussels? Are they looking to you to provide them with information and evidence?

**Miles Celic:** They are looking for information and evidence from wherever they can get it that is credible, evidentially based and where a dialogue is possible. For instance, Sir Jon commented on the Oliver Wyman research that was released last week, and which we commissioned in order to provide exactly that kind of fact base. It is not a “lobbying” document; it

\(^4\) Note by witness: there are nine different passports that banks rely on in order to provide banking services to businesses and customers across the EU.
is a fact-based analysis of the various high to low access end points. There is a real desire and appetite, certainly that we have come across, to understand that.

Q53  **Lord De Mauley:** This is quite a broad question. What do you think UK financial businesses that currently benefit from full market access might be planning to do in its absence?

**Miles Celic:** A variety of work is under way, as Huw pointed out. People are trying to get a sense of what the outcomes are. As you would expect with any well-run business, scenarios are being run, and planning is under way to look at what might be done so that those companies can access and continue to access the European markets and have the European players continue to access the UK markets. It is difficult at this stage to point to a uniform approach that is being taken, but from the conversations I have had, there is certainly a great deal of thinking and planning under way about how that might be done. Some of it is through passporting, and other options will be looked at, including, as Sir Jon alluded to earlier, almost going back to the future—what was done previously. Has the regulatory and legislative environment changed in such a way that that is no longer possible? That is for the European element.

Clearly, as I have spoken about, there is an element of looking to other markets. A great deal of work has been done down the years on the way that UK financial and related professional services work with the well-known large markets in places such as the US, Japan, China, India and so on. We have started work at TheCityUK on how you build an independent trade and investment policy that drives activity in those markets and in other markets. I think it remains the case that six of the 10 fastest-growing economies of the world are in Africa. As Africa and other markets move up the development curve, there tends to be more of an expectation, more of a demand and more of an appetite for services and service-based trade. That is something we would certainly be looking at. That is not to say that companies are not already doing it. Some of the companies that have given evidence to you are examples of very successful British firms that sell globally already. We would be keen to see whether that is something we can do more of through the financial services sector.

**Lord De Mauley:** Sir Jon commented on the risks of people relocating and so on. Do you have anything to add to his views on that?

**Miles Celic:** No. He made the points on that very eloquently. As I said, companies are going through scenario planning; they are making their plans at the moment. I have no sense that companies are saying that they will relocate. It is important to get a sense of what relocation is because, again, it is one of those terms that is used in a reasonably generic way. It may be that you do not see companies lifting lock, stock and barrel and moving elsewhere. It may be, as Sir Jon talked about, that individual operations move elsewhere, or that if those operations no longer economically make sense they are no longer conducted. There is a planning process going on, but, as Mr Evans has alluded to, there is a
timescale within which certainty would be beneficial as regards whether or not any of those plans are triggered.

**Huw Evans:** That is where, although the quite speedy timescale on Article 50 that was announced last week in some respects points towards a harder Brexit, the greater certainty about where we end up may help businesses. Even if they do not like the outcome, they will at least be clearer on what that outcome is going to be—it is certainly clearer for us. Any board that is publicly listed has a considerable responsibility to examine all the options and to make considerable contingency plans. As Miles said, most businesses are doing so. Of course, these are not just businesses that are directly affected by passporting. They could just as easily be businesses that have significant EU subsidiaries that do not rely on passports to do businesses in those EU countries, but have to consider how the future development of EU regulations and directives will be affected without the UK in the room. That is an area we need to begin to think about more, particularly in financial services where, contrary to some of the wilder rhetoric of the Euroskeptics, the UK has always traditionally had the last word on financial services legislation in the EU. It is very important for firms that have significant EU operations to consider what that may look like five or 10 years down the line.

There are two other areas that I think are important for firms in that position, other than transitionals, which we have already talked about. The first relates to the early signals that are sent on talent and on access to labour. This is not an immaterial consideration across all parts of the economy, but certainly for the insurance and long-term savings sector it is something that comes up repeatedly from our CEOs. The other is of course what the authorisation procedures, processes and timings are in other countries in which firms may be exploring or putting in place contingency plans. Lots of names get bandied about, but it is easy not to look into the detail, and the fact is that those countries all have regulatory approval processes of their own. The Central Bank of Ireland was on record last week reminding people that there is no such thing as transferring a licence from the UK to Dublin; it is a new application that has to be done according to their rules and standards. Clearly, if they or any other regulatory body is inundated with too many applications, even if they are just on a contingency basis, it will significantly slow their ability to process them and do them properly. There are lots of considerations, once you go beneath the surface, that affect the ultimate question of what firms may do and on what timescale, but you are absolutely right to think that firms are actively considering this at the moment, and indeed it is their duty to do so.

**Stefan Hoffmann:** There is not much to add from me. We have quite a few Swiss companies active in London and they are all considering the situation, in the sense that they are part of a worldwide network. Of course they have their subsidiaries in the UK and they can profit from passporting, but they are setting up subsidiaries in other EU countries as well, to make sure that they can cover the EU as a whole. So far London has been a base for wholesale banking—asset management in particular, less for private banking and wealth management, as those areas are probably more likely to be served from Luxembourg or Frankfurt. London remains for asset management, and for investment banking in general,
the place to be. It is not European business; it is worldwide business, and London has the business for the Far East and for the Middle East as well. It is not centralised. It is not just a hub for Europe, and therefore we need to be careful not to be too alarmed. Not all of that business will vanish from London even with a bad Brexit, because London is a worldwide centre for a lot of businesses, and most of them will remain here to some degree, together with their experience and networks, such as auditing and law firms and so on. It is a whole network that plays together and it cannot be replicated easily somewhere else.

Q54 Lord Desai: We have been around this point. Do we know what would be the consequence of fragmentation? Have people done stress-testing on how much fragmentation could happen, given the uncertainty, and what would be the effect on the financial system?

Miles Celic: Work has been done and work is under way on that. There are two or three things that I would point to immediately. As has been talked about, one advantage of London is that you have everything in one place. It is a quite enviable hub compared with many other potential sites in Europe. It is very difficult to identify another individual smaller financial centre in Europe that has anything like the sort of advantages that London has. Indeed, in some sectors of the financial and related professional services industry, London has an even stronger advantage than somewhere like, say, New York. One example that I would pick is fintech. With fintech you have the creative centre in London, the regulatory centre in London, and the legislative centre, the funding centre and the tech centre in London. They are all in one place, whereas even in the United States they are spread in about two or three—arguably more—different locations. The netting effect that the ecosystem brings, the contextual effect, has been a dynamic and virtuous circle that has kept feeding itself. It has led to greater competition, greater innovation and reduced costs. The risk of fragmentation is that you reduce that. I happen to think that London, for some of the reasons I have already talked about, has a number of natural advantages that mean that there is, if you like, a floor below which it would be very difficult for London to go, but it will if it is handled badly. If we end up in a position that we would not seek to end up in, it will obviously have an effect on London and how that ecosystem continues to operate. It is not just London. London is one of the only two genuine international financial centres, but there is really valuable work going on in other parts of the UK that drives dynamism and economic investment and high-value jobs in places such as Edinburgh, Manchester, Leeds and Bristol, et cetera. Manchester is, I think, the second largest legal centre in the country and has significant fintech advantages, as does Bristol. Edinburgh is a huge centre for asset management. I would not simply think about it as London but rather as the advantage that London brings generally. There are fragmentation risks, but, equally, London has a number of natural advantages. That said, one thing we need to guard against is complacency. That goes back to the argument I have been making that we need to be able to sell this sector, this industry and what it does, as an advantage for Europe as well as just an advantage for the UK.
Huw Evans: It is right to take a balanced approach on fragmentation, as Miles has just done. From an insurance perspective, it is worth bearing in mind that for Lloyd’s of London in particular London is a marketplace. Clearly, you need buyers and sellers in any marketplace for it to succeed, and you need the mechanics of buying and selling to be straightforward. That is a particular challenge, which is why I think Lloyd’s and the market participants there have been so vocal. Otherwise, it is right to take a more balanced view, particularly from an insurance and long-term savings point of view. Most of our 330,000 employees across the whole of the industry and its supply chains, including its brokers, work outside London. Edinburgh is a very significant European centre for asset management and the life industry in its own right. Indeed, if you stick a pin in a map of most of the regional centres of the UK, you will find an insurer or long-term savings provider as a significant employer, not just the places Miles rattled off. I could rattle off another 10, but I will not. It is important to have that balanced perspective on the way in which the economic and social benefits of our insurance and long-term savings industry, the largest in Europe, are spread quite evenly across the UK as the market has developed over many years. It is right to have a more balanced view.

Also, there are—we may come to this—opportunities for the UK in leaving the European Union in international trade and the focus that the Government will now place, as they have already started to do, on concentrating much harder on opening up routes to India and China in particular. Those offer opportunities over the medium to long term for many leading UK insurance and long-term savings providers.

Lord Haskins: Is it fair to say that the insurance activities outside London for the most part are domestic and for the most part not too much affected by Brexit?

Huw Evans: Very broadly, yes, but it is not the case—I do not think you are implying it—that the only people working outside London in the insurance sector are doing processing work. You will find executives and significant bodies of high-skilled and important management activity taking place outside London, as reflects the history of the insurance industry. The biggest part of Aviva was the old Norwich Union, so, unsurprisingly, it is still largely based in and run from Norwich, and obviously many of the big financial institutions are headquartered in Edinburgh.

The Chairman: Mr Hoffmann, did you want to come in on that point? I assumed you would not.

Stefan Hoffmann: No, thank you.

The Chairman: Catch my eye whenever you want to come in with a particular perspective.

Q55 Earl of Lindsay: Can I ask the panel about their views on the EU’s equivalence regime? Sir Jon and some other witnesses pointed to the relatively greater significance that they see in global equivalence, which perhaps transcends the role of the EU equivalence regime. None the less, in the UK negotiations with the EU, a decision will have to be made as to whether or not participating in the EU equivalence regime is a good thing
or a bad thing. What are your views?

**Miles Celic:** The caveat always put on equivalence is that, certainly in the way it is looked at and judged, it can often be a political as much as a technical decision. It tends to be a static point in a dynamic environment; from recollection, this may be what Sir Jon said as well. You can be equivalent on a point and on a certain day but there is no guarantee, unless there is very close matching of regulatory environments, that you will be equivalent at a later point. There is also the risk of withdrawal of equivalence, which again is something that companies would be very conscious of. It might be interesting to follow the idea of mutual recognition. This is grounded in the idea of international standards and speaks to a really important thing for the future of this industry outside the European Union, which is that we do not follow some sort of regulatory fall in standards in an attempt either to arbitrage the system or to attract business from elsewhere and so on. Reflected in the conversations I have been having is a desire and an expectation for the highest standards, and that London and the UK are seen as centres of regulatory excellence, expertise and the highest standards, and that in itself will attract and retain business.

The other factor—I think we have skirted around it—is the idea of how influential the UK will be outside the European Union as regards the shape of regulation and directives and so on. Two points relate to what you are talking about. The first is that we have helped shape this environment. It is very much a British-shaped environment. I do not want to tread on Huw's toes, but Solvency II, for instance, was originally a British idea. Because we are Europe's financial centre, the expertise in a lot of these situations has come from British officials, the British Government and British regulators. There are a disproportionate number of British officials in the European supervisory authorities. When we talk to the negotiations, I would be very interested to see what we choose to do on that. This is by no means denigrating other parts of Europe, but we tend to be the intellectual powerhouse that produces a lot of the more forward thinking on regulation. I hope that we can get to a point, working with the other 27, where we design an equivalence regime that is better suited to the requirements of the UK and the opportunities that the UK industry can provide to Europe as its financial centre.

**Earl of Lindsay:** You are arguing, therefore, for a bespoke equivalence regime.

**Miles Celic:** Yes. I would argue that it would be in the interests of both the UK and the 27 that you have, effectively, a bespoke equivalence regime as part of a broader bespoke agreement.

**The Chairman:** That could be described as mutual recognition.

**Miles Celic:** It could be described in a number of ways. It could be called equivalence or anything else, but if you are going back to the basis of international standards, and if the UK adopts and encourages the highest standards, it is very difficult to see how you would not end up with a more positive and constructive starting point.

**Huw Evans:** Yes. This has to end up in a bespoke treaty. It cannot possibly be done based on the way in which the current equivalence
regimes work. They do not guarantee market access; they are political decisions; they are temporary and, of course, the regulatory environment is ever-changing, which is particularly relevant to the insurance and long-term savings industry, because Solvency II is subject to a significant review in 2018, so you have a moving target. The challenge I had with Sir Jon’s analysis previously was his reference to the international architecture. That simply does not exist in the insurance sector in the way it does in the banking sector, and it is hard to see how it can develop in the near term when the US and the Europeans have such fundamentally different views about how insurance should be regulated, principally around the question of the use of risk-based models for determining capital levels.

This is not some sort of minor disagreement. It is a fundamental ideological disagreement between the US and the Europeans, which makes it hard to see how the insurance capital standard can become a reality any time soon. In the absence of that, the focus on having a bespoke treaty that cannot be unwound at the whim of the Commission, or that becomes irrelevant because the regulation that it was equivalent with has moved on, has to be the aim of the exercise—not least because the most important issue for the UK insurance industry is that we are in the room when regulatory issues are decided and discussed, not outside the room. It cannot be a functional way forward for the largest market in Europe not to have a say in its own regulatory environment.

Lord Haskins: Are you saying that the EU insurance regulatory regime is a pretty good one?

Huw Evans: Yes. As Miles said, it was broadly designed and inspired by the UK model that was developed after the dotcom bubble crisis in the early 2000s. It has been implemented in quite a process-heavy way that has added significant implementation costs that, in our view, did not need to be there, but it is fit for purpose and it has the broader agreement, painstakingly reached, of all 28 EU member states. It works, although it could be improved, and therefore it would not be in our interests to look for a blank piece of paper and move fundamentally away from it.

Stefan Hoffmann: In our experience, EU equivalence is a useful and valuable concept in general for third countries. However, it has its limits,

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5 Note by witness: EU equivalence is but one pillar to rely on for Swiss banks to maintain market access to the EU. Other means are:

- Binational arrangements with some EU member states (among others a tax agreement with the UK where an associated Memorandum defines permissible ways of approaching UK-based clients from Switzerland).
- Passive freedom to provide services is granted under WTO/GATS. However, many blurred lines between active and passive freedom to provide services create legal uncertainty impairing business in practice.
- Some passporting rights; for instance with the Alternative Fund Managers Directive (“AIFMD”) and the European Market Infrastructure Regulation (“EMIR”).
- Finally, there is the option of establishing separate subsidiaries in EU member states to service EU-based clients (through passporting); this is the case for some Swiss banks with wealth management units being set up in Luxembourg and Frankfurt (however, provoking higher capital and operating costs).

Financial services are not part of the bilateral EU agreements. There is no single approach for financial market access with EU member countries but rather a patchwork
and I would stress three limits that we experience in particular from Switzerland. The first is of course the scope. There are no equivalence rules available for a whole range of banking businesses; for instance, the retail business is not covered by EU equivalence, so that limits the usefulness of the concept as such, because it is down to wholesale business and to investment banking in certain areas, but it does not cover the whole of banking as the passport regimes would allow to you do.

The second shortcoming in our experience is that you really depend on the EU Commission to take the initiative. You have no right to EU equivalence. You have to wait until you are assessed. You do not get the right to be equivalent even if you fulfil all the criteria. The third thing is that the process itself is not very transparent and not very reliable. It is a two-tier process. One is the technical tier, which is done by the ESAs, which are pretty reliable in that they are technical, but on top of that you have a political decision by the EU Commission, which is difficult to assess. In the end, it is a political assessment and it is susceptible to the overall mood and climate between two countries. Therefore, what we are arguing, or have been trying to put across to Brussels for quite a long time—probably we have an ally in the UK in that respect—is that we think it would be useful to establish an EU equivalence regime or process that is streamlined and more structured, in the sense that in the end you would get a right to be granted EU equivalence when you met certain conditions. As it is now, at the moment, you do not have that right. You really depend on the mercy, so to speak, of the Commission, and that, of course, is a considerable shortcoming of the regime.

Q56 **Lord Woolmer of Leeds:** Following on from all that, how do you think regulatory co-operation and agreement will change between the EU and the UK following exit from the EU? Secondly, do you think the EU or the UK or both parties will become less influential international bodies, given the importance of the UK as you have all described it within the global environment, but also its relative importance to the EU member states themselves?

**Huw Evans:** It absolutely matters that there is a high level of regulatory co-operation, whatever political structures are put in place and ultimately agreed by Parliament. Why? It is primarily in the interests of customers. It is in the interests of all customers, whether individual or corporate, that there are highly established and sophisticated regulatory relationships and regimes that work across borders in our heavily interconnected and globalised world economy. We must not lose sight of the fact that ultimately it is for customers that regulatory relationships are most important, and obviously that they ensure an orderly financial system. That has to remain an important priority throughout this process.

As to our international influence within the European Union, undoubtedly of course we cannot leave the European Union and hope to maintain any significant level of influence directly on how it will evolve, although hopefully, if a sophisticated treaty could be established that had a close

of different treaties, arrangements and practices that all evolved over a time of more than 30 years.
working relationship between the EU and the UK, it is possible to see a way in which influence and soft power could be used as part of that rather than the sort of hard power last person in the room-type power that we have at the moment.

In the international sphere, for the reasons Miles articulated about the role of the UK in the world economy and London as a financial centre, I hope we can exercise that influence effectively. It is certainly something from an insurance perspective that we are committed to in the development of the insurance capital standard. I think we will have to put more effort into using our influence and, dare I say it, seek to make more friends and build more alliances than perhaps we had to do when we were one of the largest players in the EU.

The Chairman: And hope we are not entirely dependent on the kindness of strangers, as Mark Carney put it. Mr Celic.

Miles Celic: I echo very much what Huw said. Clearly, if we are not in the room, if we are not part of the EU, if we are no longer part of the EU 28, we do not have the ability to vote on issues. We do not have access to or participation in the mechanisms and structures of the institutions. I would like to think that intellectually we can still contribute. There will clearly be a need to look at UK diplomatic policy and how we engage with the individual capitals, the individual members of the European Union, in our mutual interest. I also like to think that we would explore the possibility of continuing to be a part of initiatives where the UK can play a role. We have heard talk of that recently for defence and security issues, some of which sit outside the European Union formally, but I look to the capital markets union initiative, for instance. There certainly seems to be an intention to continue with the capital markets union idea, and it would be a much more powerful contribution to European competitiveness and growth if it included the 40% of the capital markets that sit in London and the UK. It would be able to access a much deeper, more liquid pool of capital. How realistic and viable it is that the UK could continue to play a part in that outside the European Union, I do not know, but I certainly think it would be worth exploring, again on the basis of mutual interest.

The Chairman: Mr Hoffmann, do you think, in a perverse way, that your members’ interests have been strengthened by Brexit, having the UK on side?

Stefan Hoffmann: I do not want to comment on the British position. Our experience is that it is always possible, even as a third country, to find and arrange useful solutions. Sometimes it needs extra effort. It is probably less easy than being a member of the EU. You need some extra things, such as more flexibility. What we really think is that the UK and Switzerland will, after Brexit, become more similar in some ways. There are two things that will likely happen: we will become more similar in the sense that we are both third countries, not EU member countries, and therefore we will probably have more common interests in the future than we used to have in the past; on the other side, we will become even more competitive because we are in similar positions. Those are two divergent effects that Brexit could trigger, but we are looking forward and, whenever you find a solution or arrangement with the EU, it could help us too in some way, I am quite sure.
The Chairman: That concludes today’s public evidence session. The Committee is going to continue its meeting in private, but we have found the session with you extremely helpful. Thank you so much for coming, and the very best of luck as you go forward to carry your messages. Thank you.
Bank of America Merrill Lynch, Allianz Global Investors and HSBC – Oral evidence (QQ18-26)

**Bank of America Merrill Lynch, Allianz Global Investors and HSBC – Oral evidence (QQ18-26)**

Transcript to be found under Allianz Global Investors, Bank of America Merrill Lynch and HSBC- Oral evidence (QQ18-26)
The Chairman: Good morning, Sir Jon Cunliffe, Deputy Governor for Financial Stability in the Bank of England. Welcome to our evidence session on Brexit and the impact on financial services.

I need to go through some technical issues, so I will go through the pro forma. You have a list of interests that have been declared by Committee members. This is a formal evidence-taking session of the Committee and a full transcript will be taken. It will be put on the public record in printed form and on the parliamentary website. You will be sent a copy of the transcript, and you will be able to revise it for any minor errors. The session is on the record; it is being broadcast and is available through the parliamentary website.

Sir Jon, I will kick off because we have only an hour with you. Given the moving feast that you and we have seen since 23 June and the impact it has had, I appreciate that you have had a pretty busy time of it, which is why I am particularly pleased you are here. Could you start by telling us, in light of the Prime Minister’s speech last week and her road map, what you think the impact of a harder Brexit will be on financial stability? What do you make of the current state of the economy since the referendum?

Sir Jon Cunliffe: I will start by looking at the recent past, because that may give us some pointers towards the future. The referendum result on 24 June was a big surprise to financial markets. We saw very big moves in asset prices. We also saw large volumes; something like six to seven times the normal volume of business in the currency markets went through the Asian currency markets that morning.

Markets did what they are supposed to do. They absorbed the news and the shock, and they changed prices relatively smoothly. Key in financial stability terms, that shock was not transmitted to the rest of the financial system in the way, perhaps, that we saw market shocks and big movements in prices being transmitted during the financial crisis. That
speaks a lot to the work that has been done over the last eight years to reinforce the financial system, particularly the banks at the centre of it, but it also speaks to the preparations that firms and central banks made to ensure that liquidity was available.

If I take that incident, the financial system is more robust to shocks from market news and the like. There was great uncertainty about the timing of the negotiations. The timing is now clearer but the process of negotiation and the outcome are quite difficult to predict. One would imagine that, as more news comes to the markets, markets will react. The pointer I take from the referendum event itself is that markets and the financial system are much more robust than they were. That does not rule out market-induced financial stability events as more news comes into the system. We saw last week news about how Brexit might play out. It seems to have affected the currency markets last Thursday. We had a flash crash, where sterling in thin Asian markets lost 6% of its value in a matter of minutes. We have seen that sort of crash before in US treasuries and German bunds. Some of it is not just to do with news about Brexit coming into sterling price but to do with the way markets are currently configured. It recovered quickly, although the underlying trend for sterling, as we know, was down. I would not rule out, in that sort of financial stability sense as more news comes in, that there is potentially stress in the markets, but I take some comfort from the resilience on the 24th.

If I now look wider than market impacts on financial stability—

**The Chairman:** Could I interject a supplementary on what you have just said? Given what you said and given that you expect markets to react as more news comes in, are you making preparations for March when the Prime Minister has announced that we will trigger Article 50, and are you speaking across central banks to your counterparts?

**Sir Jon Cunliffe:** We did extensive contingency planning beforehand. Much of that machinery and many of the preparations we put in practice still remain there to be used if we need them. Yes, of course we are in dialogue with central banks. On the particular incident last Thursday, the Bank for International Settlements markets committee is now going to look at what happened and try to understand it. Yes, the contingency planning is there. We have not dropped it or forgotten about those risks.

Turning to broader financial stability risks around the UK’s exit from the European Union and the process of negotiation, I do not know what the end point of the negotiation will be. I do not think it is sensible to comment at the moment that the end point will be this or that. We talk about hard Brexit and the passport, but actually we are talking about a whole spectrum of channels by which financial services in the UK can be exported into the European Union. I am never quite sure what lies behind the labels “hard” and “soft”. You really have to dig down to look at the detail.

In relation to the financial stability risks, wherever we are going, we clearly want to go there in a smooth and ordered way. To the extent—I do not know what the extent will be—that activities cease to happen in London, cease to happen at all or move to other jurisdictions in Europe or
elsewhere and the structure of financial firms has to change, there is great uncertainty about how much that will have to happen. First of all, you want to make sure that control over risk is maintained throughout the process. You want to make sure that contract certainty is maintained and that there is no discontinuity of service, because, suddenly, services that were operating and contracts that had been made could not continue.

The second thing is for supervisors and regulators. Bear in mind that the Bank’s primary interest here is financial stability. We want to make sure that we do not lose sight of things, as structures and business models change or activities move or adapt. You want to make sure too that the management of financial firms remains focused on the full spectrum of risk that they face and that they are not distracted by having to deal with transition and changes that are happening. I cannot say now whether the change will be large or small or how it will impact. I have read some of the evidence of your witnesses and there is great uncertainty about it. You want to make sure that it is ordered and planned and that there is time to execute the plans. If you do not, you are increasing vulnerability and you will get hit by other shocks at the same time. That is how I would characterise the financial stability risks. Do you want me to talk about the economy as well?

The Chairman: Briefly, if you would just touch on that.

Sir Jon Cunliffe: I will do it very briefly. The initial indicators after the referendum were that confidence and the like moved a long way down. Some of that came back just before the Bank made its August forecast. There was a depreciation of sterling by that point. We based the August forecast on that. The underlying narrative of that forecast is that uncertainty about the UK’s future trading arrangements with the EU and the economic impact of that will weigh on business investment and the large and irreversible decisions that businesses take about hiring and pay. In the course of next year that will communicate to household consumption and the housing market.

The news since then has been a bit stronger than we anticipated, as set out in the minutes of the September MPC. On the underlying contours of the way this will move through the economy, we see nothing to suggest that that is the wrong way to think about it. We will process all the news, including what has happened to sterling in recent days, in our November forecast to try to reach an overall view of where the economy is going.

The Chairman: Lord Skidelsky, is that adequate or do you have a supplementary?

Q39 Lord Skidelsky: Sir Jon, you referred to the depreciation of sterling and, in your last few remarks, to the economy. What do you think the connection might be? In other words, what do you think the effect on the macroeconomy will be of the plunge in sterling?

Sir Jon Cunliffe: There is no simple numerical relationship between the exchange rate, economic activity and inflation. One knows the channels. A lower exchange rate increases demand for UK goods and services abroad. It may encourage some import substitution towards domestically produced goods and services. On the other hand, if it raises prices it
lowers real income and that affects consumer demand. It may affect investment, because a lot of our investment goods are imported.

The important thing perhaps is why the exchange rate is moving. The underlying cause of the exchange rate moving will affect the path of demand and the path of supply in the economy. One has to put all those things together. If the exchange rate is moving because there is uncertainty about the UK’s future trading relationships with its biggest partner, you would expect that to affect demand and supply independently of what is happening to the exchange rate. That is a really long way of saying that I am not going to give you an answer, because I do not have one and because we have a forecast round coming up in November for the Bank that will be a very important forecast round. We will try to process all of this through our models to try to pick up how those effects, which move in different directions, will impact on the path of the economy and the path of inflation.

**Lord Desai:** Do you take the view that the market has overreacted as far as sterling is concerned, or do you think it is the right response?

**Sir Jon Cunliffe:** I normally try not to express a view on whether markets are right or wrong with the exchange rate.

**Lord Desai:** The last time we had a problem regarding the market being right all the time.

**Sir Jon Cunliffe:** All I would say is that they are processing news about the outcome. I will break my normal vow to say one thing, in the hope that it is helpful. The hardest news for markets to process is political news. Markets find political uncertainty very difficult to estimate, as opposed to economic uncertainty and the like. Clearly the outcome of the UK’s exit from the European Union will be the product of political processes here and in other countries. Markets find that kind of news difficult to face because it does not fit inside normal models and the heuristics they use about the economy. That is not to say they have over or underreacted. I think markets will continue to react to news about this because it has an impact on the economy and its prospects.

**Q40 Lord Shutt of Greetland:** Sir Jon, you said earlier that you do not know where the end point is. Can you help us with the starting point? We hear about various possible arrangements, but perhaps a special or bespoke arrangement is right for the United Kingdom. How would that best preserve the United Kingdom’s financial sector? What features would you be looking for? Is there anything where, as it were, the EU negotiators will think, “Oh well, that is not bad; we will pitch for that”?

**Sir Jon Cunliffe:** I can make a couple of important contextual points for the Bank. One is that our primary responsibility is financial stability, not the business of the UK financial sector. That is an important consideration. It is a consideration for government, but the primary objective for us is to maintain financial stability. We have a secondary objective, which is to support the Government’s overall economic objectives. We tend to look at it more through that lens. That said, changes in the structure of financial services in the UK and the way things are done, et cetera, affect not just the economic picture but financial
stability. We take a pretty strong interest in that area but we come to it from that lens.

I go back to what I said at the beginning when the Chairman asked me about hard Brexit, the single market and the passport. The single market in financial services—the so-called passport—is, as you have already seen from your examination of other witnesses, a complex web of permissions in different pieces of EU legislation, often operating in different ways for different parts of the financial sector, that allow relatively frictionless trade in financial services to happen cross-border. Trade in financial services happened before the passport and before the single market. It is not a question of tariffs, but it decreased the friction cost. The way that is used is different in different parts of the financial sector, and it is different in different financial firms.

The financial services industry is not really organised around the passport. You cannot say, “Well, there is this part of the financial services industry that uses the passport”. Your word was “preserve”. One would want to ensure that it could continue, and this part does not. Retail financial services in the UK are not very much affected by the single market and financial services. It is around the wholesale services market-based finance that you see the biggest impacts.

The Prime Minister has talked about a bespoke deal. To me that means that if we are not a member of the single market—you cannot be a member of the single market unless you are a member of the European Union or of the EEA, you share European Union law with the other members and are subject to the enforcement of the ECJ, et cetera—the current way in which that relatively frictionless interaction happens will not continue. That does not mean that that relatively frictionless activity cannot continue. You just have to find different ways of arranging it. You cannot arrange it as a European Union member subject to European Union law.

To me, a bespoke arrangement is about understanding how those permissions are used and which parts of the financial services industry use them most. That is not easy, because they have never really thought about this. They have never had to measure it. You only measure what is important, and measuring how you were using the passport in complicated transaction chains was never really very relevant to the financial services industry. It would have to work out how they are used, where they are used and which are the most important, and what the alternatives are.

Some of the alternatives involve doing things in a different way through different legally incorporated entities registered in the European Union. What are the extra costs of that? If you do the business that way—business used to be done that way, so we can go back—what is the extra cost and who pays that cost? Investment banking in the European Union is not making stellar returns at the moment, and in some cases it may be that a business does not move; it just stops because there is less depth of financial services available.

That is what bespoke means. Bespoke means trying to understand those interactions and then saying, “All right, are there different ways in which
that relatively frictionless activity can be continued, or continued to some extent?" Unfortunately with this, you really have to get into the detail of how things operate at the moment, how they would need to change and what the cost of that is before you can answer that question. I am sorry, that is a very long and probably confusing answer.

The Chairman: Lord Butler, did you want to pick up any of those points?

Q41 Lord Butler of Brockwell: May we pursue that a little? Figures were published by the Treasury Committee in the House of Commons showing that 5,500 UK-registered firms depend on passports to do business in the EU. On the other side, 8,000 European companies rely on passports to offer services in Britain. One would think that this is a very important issue for them. It is an important issue on both sides. Do you therefore see the possibility that passports as such will continue, or some equivalent of passports? Is there scope for an early financial deal?

Sir Jon Cunliffe: Andrew Bailey’s letter to the Committee set that out.

Lord Butler of Brockwell: That is right.

Sir Jon Cunliffe: It also shows that there are something like 350,000 passports, of which virtually all—more than 300,000—are outbound from the UK and the minority are inbound. It is quite difficult to go from the number of passports and firms to the amount of what I would call economic activity. In some areas like insurance, where passports are used, they are very cheap and easy to get. Passports are used for relatively small volumes of business such as selling travel insurance cross-border.

The scale of the activity that happens through the passporting channels is pretty appreciable. You really have to get at this from the private sector end and ask firms, "Which of your business lines, which of the transaction chains and which of the bundles of services you operate use some or all of the passporting permissions?" There is now starting to be some private sector analysis of this. The Oliver Wyman report, which came out a couple of weeks ago, suggested that £50 billion or £60 billion of revenues were associated with European Union business in the UK, and that something like £18 billion to £20 billion would be at risk if there were no passports. It added ancillary services to get to the number, which I think was about £35 billion or something. It had a range.

That is an appreciable amount of revenue. You can translate that into GVA, which Oliver Wyman did and came to something just above 1% of GVA associated with business between the UK and European Union financial services that would be affected if they were using the passport. I looked through it. The calculations are still quite difficult. Getting underneath it is pretty hard.

You then have to ask how much of that could continue. My point was simply that the passport as it exists, which is firms incorporated in the European Union, subject to European law and subject to the ECJ, et cetera, cannot exist unless one is in the EEA. You can replicate those permissions in different ways, either with some sort of umbrella agreement or sector by sector. It is a painstaking process, and maybe it is the converse of the painstaking process that we see firms go through of
working out how they use the passport, but one could certainly replicate that. There is nothing to stop that happening. That would be part of a much bigger negotiation with the European Union.

If your question is, “Is there an interest on both sides in doing that for the 8,000 plus European firms that have passports into the UK?” I think I would say that the UK—let us call it London for shorthand but it goes much wider than London—has a pretty unique and complex financial ecosystem with very deep and liquid capital markets. That lowers the cost of capital and financial services for the real economy in the UK and in the rest of the world that uses it, particularly the European Union. If one fragments that ecosystem, and puts up barriers and increases costs, for example by banks having to hold more capital because they have to hold it in different locations, and if certain things that happen in a fairly frictionless way actually happen with constrictions and constraint, that is going to put up the cost of finance and financial services more generally on both sides of the channel.

Lord Butler of Brockwell: We have had some evidence that one of the strengths of London—let us continue to call it London—is that the ecosystem is so complex that it is really difficult to replace elsewhere in Europe. The only place where it could be replaced is in New York. Do you think that constitutes a reason why it is in the EU’s interests to disrupt that ecosystem only to the minimum extent?

Sir Jon Cunliffe: In the economic and financial stability terms I talked about a bit earlier, yes. There are broader political issues around the negotiation of exit on both sides and I am abstract from all of that. Economic geography is not my specialism; predicting tipping points in agglomerations, when they move and when they do not move, is hugely difficult. For me, it is pretty unlikely that what we call London—I make the point, because a lot of financial services and infrastructure is not in London but elsewhere in the country, but let us call it London because that is what seems to be happening in the broader discourse—will be replicated in the foreseeable future in one place in the European Union. It takes an awful lot of time and human capital. It is based around the interaction of financial services and other services. A great deal of the business is not to do with the European Union; in fact, only a minority of the business is to do with the European Union. The idea that this ecosystem is transplanted somewhere else into Europe in the foreseeable future is highly unlikely to me; over time, I do not know.

Could it be transplanted to New York? Of course, it already exists in New York. There is a large and complex ecosystem in New York, so could some of the things that now happen in London transfer to New York if they could no longer happen here? We are talking not just about economies of scale and scope but about how information is used by different players. In these complex financial transaction chains, even though one firm has a transaction chain, I have seen work suggesting that more than a quarter of the value of that chain comes from other financial firms that participate in those transactions in some way. About a quarter comes from non-financial firms such as lawyers, accountants, et cetera, who are also necessary to make that complex financial transaction work. You need all those things to be not just close to each other but able to interact with
each other quickly and seamlessly. You cannot just take all of that and move it somewhere else. It exists in New York. Those economies of scale, scope, information-sharing and ancillary services are there, so some of it, yes, could certainly go there.

The Chairman: That brings me to Lord Callanan, and after that Lord Haskins on transitional arrangements.

Q42 Lord Callanan: One particularly important part of the ecosystem in London is of course euro clearing. There has been a lot of speculation about the risk or otherwise of London remaining the centre of euro clearing when we are no longer part of the EU. Do you think that is at serious risk of relocating?

Sir Jon Cunliffe: I have spent much of my career on this subject, so can I be forgiven a slightly long and technical answer, if that is okay? First of all, there is a political angle. It is unusual to see Heads of State or Government talking about where clearing services are located or whatever. The issue of euro clearing clearly has political weight and significance and that may determine the outcome. I cannot really comment on how that goes into the overall, much broader negotiation between the UK and the European Union about the terms of the exit and what it looks like.

I will dodge the political question, if I can put it that way, and just turn to the technical. By clearing, we are not talking about paper clearing but essentially about central counterparties clearing derivative contracts. I will make a number of technical points that go to what this business is. Following the financial crisis, the G20 pushed very hard to put derivatives contracts into central clearing, to have them centrally cleared. That means that the margin you provide against changes in value is provided centrally, and regulators can look at the models that generate how much margin the different counterparties have to put up in advance for movements in the prices that can happen. It is transparent, and you avoid what happened in the financial crisis. Financial instruments move very quickly and counterparties start requiring more margin from other counterparties. That was a real accelerator in the crisis that drove firms’ margin call and drove them into distress.

I was at the Pittsburgh G20 when we decided to do that. It is the right thing, but it requires concentration of the central clearing of derivatives contracts, because that is where you get the benefits and that is where you can net risk. That is where a firm that has some contracts with a plus direction and some with a minus direction with different counterparties can put them into central clearing and only has to take the margin cost of the net rather than the gross positions. That is a huge reduction in the margin that they would otherwise have to post; if you like, it is the insurance they have to pay against moves in prices, if they can take their pluses and minuses and net them off and just pay the net as an insurance into the central counterparty.

This is multicurrency infrastructure. If you are talking about interest rate derivatives, you want to be able to put into clearing—into the central counterparty—dollar-denominated, euro-denominated, sterling and yen, and get the netting benefits of that. By doing that, you reduce the cost
because you can take the pluses on your dollar-denominated interest rate stocks and the minuses on your yen-denominated ones. It all goes in and it comes together.

When I hear the argument that derivative contracts have to be cleared in the jurisdiction of the currency at issue, so that if it is a euro contract it has to be cleared in the euro area, and if we extrapolate from that that dollar contracts have to be cleared in the US, sterling here and yen in Japan, et cetera—some jurisdictions take that view—you make multicurrency infrastructure impossible. If you do that, you make the cost of clearing much higher. To me, clearing from a financial stability point of view through central counterparty is a really important reform since the crisis.

If you look at some of the clearing that happens in the UK, 25% or 30% of the instruments in that will be euro-denominated, but they are clearing against dollar-denominated and all the rest. I can understand the politics around this from previous existences, but what we are talking about technically is multicurrency infrastructure and, in this case, the benefits that netting and compression of margins bring. If we fragment the clearing systems—this goes back to Lord Butler’s point—the cost will go up across the system.

I have one last point on clearing and then I will stop. The fact that it is multicurrency infrastructure means that many jurisdictions will have financial firms that are dependent on it. You have to ensure that they have line of sight into the regulation and supervision of that infrastructure and influence over it. It is efficient to have large multicurrency machinery. We have it for payments: SWIFT, for example, located in Belgium. We have it in securities, depositories. We have it in CLS, which does foreign currency settlement. Lots of the pipes in the global system are multicurrency, but they are in one location. That means that there have to be arrangements through colleges and elsewhere to ensure that other jurisdictions whose firms use the infrastructure have some line of sight and have some confidence. If they do not have confidence that it is being run well and is secure, they are within their rights to say, “Well, I don’t want my firms to use this infrastructure because it is a bit precarious and if it falls over that is a problem for me”. There is a quid pro quo, if you like, on the way in which you supervise and regulate these things with the fact that they are multicurrency. If we are talking about going to a world in which you have to clear in the jurisdiction of issue, the costs are going to go up in a pretty big way.

**The Chairman:** In plain English, I think you are saying that it is unlikely that relocation of eurozone trading will go back to the eurozone, if it is a rational decision rather than a political one.

**Sir Jon Cunliffe:** I am grateful for the rider. I think the system works well at the moment, in terms of how it is developing. We are putting more contracts through central clearing now, not fewer, because that is the impulse from the G20. More is coming into the system and at the moment it works well. The supervisory arrangements work. There can be other reasons for moving it. I am not going to make a prediction, unlike my erstwhile colleague at the Bank of England, about what is going to happen, but it is important to understand what we are talking about.
Lord Haskins: I want to come back to the issue of financial stability and uncertainty. The banks have said to us several times that on the one hand they want uncertainty to be cleared up as quickly as possible. On the other hand, they have said that this a very complicated business and is going to take several years to sort out. There is a contradiction in terms on that.

It seems to me that there are two aspects to the uncertainty: first, the uncertainty leading up to a deal being completed, and, secondly, the uncertainty of, as inevitably there will be, transitional periods thereafter. We are going to have some degree of uncertainty for several years to come. You said at one point that uncertainty created by politicians making slightly rash judgments in public is something that markets find difficult to deal with. The reality is that, between now and when the negotiations are complete, the politicians are going to say lots and lots of things in public. The Bank will scarcely be able to keep quiet if some of those statements are clearly going to stimulate uncertainty. That is the first thing. How is the Bank going to respond to that? The second point is that there are politicians who have told us, “Let’s bash on very quickly and get the thing dealt with. It will all be simple. We can go to the WTO or whatever it is, and everything will be resolved and the uncertainty will go”. What would your view be on that?

Sir Jon Cunliffe: First of all, I do not think I said that markets had difficulty in processing uncertainty to do with rash words or rash decisions. My point was a much more general one, which is that markets have difficulty predicting politics because it does not fit into economic models, and you cannot use the past as a guide to the future. It is a general point. Political uncertainty is the most difficult thing for markets to calibrate. I was not making any comment about political statements. There will be a lot of political noise around this negotiation because it is, in the end, a political negotiation and that is what happens. Markets will have to deal with that.

To go to your last point, we will do our assessment. The FPC has said that it is assessing and we will find out more as the process goes along. It is assessing financial stability implications and we will use our normal publications—the financial stability report and the like—to report on that. As far as the economic impacts are concerned, we will use the inflation report to report on those. We did that before the referendum, and we will continue to give our forecasts for parts of the economy and our assessment of financial stability. We will give that through the statutory products that we are responsible for producing.

On the question that the private sector would like certainty, this is very complex, and it comes more broadly to the question of transition. This is a very difficult part of the negotiation and you can arrange it in different ways. You normally do the transitionals for trade deals at the end, but then of course trade deals normally increase access. I do not know what the result of the negotiation will be, but to the extent that it decreases access or changes the way that people do things, it is possible that they will need more advance warning of what is going to happen, or what will happen in the transition, than when you are increasing trade access.
Politically, there are different ways to say this can be done. There has been lots of comment on it. My point was a broader and perhaps more unhelpful one. No matter how it is arranged, we just want a smooth and orderly progression from where we are to where we are going, wherever that is. That is to do with ensuring that firms are able to plan and to execute those plans. I can think of lots of different ways it could be done, but they are political choices. I do not think the Bank would want to comment on this.

**Lord Haskins:** The difficulty is that events can sometimes be ahead of things. We have already had evidence that businesses in the City, and indeed non-City businesses in manufacturing, are taking their own steps to make up their minds about it—Nissan, for example—and they will not wait three years to get certainty. They want financial certainty as much as anybody else. The danger is that they will make the decisions before it is clear long term what the position is going to be.

**Sir Jon Cunliffe:** I think that is right. It is true for financial firms as well. They have a duty to their shareholders and a duty to their customers and clients. In the end, they exist to serve the real economy, and that is who their customers and clients are. To the extent that they are providing services, they have to try to make sure that there is no discontinuity and they do not have breaks in services. We will be trying to ensure that they have plans to do things smoothly. If they do not know the outcome, they may have to prepare for different outcomes to be able to deal with them.

If your point is that that may lead them so far down the track of preparing for alternatives that they may then have no choice, and that if they reach the tipping point they may have to go ahead even if they do not know, then yes, that is quite possible. My point was more about the stability and order of the process; it is important that they have time to plan and to execute. You might not be able to do some things very quickly: for example, novate contracts in financial services. The experience is that that takes time. Those considerations have to be built into the arrangements. As to how you do it, there are lots of different ways, as we read in the newspapers. Those are political choices.

**The Chairman:** Lord Shutt wanted to come in briefly and then we need to move on.

**Lord Shutt of Greetland:** I hope this is helpful. There was a news item yesterday, which I do not fully understand, concerning a little London issue about a bridge over the river. I raise this because there seems to be some doubt about expenditure. A civil servant is marking the card of a Minister and saying, “There are certain dangers here and I really do put this in big print”.

We have the issue of the trigger of Article 50. You have been talking this morning about difficulties, uncertainties and passporting. Is there any sense in which the Bank of England would mark the card of Ministers and saying, “Look, you are not ready to pull triggers because there is more work to be done”?

**Sir Jon Cunliffe:** I have been an accounting officer. As an accounting officer you have a responsibility, if you think something is outside the
rules, to ask for an instruction. I am pleased to say that I never had to do that. I have had colleagues who had to do that. That is part of the system within the Civil Service.

The Bank has statutory objectives around monetary and financial stability to try to use the instruments that Parliament has given us to deliver those two things and to comment on the path for the economy and why monetary policy is as it is, how we see it developing and, as I said earlier, the risk to financial stability. We do not have an accounting officer responsibility to mark the card of Ministers—to use your phrase. We have a responsibility to say how we see those things evolving, and to say it publicly. We are required to produce public assessments of those things. Before the referendum that is what we tried to do, and we will continue to try to do it.

Q45 Earl of Lindsay: I want to ask you about the EU equivalence regime as it is currently designed. Is it something that the UK negotiations should seek to achieve for the United Kingdom, and therefore for financial services in the United Kingdom, or is it something that we should be striving to avoid? Is it something that would bring sufficient benefit by allowing companies from the UK to plan for the future, or might it actually stifle innovation and competitiveness and be subject to the sort of vulnerability of decisions relating to equivalence that are essentially political decisions?

Sir Jon Cunliffe: I will not give advice to the negotiators, if only because one of the most irritati ng things when you are a negotiator is to have your predecessors give you advice. It is not the job of the Bank to do that.

Generally, the principle of equivalence is much more within the European Union. One of the lessons of the financial crisis is that, if we want globalised financial services, we all have to have confidence in each other’s regulatory and supervisory machinery. That is where international standards come in. We should also recognise the equivalence of our regulatory and supervisory structures. It is more about recognising the equivalence of the outcome than the equivalence of the input. We may do things in a different way. The US does prudential capital for banks in a very different way from the UK and the EU, but they are both equivalent in that they are implementing a Basel international standard. Equivalence is a broader concept.

More generally in trade and financial services, irrespective of the EU issues, people are starting to think about how we build regimes that can recognise each other’s equivalence. There is some talk about that in the Trade in Services Agreement. In TTIP there has been some talk too, but not in financial services, about how we get to more mutual recognition of equivalence in our regulatory and supervisory structures. Equivalence is a general thing. It is a good thing if we can do it properly, because it will allow more trade and interaction in financial services while assuring people that it happens within a robust framework, so that you can depend on the other guy.

The EU equivalence regimes are relatively new. They came in the Barnier wave—the second wave of financial services legislation—and are quite different in the way they operate from other things in the single market. I have certainly been involved in one equivalence decision, which is the
recent agreement between the EU and the US—the CFTC—on clearing houses. It is useful for the EU to have regimes that recognise third countries and that allow for that trade to continue. I thought that before the referendum, and I think that now. It is useful for the UK to have regimes that recognise equivalence. The general principle of this is useful: the ability to have a globalised financial sector and to be confident that it is robust and is serving the real economy.

As for the specific EU regimes, we do not have much experience of them yet. Equivalence is a decision of the Commission. Conceivably it could be politicised, and we know that equivalence can be reversed. Of course, if you have a global system in which you try to ensure that cross-border activity happens under an umbrella where you are confident in the other jurisdictions’ regulatory and supervisory structures, you need to make sure that if you diverge at some point you have a way of dealing with that, and either no longer have the access or settle the divergence in some way. The EU will have to do that.

I think they are useful regimes, globally as well as in the European Union. They do not cover many areas, as you know, in financial services. There is no equivalence regime in banking, for example. The equivalence regime in insurance is not really about access. They are not there to cover all the things the single market covers. It is a useful concept that could be developed further globally and within the EU. If a financial firm is covered by one of those agreements, could it depend now on the fact that there will be an equivalence agreement between the UK, when it is not a member, and the EU, and plan on that basis? All of that will be part of the negotiation. My answer is that, to the extent that you can depend on the outcome of the negotiation, you can depend on that. My more general point is that the world generally is going to have to think more about how we develop those regimes because they are a necessary part of a globalised financial sector.

The Chairman: And we remain of course with membership of Basel, the Financial Stability Board and all the other bodies that also regulate those areas.

Sir Jon Cunliffe: They do not regulate, but they—

The Chairman: They set the standards.

Sir Jon Cunliffe: They set the standards and, to my mind, the only way equivalence regimes can work generally—

The Chairman: Is through them.

Sir Jon Cunliffe: —is if there are global standards. If we have all agreed a standard, you can assess that the standard is met, although your legislation may look very different, because different countries have different structures. Equivalence regimes then become easier to do. Even without this question, there is some underlying move in that direction, but it is very difficult. As a regulator and supervisor from a UK perspective, as Lord Butler observed, the passport works both ways. We are responsible for financial stability of possibly the largest international financial centre that there is. We want to ensure that firms that do business here either come under our regulation and supervision and that we will take
responsibility, or are being regulated and supervised by equivalent jurisdictions. It is important both ways.

Q46 **Lord De Mauley:** Sir Jon, what are the prospects for the UK continuing to have influence on financial regulation in the EU, and indeed internationally, once the path to exit has been decided?

**Sir Jon Cunliffe:** Once exit has happened, we will not have influence from inside on the making of EU legislation. I certainly hope the EU will continue to be a big proponent and supporter of global international standards. I think it will, because the European Union supports international rules-based systems. It is important to the European economy that it is open, and you need international standards for that. But we will not be inside the Council working groups or the negotiations as to how those international standards are put into EU law. To that extent, we will necessarily lose influence, because if you are not an EU member, you cannot be inside the machinery that makes EU law.

This goes back before the crisis, but it intensified afterwards. We have tried in the UK, and in the Bank in particular, to exert an influence on international standards. We have tried to do that because we are an international financial centre and they matter hugely to us. I think the UK has played a part, particularly post-crisis, in the way those standards have developed. I hope and assume, and will devote considerable effort to ensuring, that we continue to do that in the international system. To the extent that we are able to do that, it will influence what the EU does and how the EU sets its own standards.

Of course, good ideas are good ideas whether you are in or out of the EU. To the extent that we are able to show that we have analysis, good evidence-based approaches to dealing with financial service regulation and practical ideas, I think we will continue to have influence. The financial sector changes and adapts so quickly that there will be more regulation, because it will change. We have much of the machinery and investment in human capital in international standard-setting. If anything, we will redouble those efforts. I think we will continue to have a relationship with the EU on financial services, which is another channel, so I expect we will have influence there. The influence that one used to have sitting inside the Council working group or chamber, or inside the parliamentary committee on a piece of legislation, no, of course one will not have that. That is because we will not be a member.

**Lord De Mauley:** That is, as it were, two years from March, but in the intervening two years how do you see our influence? We are hearing rumours that it is—

**Sir Jon Cunliffe:** The formal and underlying position is that we are a member until the day we are not. We have a voice and we have a vote. Certainly when the Bank is participating in discussions now on legislation and the like, we are making the points that we would otherwise have made.

**Lord De Mauley:** And the doors are open?

**Sir Jon Cunliffe:** My point earlier is that, if you have good ideas which are evidence-based, the doors are always open, in or out. If we are
talking about things that are likely to happen after we have left, it is unavoidable that people will pay less attention unless it is a point that is relevant to others. That is entirely natural. If we now know when we are going to leave and we are talking about something that will not affect us, clearly the points we make get read in that light. When we make points, we have to be aware that some of the legislation and the like will not apply to us. We have to make the points recognising that. At the moment, we are not withdrawing from the process. No one has done this before so it is pure conjecture, but as you get closer and closer to the point of exit, the number of things that you are talking about that will not apply to you will increase and the influence over those things will diminish.

Q47 Lord Woolmer of Leeds: In the event that the UK exits the European Union, what are the areas where the Bank of England would welcome greater regulatory discretion and control over financial firms? Some witnesses have said that it will be important to maintain regulations that parallel those within the European Union. Others have said that there will be real, meaningful discretion in the future that we will want to use. What are the areas that would be helpful?

Sir Jon Cunliffe: The future will bring new ideas, but looking at the existing stock of regulation, as we did when the Bank produced its report about this time last year on the way in which being a member of the European Union affected our objectives, we came to the conclusion that EU regulation on financial services had in the main been high quality and had implemented international standards—I cannot remember the exact words. I keep coming back to the international standards point because that is the touchstone. We listed a few areas where we thought it had not happened, but the judgment in the main was that the EU legislation had been high quality and robust, which is what we need for the UK, given the task we have of financial stability for what we have just called London. It has enabled us to fulfil our function.

We did not think about it then in the context of how you would change things now, but it follows from that assessment that on the existing stock there are things you might change. As to the overall thrust of the regulation, the way it operates and what it is trying to achieve—take prudential standards for banks and the implementation of Basel III—we would not change that. That will develop over time, and it may develop in the UK in a different way. Inherent in that European legislation were compromises, because it had to apply to all member states. When we look anew at the future we may say, “Well, we no longer need to make that compromise because the structure of our industry needs regulation of a certain sort”.

In the main, the judgment was that that regulation was robust and high quality. The FPC in its recent record made it clear that regardless of being in or out of the European Union we will need high-quality regulation and supervision in the UK that implements international standards, or goes further. One of the areas you might also think about is that a lot of the European legislation was maximum harmonisation, which meant that you could not do less but you could not do more, nor do different things. Where there are good cases for flexibilities that address the UK and things we might do in a different way—where there is a good case to change
something—we would look at it, and the Government would look at it and be prepared to change it. The overall picture on the stock is the assessment we reached last year, and it has not changed.

**The Chairman:** Thank you, Sir Jon. That concludes today’s first public evidence session. The Committee will adjourn for a few moments while we bring in the second panel. Thank you so much; it was a very fruitful discussion.
Evidence Session No. 1 Heard in Public Questions 1-9

Wednesday 7 September 2016

Members present: Lord Butler of Brockwell (The Chairman); Lord Desai; Lord Haskins; Earl of Lindsay; Lord Shutt of Greetland; Lord Skidelsky; Lord Woolmer of Leeds

Examination of witnesses

Professor Sir Charles Bean, London School of Economics and Political Science and Professor Eilís Ferran, University of Cambridge.

Q1 The Chairman: May I welcome Professor Ferran and Professor Bean on behalf of the Committee? This is a formal evidence session. You have in front of you the declarations of interest of members of the Committee just so that you should be aware of them. A full transcript will be produced and put on the public record and on the parliamentary website. You will be sent a transcript and will be able to revise it in terms of any minor errors. The session is on the record and is being broadcast, and it will be accessible subsequently via the parliamentary website. Would either of you like to make any—brief, preferably—opening remarks?

Professor Sir Charles Bean: As far as I am concerned, let us go into questions. I do not have an opening statement that I want to make. I do not know whether my colleague does.

Professor Eilís Ferran: I do. I have a few remarks to tell you where I am at on this. For me, although there is a lot of uncertainty, the future, is outside the European Economic Area, not for reasons of free movement of persons but because I think that that is the best way of ensuring a degree of regulatory flexibility in the longer term. It is a bespoke model that we need to look at. The existing alternative models do not really work for financial services in my view, and there needs to be a distinct arrangement. We can talk about the details of that, I am sure.

My second point is that, although there is a great deal of attention on the need to ensure that the industry is able to continue to thrive, I would like also to emphasise the importance of ensuring that supervision continues as seamlessly as possible. The UK will have to step outside the EU system of financial supervision, but the reasons that made that system necessary are still there and we have to ensure that we preserve as much as possible of that and not turn the clock back in that respect.

The Chairman: Thank you very much. That is very helpful. Could we
start, as it were, on the general question of what your expectations are for investment and the economic climate over the short to medium term? Do you foresee a prolonged period of uncertainty, and, if so, how do you expect it to affect the day-to-day running of the industry? Professor Bean, perhaps particularly addressed to you, what impact do you think Brexit will have on the UK public finances and the overall economic environment of the country? The effects so far seem to have been rather less than the doomsayers said before the referendum. Professor Bean, would you like to start on that?

Professor Sir Charles Bean: On that last point, as I will explain in a moment, I think some of the recent indicators have been greeted a little too enthusiastically. The picture is a bit more mixed. Certainly what most, if not all, economists expected was that—at least in the short term—there was likely to be a slowdown in growth, essentially because the heightened uncertainty was likely to lead businesses to put investment spending on hold. There is plenty of evidence from past experiences where there has been heightened uncertainty of that happening. Clearly, particularly for foreign businesses that might be expecting possibly to locate to the UK, while the nature of our relationship with the rest of the European Union is unclear, they might want to hold off on that—and similarly for businesses that might be expanding. So most economists expected to see a weakness in business investment going forward.

Investment intentions have been weakening through the year. The question is what that maps into in reality. To give you some numbers, the central expectation from the Bank of England was that business investment for this year would contract by a bit over 3%, a further 2% next year, and then recover in 2018. That compares with a pre-referendum viewpoint of reasonably robust growth in business investment. It translates across into GDP growth of about 1.75% for this year, about 0.8% for next year and then picking back up to a little under 2% in 2018. Most City forecasters and most independent forecasters are in pretty much the same ballpark. The pre-crisis Treasury document is not so far away from where the Bank forecast is; the Bank’s forecast has GDP two years out from where we are about 2.5% below where it would otherwise have been. The Treasury’s document, which it released during the campaign, had 3.5%, and half of that difference can be accounted for by the monetary actions that have been taken by the Bank of England. The Treasury had a slightly faster slowdown in the near term.

That is where the economic forecasters are. The one thing I want to stress is that there is a huge amount of uncertainty here. There is uncertainty in the world and that extrapolates across into uncertainty about economic forecasts. We are only two months on from the referendum. We have next to no hard information about what is going on—some business surveys, and really that is about it. A lot of the consequences of the uncertainty, particularly for business investment, will show up only over time.

I said that I think some people have overreacted to some of the recent indicators, particularly if you look at the purchasing managers’ indices. They fell very sharply in the first release after the referendum, implying contraction. Only the ones released in the past few days have bounced
back into expansionary territory. A lot of people make the mistake of thinking of those as telling us about the level of activity, whereas they really tell us about the growth. If you have a sharp contraction in one period, you need an equally strong expansion the following period to offset that. So it is better to look at the two months together, and they are averaging round about 50, which corresponds to broadly flat output, whereas before the referendum campaign got going, if we go back into last year, the economy was growing at round about 0.5%, or a little bit more, per quarter. That corresponds for the purchasing managers’ index to numbers like 55 or 56. So the underlying picture at the moment does not suggest that the economy has just shrugged off the Brexit result. The real issue is that it is too early to draw a firm conclusion. We will learn over the course of the coming months and quarters, as we get GDP releases, firmer information about what is going on, and about how much of a drag the uncertainty created by the result will exert. Clearly, the sooner the uncertainty is resolved, the faster that will go away.

The Chairman: Thank you very much. Professor Ferran, do you want to add to that?

Professor Eilís Ferran: I want to stress the critical importance and risk of legal uncertainty in this respect. One thing that has made the UK, and London, such an important hub is the fact that its legal system is certain and predictable, and so the shadow of what comes next hanging over us is a critical risk, in my view. So the sooner the shape of the exit terms becomes clear, the better that has to be. That has to be a priority so that industry can start to plan ahead. The prospect of a cliff edge and that cliff edge getting closer and closer is one that we should be very concerned about.

The Chairman: Can the Government do anything about that—for example, by declaring that EU regulation, as it is, will continue until there is a change so that a period of stability can be forecast?

Professor Eilís Ferran: At one level, it will continue until it changes—we remain a member of the EU and we continue to have those rights and obligations—but what is needed is a clear sense of what the change is going to be like. So the Government could—and I think this would be a wise course—indicate that, in the short term, we will be keeping the body of EU financial regulation effectively intact, and will be bringing home pieces of legislation that are currently in the form of EU directly applicable requirements and taking steps to turn them into domestic legislation. So there is a way of providing predictability for the period post the exit that will provide very important reassurance.

Q2 Lord Skidelsky: I am going to ask a question about the revenue implications of not just the period of uncertainty in which growth may well slow down, but on the expected profitability of the financial services sector, which has been a large revenue source for Governments. That is not just because of the uncertainty but because of the shape, as Professor Ferran said, of the exit terms when they are known. The implication of that is that, on given policies, there will be a widening of the budget deficit. Do you think that that is a reasonable conclusion to draw? I do not know whether you would like to venture an opinion on what the response to that
Professor Sir Charles Bean, London School of Economics and Political Science and Professor Eilís Ferran, University of Cambridge – Oral evidence (QQ1-9)

by the Treasury should be.

**Professor Sir Charles Bean:** Certainly, if we confine ourselves to the shorter term, if there is a slowdown, and let us say it is of the order of the Bank of England’s central projection, with output a couple of percentage points lower than it would otherwise be, broadly speaking that translates into about £15 billion less in tax revenues. The exact numbers depend upon the precise mix of demand and all those sorts of things, but that is the order of magnitude. As one goes further out, of course, the crucial thing is the nature of the settlement with the European Union. If we minimise the trading costs associated with Brexit and maximise the opportunities that are made possible by leaving, clearly the impact on GDP and tax revenues would be less than otherwise.

The one thing that might be worth adding in here—you mentioned the profitability of financial services—is that, if you are putting more grit into trading with European markets, that is going to have an adverse effect on profitability and you may lose some business and so forth. But there are lots of other challenges out there in financial services. There is the shift in economic activity towards Asia. We are in a world of sustained lower interest rates than we were, reflecting the lower world real interest rate that is consistent with a reasonable level of activity. As you will certainly be aware, there has been a lot of discussion of this in the academic literature. The so-called ‘secular stagnation’ thesis suggests that we might be in this world of very low real interest rates for a long time.

That has implications for the sustainability of lots of different business models. It includes banks but also asset managers, pension funds and so forth. It is easy to think that handling Brexit is the only thing that really matters, but there are a lot of other challenges out there to the financial services sector. There are also opportunities and, when it comes to ensuring adequate profitability, the key thing is seizing the new opportunities, some of which might be associated with increased trade with Asia, increased financial services there, and new developments such as fintech. The prospects for the profitability of the financial services sector are going to depend as much, if not more, on those things as on exactly what the Brexit deal is. Having said that, the better the deal the UK can get, obviously the better it is.

Q3 **Lord Desai:** Assuming that we will have our passporting rights withdrawn, how would that affect the market, with firms moving out, as well as other things the firms will do to compensate for loss of access to the EU?

**Professor Sir Charles Bean:** The key thing about the current set-up is that clearly with the passport you can either sell services into, or you have the right to establish a branch in, another EU member state. Removal of that right removes the right to establish a branch, but MiFID still allows you to sell cross-border financial services provided that the regulatory regime is regarded as equivalent. A key thing will be whether that equivalence is satisfied.

Secondly, it will matter a lot where the firm in question is mainly operating in wholesale financial services where it can sell its services cross-border or whether it needs to connect with retail consumers. If you need to connect with retail consumers, you basically need to physically
operate in the member state, and the loss of passporting rights will essentially mean that firms will need to set up subsidiaries over there.

If you look at the major banks—the non-EU banks that are headquartered in London at the moment—many of them also have subsidiaries already in other parts of the European Union, so they can still retain the access that they need; but then the question will become to what extent they need to transfer activities that are currently undertaken in London across to the member state. This is partly about what makes economic sense for the business itself and it will partly depend on the home state regulator. It may well insist that the subsidiary has lots of supporting services.

To make this concrete, to show that this is not something that is peripheral, I can remember discussions at the Bank when Santander was generating a presence in the UK but there were concerns about the stability of the Spanish banking system. The Santander operations in the UK relied for their back-office functions on an entity in Spain. A key question for us was whether, if the parent back in Spain got into trouble, even if the operation in London was fine, it would still have access to all the necessary back-office functions. There is a natural tendency for supervisors and regulators to want ancillary services to be there supporting the subsidiary to ensure that, even if the parent got into trouble, the subsidiary would still be able to function well. So how much gets transferred out of London into member states will depend both on the economics as far as the business is concerned and the response of home state regulators.

Professor Eilís Ferran: Without getting into the detail of it, I think we should be careful about assuming that there will be equivalence solutions across the board. There are not. There are key areas that are not covered by equivalence. For example, the area of payment systems is one that is critically important and not covered. If we look at MiFID and MiFIR, yes, it is true that wholesale services will be covered under the new regime, but retail will not, and indeed that will depend on a member state by state permission to provide retail services. Another area that I would pick out as being hit in a significant way will be the asset management industry. All the European fund brands, UCITS and the like, will no longer be available to UK funds and fund managers; so we will then be in the very complex world of being a third country under the notorious alternative investment fund managers directive—AIFMD. The third-country provisions of that stand out as one of the most complicated and unsatisfactory sets of EU post-crisis law. The passport under that regime for third countries comes at a heavy price, namely, having to comply with EU law in that respect. So the world will be significantly different there.

One obvious problem on the horizon is with respect to clearing houses that do euro trades. We saw that when we were a member state the UK was able to resist the ECB’s attempt at location policy, using its right as a member state to challenge that in court, and using its protections from discrimination as a member state with respect to currency or location. It is very likely, it seems to me, that the ECB will reopen that issue and want to have an extended competence in that regard. Although there has been some suggestion that this may be a problem that is disappearing because new technology is going to change the way that clearing and
settlement is done, I am not convinced by that. I think that what will happen is that the existing clearing houses will probably incorporate that new technology into their business operations but they will continue as they are. So there is a major problem there that will not be covered under a passporting regime. That would be my sense of where things are in a number of areas.

**Professor Sir Charles Bean:** Can I endorse that? It is very easy to think that we can get equivalence in lots of areas. By definition, we are equivalent at the moment since we are part of the single market, but, in practice, proving equivalence and maintaining it is quite challenging. So the notion of it being across the board I do not think is plausible. In selected areas it may be perfectly viable. On the issue of euro clearing, I will not say it is likely that we will lose it: I will say it is certain that we will lose it. Independently of the economics of whether it needs to be in the eurozone or not, I have absolutely no doubt that it will be mandated to be taken back into the European Union.

**Q4 Lord Shutt of Greetland:** What are the most important priorities for the UK financial services sector, both in withdrawal negotiations and in negotiating a fresh future relationship, and where does free movement of people come in this?

**Professor Sir Charles Bean:** To start with the last question, part of the City’s strength comes from access to a deep pool of skilled labour, and a lot of that labour comes from overseas. Something like 11% of the 360,000 people who work in the City are from other EU member states. Of course, there are also plenty from non-EU countries. That is clearly one of the several attractions of London as a place for business. Were access to that skilled labour to be seriously impaired, it would impinge on London’s attractions. So a lot depends on the nature of the controls on migration that are put in place. Clearly, there is a debate going on at the moment on different models. We do not know what it is going to look like, but I would have thought, from the financial institutions’ perspective—and that of many other employers, for that matter—the key is that whatever is there enables them to get the specialised labour that they need in a relatively efficient and smooth way. My worry is that some heavy bureaucratic process is put in place that takes a very long time to operate and becomes very cumbersome. Certainly, the more efficient whatever is put in place is, and with sufficient flexibility, if you like, for the City and other employers’ needs, the better.

**Professor Eilís Ferran:** I agree completely with that. I will say three things on the broader priorities. The first is replicating as far as possible the current arrangements that we have with the EU, partly through equivalence, partly through bespoke provisions in the exit terms, and doing that as soon as possible so that we can avoid that cliff edge and businesses can start to plan. The second is thinking about the UK and the rest of the world. To the extent that the UK has access to international markets by reason of EU-brokered access arrangements, we need to ensure that those access terms are preserved and protected. The third is thinking about where the UK repositions itself in international financial regulation. In the design of that it is important for the industry that the UK continues to play a very influential role. It is losing some levers of
Professor Sir Charles Bean, London School of Economics and Political Science and Professor Eilís Ferran, University of Cambridge – Oral evidence (QQ1-9)

influence by not being part of the EU but gaining by being more independent and more able to form different coalitions. Figuring out how all that is going to work is very important for the industry and for the UK’s interests as a whole.

Q5 Earl of Lindsay: Can I go back to the issue of equivalence, which you both touched on? You have both mentioned already some of the shortcomings and difficulties that would emerge if, as a third-country regime, we were hoping for equivalence to be, as it were, the saviour of financial services and the means by which they could continue to access the single market. Are there any other shortcomings or difficulties associated with equivalence that you have not mentioned that we should be aware of? If that is the destination that we end up heading for, how can we mitigate those shortcomings and difficulties to make the best fist of an equivalence scenario for our financial services?

Professor Eilís Ferran: Equivalence can take a long time. We saw that with clearing houses—more than three years between the US and the EU. That should not be a problem in the short term in the sense that we are, as Charles said, equivalent now, so we should be able to have that agreed pretty efficiently, provided that politics does not get in the way. I am reasonably confident on that. We do need also to think about future-proofing. As to the Swiss relationship with the EU and its special bilateral treaties, one of the big problems there has been the need for renegotiation every time something changes. Because financial services move very fast, there will be new issues and we will start to diverge, so we need to think about what the mechanisms will be in the future so that we do not have to keep going back and doing an equivalence check every time there is a change. We need a streamlined process and a degree of certainty over when that will be triggered so that there is room for manoeuvre on both sides. For me, it is very important that we think about that.

Professor Sir Charles Bean: To be honest, the only way I could see equivalence operating on a long-term basis is that, if we want to sell services under an equivalence basis, we would just have to accept that we would be adopting whatever regulations the European Union decides to adopt.

Professor Eilís Ferran: Can I disagree with that?

Professor Sir Charles Bean: You can certainly disagree with it, but it will be quite difficult for us to think about this as a negotiation every time. There may be some small areas where there is some flexibility, but I think that we will see ourselves as predominantly being driven by decisions by the other European member states.

The Chairman: Professor Ferran, this is your chance to negotiate.

Professor Eilís Ferran: I agree in the short term that we are the ones trying to disturb the status quo, and that is a weak hand, but over the longer term—equivalence is not about being identical; it is about getting to the same outcome, and that has been very clear in our negotiations within the EU with the US and the like. There will be new issues and new problems. The UK has a very good record of being an effective first
mover. It was ahead of the EU on bank resolution and other areas as well. So there is plenty of room, I think, for the UK to take the lead in solving new problems, and, in a sense, that first-mover advantage will allow it to set the agenda in equivalence negotiations. So I am more optimistic.

**Earl of Lindsay:** Can I check your optimism, when you said that there should not be delays in negotiating and agreeing equivalence because you do not think politics will get in the way? I am interested to hear you say that, because there seemed to be political signals from some players on the European stage that suggest that politics might get in the way. Can I raise one other point, Professor Bean, that your colleague Professor Moloney at the LSE has raised: that equivalence is not just about regulatory equivalence but about supervisory and enforcement equivalence, and that making judgments about supervisory and enforcement equivalence is much more difficult? Is that a real issue that we should be wary of?

**Professor Sir Charles Bean:** It certainly is a real issue, yes.

**Earl of Lindsay:** Can I go back to the first question, then?

**Professor Eilís Ferran:** Yes. Why I am relatively optimistic about politics not getting in the way is that, one, the EU needs us as much as we need it. If we look at, for example, the flagship Capital Markets Union plan, it is about opening up new sources of finance and new investment opportunities. Cutting out the UK as a market, both for us to provide services there and for the EU firms to provide services into the UK, is not wise in that respect. Secondly, both the UK and the EU are committed to open markets. We saw that again this week in the G20 communiqué—there was a reaffirmation of that—and they both care about their international profiles and being able to influence the international agenda. Erecting fortress Europe would cut across that. My third point is one that picks up on a recent paper by Niamh Moloney, who is a close colleague of mine as well—we work together a lot. She has made the point that the rise of the European supervisory authorities and the role that they play in determining equivalence is one that brings a very strong technical expertise to it. I would hope from that that there is a buffer zone in these processes that will act as a shield against political interference.

**Q 6**

**Lord Skidelsky:** How would financial regulatory co-operation between the UK and the EU change or be affected under different models of EU membership—the Norway, Switzerland, WTO options? What motivates my question is that the reform of the banking system since 2008 is work in progress. Under any of these regimes, we would lose our influence over that work as it is undertaken by the EU. We have reservations about many of the macroprudential instruments that have been put in place. We have great reservations about tax on bonuses, just to take one example. Would not the effect of that loss of influence be quite serious, because much of the work is really directed to the particular problems of the eurozone and we would just lose our input into that?

**Professor Sir Charles Bean:** First of all, there are some areas where we will be just as influential as we are now, if not more so—most obviously in things like bank capital requirements. The Basel Committee is the key body there, and things like the Capital Requirements Directive, and so
forth, are just implementing agreements that are made at Basel and have the imprimatur of the G20. So that sphere I would not be too concerned about, and a lot of what goes on there is building alliances with the Americans, with Asian countries and so forth. There are, though, other areas. You raised the bankers’ bonuses issue. That is not something that we have been particularly in favour of, not because we like people having big bonuses, but if you restrict the size of bonuses you restrict the elasticity of remuneration with respect to performance, and, particularly if you want to penalise people for bad performance, you need potentially quite a chunky area there. So it seemed to us that that was not helpful.

It certainly is true that some of the initiatives in Europe have been focused on issues that are not primary. There has been quite a lot of attention from some countries on reining back hedge funds. Hedge funds were not the source of the financial crisis: they were bit-part players at most, but they are often the messenger; they are the people who are betting against unsustainable positions, and in the case of the eurozone debt crisis, of course, they looked like the villains. But it is a case of shooting the messenger if you are trying to rein them back, in my view. Certainly, quite a lot of the initiatives taken in Europe are focused on the particular issues as seen within Europe. Europe is a very bank-centric financial system. They are starting to get more concerned about diversifying forms of corporate finance. So starting to move into other areas of regulation and the like. Certainly, there will be some areas where we will not have much influence on what they do other than where supervisors meet in fora where they can discuss these issues and we can pass on our views. But it is not the same as being around the table in the relevant fora, whether it is ESMA, EIOPA, the EBA or discussions between Governments at Ecofin and so forth. We have to accept that we will be on the sidelines of some of those discussions.

Professor Eilís Ferran: I agree on the importance of international standard-setting fora. That was one of my priorities earlier, and the UK’s influence in that will still be significant. I accept that if we went for the Norway model we would still be an observer in EU processes, but the drawback of that model is that it then ties us in to following the EU. Having said earlier that I think there are opportunities for us to lead in regulation in the future, the trade-off there for me comes out as being in favour of giving up that influence as an observer within EU processes for other things.

If I could just add one point on bankers’ bonuses, having said that I was optimistic, relatively speaking, about coming to a sensible deal on equivalence, if we want to scupper that possibility, the best way of doing that would be to start picking a fight over bankers’ bonuses. We should leave that for now and move on to other things.

Lord Skidelsky: But we are in a stronger position than Norway to influence the shape of our settlement.

Professor Eilís Ferran: That is true. We are in a stronger position now, and in the future I think we can influence in other ways, notwithstanding that we are not around the table in the EBA, for example. We will still be in the supervisory colleges. We will be there as an observer rather than a
member, but my expectation would be that those discussions will be ones that are fully open to the UK’s participation.

**Lord Skidelsky:** Can I ask one other supplementary? It seems to me that the trend of financial services reform, or the mood, I should say, is one of repressing the scope of financial services to some extent, which goes directly against the philosophy of the City of London and the position of the City in our economy. Is there a tension there that will become more acute from the fact of our leaving?

**Professor Sir Charles Bean:** It is a fair statement of the facts that there is, shall we say, suspicion of Anglo-Saxon financial markets in many other EU member states, and at a superficial level they think that it was that model that led to the financial crisis and that is a huge real-economy cost, so it needs to be reined back. London is the only big global financial centre in the European Union. Most of the other financial centres are really focused on their domestic markets, and it is about providing finance for consumers and businesses and so forth in a relatively straightforward way. They have a very different perspective on the matter that they are dealing with. It is fair to say that, while we have been in, we have been able to put the other side of the case and to try to make the case for more liberal markets, or whatever it might be. That will be harder on the outside. We do not have to stay silent, obviously; we can try to make our case in the relevant fora, but we will have less traction. We have to accept that.

**The Chairman:** May I ask one supplementary under this heading? Switzerland is a country with a strong financial services tradition and industry. Has its financial services industry suffered by it not being a member of the EU?

**Professor Sir Charles Bean:** There is always a question about what the counterfactual looks like—what it would have looked like if it had been in. Of course, if you have arrangements like Switzerland, you are outside but you have some dealings with the European Union and you find ways to work with whatever the set-up is. People in financial institutions are very good at working out how to deal with whatever the set-up is and what is the profitable way around obstacles and so forth, whether that is having correspondent banks within the European Union or whatever it might be. It is very difficult to answer the question in the way you put it: would Switzerland have been much better off had it been a member of the EU with full access to the European Union financial markets instead of the arrangement that it has, which really just has equivalence on insurance, but nothing special on the banking side?

**Lord Desai:** I have one supplementary, which is a sort of counterfactual. The resentment of financial markets is as much in the UK as outside. They may not like Anglo-Saxon capitalism, but some of the people who voted for Brexit actually did not like the way banks worked.

**Professor Sir Charles Bean:** Yes, absolutely.

**Lord Desai:** Do you think that the Government will be able to take a stance in negotiations that would be really protective of City interests or will they let go? I know that that is a political question.
**Professor Sir Charles Bean:** It is a political question and I am an economist. So my view here is just like that of any other punter, if you like, but I think you are right that it would be quite difficult for the Government to have a negotiating stance that said they are going to prioritise the interests of the City ahead of, say, migration control or any of the other myriad issues that will be involved in this. I do not think that that would go down well domestically. Clearly, they can make the case that it is important, as a big foreign revenue earner for us; it is getting on for 10% of GDP, with something like £60 billion net earnings from it and so forth. So they can make the case that it is important that there are arrangements that allow the City to prosper. But something that looked like it was prioritising the interests of the City ahead of other things would be quite difficult to sustain. But as I say, that is politics; it is not my sphere.

**Professor Eilís Ferran:** I would say that it is very much in everybody’s interests that we have a safe, secure and resilient financial system. We need our payment systems to work. We need settlement finality. A lot of things are currently up in the air as to how they will operate, and I think it is a priority, not for the profitability of the City of London in itself but for the well-being of society, that we ensure that the system that we have with all of those checks that are in place at the moment is continued and that the checks are not disturbed by any kind of fragmentation post Brexit.

**Q7 Lord Woolmer of Leeds:** Professor Ferran, you started with an opening statement that mentioned the advantage of a bespoke arrangement. Could you set out the main features of a bespoke trade agreement that would best maintain the position of the UK’s financial sector? Which arrangements within that bespoke deal are most likely to be acceptable to EU negotiators and which would be the most difficult to achieve, because a lot of our discussions in the UK seem to assume that the EU members have no views about this and are just waiting to know what we are demanding? It would be helpful to know what the EU would want out of these negotiations.

**Professor Eilís Ferran:** I would suggest that we have an early agreement on a badge of equivalence in areas where there is an equivalence regime currently in the EU framework; that we come up with something similar in each of those different areas where there is equivalence regime in the current EU framework; that we agree on issues of legal certainty, for example around settlement finality; and that we do all of that as quickly as possible, recognising that politics will come into the timing of things. There are some relatively easy wins on some of the technicalities. For example, there is should be an easy win with respect to how the treatment of exposures to the UK held by European banks will be worked out for capital adequacy purposes. Those exposures currently benefit from a favourable treatment because they are EU. We need a quick equivalence agreement in relation to those. That is for the benefit of European banks and is an area where we can perhaps easily sort things out and get rid of politics in equivalence.

There are potential easy wins, too, in ensuring supervisory co-operation. We can use the fact, if we come back to MiFID, that the UK currently has
a really rather generous overseas person exemption allowing third-
country firms to provide investment advice and services in the UK without
a local authorisation. That is not replicated across the EU. I think we have
a bargaining chip there in what we are able to offer to firms coming in. As
to where the greatest difficulties are, it is hard for me to pick out one area
and say that it is likely to be the absolute sticking point. It is the volume
more than anything else that worries me and how you work through each
of the issues. At the operational level, if in future our MiFID trading
depends on our firms being registered with ESMA, which it will under the
current regime, and we want to have an equivalent type of registration
regime, we need to get going quite quickly on those operational things as
well. ESMA is not a well-resourced institution. We do not want to find
ourselves having a very nice framework but operationally things getting
gummed up in the system because there is just an overwhelming body of
applications to process. I would look at that as well.

The Chairman: Professor Bean, do you want to add anything?

Professor Sir Charles Bean: I do not have much on the specifics. I
would just make a more general observation that what we want to give is,
if you like, a quid pro quo in the negotiations, is something that our
European partners will want. Going back to what I said earlier about
London being really the only global financial centre in the European time
zone, clearly for financial companies in Europe there are advantages to
them in being able to operate relatively freely in the London market.
London is partly built on the idea of welcoming outsiders to operate—the
“Wimbledonisation”, as it is sometimes referred to, of the City.

Professor Eilís Ferran: That was before Andy Murray started winning.

Professor Sir Charles Bean: That is true, yes. The other thing is that
when it comes to corporate finance, because corporate finance is
relatively underdeveloped relative to bank finance in a lot of the European
markets, the European corporates often, when they are looking to raise
finance other than through banks, will come to the London market. They
want access. Looking to exploit the things that we can offer in return for
things that we want makes some sense. But that is a rather general,
high-level observation.

Q8 Lord Haskins: I want to raise the issue of uncertainty and the degree and
the length of the uncertainty. My background is in dealing with the
manufacturing side and dealing with foreign direct investors in the north of
England. Their position on this is, basically, to sit tight, wait and see. They
can do that for quite a period of time. Saying nothing is happening is
absolutely right—nothing is happening—and that is a worry; but in our
discussions with the City just before the break I got the impression that
things were already happening and that people could not hang around. It
is much easier to make a decision to move people from one place to
another than it is to build a new car factory in one place rather than
another. These things take a long time to come. The worry I picked up
from that was that the City was already walking, and we indeed talked to
two or three people there who were already moving. During that period of
prolonged uncertainty—and it is likely to be prolonged—how can the
Government maintain the confidence of the City such that it does not do
rash things too quickly?

**Professor Sir Charles Bean:** One thing that might be advantageous would be to try to have a reasonable transition period. If you are going to relocate activities to another EU member state, particularly if you have to set up a subsidiary from scratch, getting the authorisations and so forth, takes time; it can take as long as a year. You have to set up associated systems; then you have to move your staff across. It can take quite a long time to plan it, execute it and go through all the process. If you think, okay, the button is going to be pressed on Article 50 on such and such a date and two years after that to the day, whatever happens, we will have whatever deal that has been agreed, whether it is WTO or some bespoke agreement, that does not leave you that much time to execute it.

Certainly, it would help firms if they knew that, even if the negotiations were going to be concluded within two years, there might well be some transition period afterwards. That would mean that they would not need to worry so much about starting to move now. I am sure that they will already be planning what they might do under certain models, but, until you know exactly what the model is, it is a bit precipitate to take hard decisions to start moving. The more that you think that there will be a transition period after the actual implementation of Brexit, the less need you will have to move now. That is one thing that might be useful. It may not quite be in the Government’s gift to say, “Yes, you will have it”, because it may depend also on our partners, but they could at least indicate that it would be something they would go for. Frankly, as far as our partners in the negotiation are concerned, they do not want to see disruption in financial markets. That does not help them. They would want the process to be executed smoothly too.

**Lord Haskins:** You do not think people are going to make precipitate decisions in the short term.

**Professor Sir Charles Bean:** Some might. Frankly, if you are a business where it does not really matter too much where you are, you might as well move now.

**Lord Haskins:** Like the big American banks, for example. They could move. They do not take a year. They do not have to carry out all the set-up that you are talking about.

**Professor Sir Charles Bean:** The thing is, if it is very easy for them to move, you do not need to move so precipitously. You do the planning. I am sure that there is lots of planning and I assume in your inquiry you will talk to people from institutions who will be able to tell you exactly where they are. I think a bank or any other financial institution, for that matter, would be very remiss if it was not doing all sorts of contingency planning. Unless it is either pretty irrelevant where you are, or you are really worried that it will take you a long time to execute a switch, it does seem to me unwise to be moving before you have to. There is an option value to waiting. That is why firms hold off investing—there is a value to them to waiting—and, equally, there is an option value to not moving yet.

**Q9** **Lord Shutt of Greetland:** Can I put this to you? I think that all your
answers this morning are there or thereabouts where I had expected them to be, and I am not unhappy in one sense, but it seems that what you are really saying is that we should hug the existing arrangements and the EU as much as we can. Let us hug it. How does all that fit with this “Brexit means Brexit” rhetoric? Is this what these Brexiteers want and what so many of the British people said—“Yes, this is what we want; we want out of all this lot”? What you are saying is, “Hug it”.

**Professor Eilís Ferran:** I do not think that financial services were perhaps the driver for many people’s decision to vote in the way they did. As to hugging, I am saying that we should hug in the short term. In the longer term, there will be opportunities to do things differently while remaining equivalent and while remaining within the bounds of international financial regulation. We can more easily be super-equivalent, for example, and we can be a first mover in solving new problems that come along. We can also, I think, look at developing parallel regimes—EU compliant and non-EU compliant—to cater for different groups of market participants as well. “We can start to release the bear-hug over time” would be my view of things.

**Professor Sir Charles Bean:** My picture on this is that it is a case of wanting to minimise the costs and maximise the extent to which you take advantage of the opportunities, but of course the interesting question is when there is a trade-off between those two. If preserving access to the EU under some equivalence arrangement or whatever involves having an adverse impact on your competitiveness in a way that it impacts your ability to compete on the global scale, you are faced with a trade-off and you have to decide where you want to be on that. As I said earlier, it is very easy to get focused on the problems of extricating ourselves from the European Union and the adverse consequences that might flow from it, but there are also an awful lot of opportunities out there. There are big challenges in financial services because of the changes that I mentioned earlier and the rise of Asia and the low-interest-rate world, but there are lots of opportunities, too. The key challenge for the City collectively is to try to seize those opportunities and make a success of them. In the past we had a good record, when the world changed, of actually embracing and taking advantage of it, instead of pushing back. The central issue, when it comes to thinking about what the new regulatory environment is and so forth, is how you balance the two objectives of minimising the costs of withdrawal and maximising the extent to which you can take advantage of the opportunities. And there will be times that they conflict, I have no doubt about that.

**The Chairman:** May I thank you for your admirably clear answers? Is there any further thing that either of you would like to say without which the evidence you have given to us this morning would not be complete? Ladies first.

**Professor Eilís Ferran:** Not me.

**Professor Sir Charles Bean:** Not from me.

**The Chairman:** We are very grateful indeed. Thank you very much. That ends our first public session
British Bankers’ Association, PricewaterhouseCoopers (PwC) and Reuters – Oral evidence (QQ10-17)

British Bankers’ Association, PricewaterhouseCoopers (PwC) and Reuters – Oral evidence (QQ10-17)

Evidence Session No. 2 Heard in Public Questions 10 – 17

Wednesday 7 September 2016

Members present: Lord Butler of Brockwell (The Chairman); Lord Desai; Lord Haskins; Earl of Lindsay; Lord Shutt of Greetland; Lord Skidelsky; Lord Woolmer of Leeds

Examination of witnesses


Q10 The Chairman: May I start our second session today? I welcome Mr Andrew Gray, Global Financial Services Brexit Leader of Pricewaterhouse, Mr Anthony Browne, chief executive of the British Bankers’ Association, and Mr George Hay, European financial editor of Breakingviews for Reuters.

Again, this is a broadcast session—a formal evidence session of the Committee. A full transcript will be taken. It will be put on the public record in printed form and on the parliamentary website. You will be sent a copy of the transcript and will be able to revise it by correcting any minor errors. The session is on the record; it is being webcast and will be accessible subsequently via the parliamentary website. You have a general statement of the declaration of interests of members of the Committee before you. Would any of you like to make an opening statement?

Anthony Browne: Can I make a very brief one? The UK banking industry—both UK banks and UK-based international banks, which we represent—clearly accepts the verdict of the British public in the referendum. We are committed to working with the Government and with Ministers to make sure that Brexit is a success. We are talking to the Government about that.

We think that it is important that we approach this in a way that minimises disruption, maintains financial stability and ensures continuity for customers, both in the UK and in the EU. It is important that it is seen in both ways. Customers in the UK are often served by EU banks that operate here, but customers in the EU 27 are also served by UK banks. It is important that they continue to get those services.

The Chairman: Mr Hay or Mr Gray, do you want to make an opening statement?
George Hay: No.

Andrew Gray: I will add to and reinforce the point that Anthony made. This is a complex issue that is not just about the UK versus the EU. Financial services are a global industry. Changes to the current environment will have implications across both the UK and the EU, as well as more widely in the international community.

The Chairman: Thank you very much. Could I start by asking you a general question? The value of your panel is that you cover specific sectors. It will be very interesting to know your answer in relation to each of the sectors. What are your projections for the investment and economic climate in the short to medium term? Will what is likely to be a prolonged period of uncertainty affect the day-to-day running of the industry? Would you like to take those questions? Who would like to go first?

Andrew Gray: I am happy to start. We have been doing work with a number of clients across the sectors of banking, insurance, asset management and the financial market infrastructure, both in London and the rest of the UK and also internationally. There are several issues that our clients face.

There is a particular point around uncertainty as regards the timeline over which agreements may be reached. There is also uncertainty about what those agreements may be. That requires firms to look at options that they have and, potentially, to start to develop plans that enable them to have contingency arrangements in place that can be implemented within the timeframe that they have available. Clearly, firms are looking at the range of business activities that they perform and the extent to which they use various passporting arrangements.

There are questions around immigration. The UK financial services industry relies extremely heavily on overseas talent coming into the UK and London. Finally, the issue of the speed at which firms need to move relative to the speed at which the negotiations move provides a very complex situation. While a degree of certainty would be welcome, there is nevertheless a sense of realism that that may not come for some time.

George Hay: I echo those thoughts. Probably the key thing that investment banks, in particular, are worried about at the moment is that, as and when Article 50 is triggered, the clock starts ticking and you have two years. They are hyperaware that, if the answer at the end of that two-year period is not very positive as regards our equivalence with the rest of the European Union, they probably need to start doing whatever they are going to do in response to that now. The people I am talking to say that it takes a number of years to move a large number of people to various bits of the EU or to make big carve-ups of your business, in the way that may be required if we do not get a good deal. There is a lot of uncertainty. That will have some impact on business activity, I would say.

The Chairman: Is there any way in which the Government can minimise that by giving indications of what their negotiating parameters are at an early stage?

George Hay: The problem is that we are about to go into a negotiation that will potentially be a hard-nosed one. The issue is how much of our
hand we want to reveal early doors, as it were. Clearly, from the bankers’ point of view, it would be really helpful to have some idea of what the UK Government’s position is—what kind of equivalence regime we want to shoot for. But, from a negotiation point of view, it may not be the best idea to show Europe exactly what we want, working on the assumption that we probably will not get what we go in and ask for originally.

**The Chairman:** Mr Browne, do you want to add to that?

**Anthony Browne:** Yes. What we would like, which we believe is in the interests of both the UK and the EU 27, would be to have the fullest possible bilateral access to the European market—as close as possible to what we have at the moment. That is in the interests of customers on both sides of the channel.

You raised the point about uncertainty. No businesses in any sector like uncertainty. It is very difficult to plan for that. The red line for the banks is being able to serve their customers. That is what they really do not want to put at risk. What they need is as much reassurance as the Government can give them about the road map towards an end deal. As George said, we totally accept that neither the Government nor we as an industry can try to negotiate in public. But if you are making big decisions about where and how you can serve your customers, against a background of triggering the Article 50 negotiations and potentially, at the end of two years, ending up with no agreement, and as it takes years to relocate activities from the UK to elsewhere—if that is what you decide that you need to do—clearly you need to start making decisions about this quite soon in the process.

As your previous witness, Charlie Bean, said, there is an optionality to waiting. There is a “wait and see” situation at the moment. But the more certainty the Government are able to give—we totally accept that this is a bilateral thing and that it depends on their discussions with other European countries—the less risk there will be of disruption to financial services and to customers across the EU.

**Lord Skidelsky:** What do you think the macroeconomic impact of the Brexit decision will be over the next two years? Obviously there will be a lot of uncertainty, but what will be the impact in concrete terms? Most of the central projections are for some decline in the growth rate. That will have an impact on public finances. What steps do you think the Government might take to mitigate that, assuming that the central projections are right and that this does not depend primarily on the shape of the settlement? In your view, what steps should the Government take to minimise the adverse macroeconomic effect of the Brexit decision?

**Anthony Browne:** We think that there are three different economic effects of the Brexit referendum result. First, there is the immediate market reaction. The banks planned for that immediately—there was obviously a big drop in sterling—and weathered the storm, largely, with the support of the Bank of England, which injected a lot of liquidity. There is then the longer-term macroeconomic impact, which is what you are referring to. As representatives of the banks, we do not do macroeconomic forecasts and do not advise the Government on what we
British Bankers’ Association, PricewaterhouseCoopers (PwC) and Reuters – Oral evidence (QQ10-17)

think they ought to do. I note that so far it has not been quite as bad as some projections—

**Lord Skidelsky:** Did I understand you right? Did you say that you do not do macroeconomic forecasting?

**Anthony Browne:** There are lots of people in the industry who do macroeconomic forecasting, but we as a trade association do not do that. The industry does—banks do. However, as the British Bankers’ Association, we do not do forecasts on behalf of our members. They do it themselves.

**Lord Skidelsky:** I understand.

**Anthony Browne:** The one thing that is a concern for the future goes back to the point about uncertainty and the shape of the deal that we have. That could have an impact. As I said at the beginning, what we really want to avoid is disruption to our financial markets. If you end up with cliff-edge effects and disrupting London’s access to capital from Europe and vice versa, that could be quite disruptive. That is why we need certainty and want to have as much access to financial markets as we have at the moment across the EU. That would be the way to minimise the macroeconomic impact.

**George Hay:** The Bank of England has already given its monetary response to the Brexit shock. The obvious thing for the Government to do is some kind of fiscal stimulus, if that is deemed to be needed. What that is will be revealed if it comes out in the next year or so. There are plenty of things that you could do on infrastructure in this country, especially with borrowing rates at such low levels. The counter to that is that in the last couple of days the actual economic data has come out and was an improvement on what you saw last month. What you say is definitely true—there will definitely be slower growth. The question that some people are now asking is whether there will be a recession in the way that a lot of people were expecting a couple of months back.

**Andrew Gray:** One of the difficulties—pointing to the recent upturn in economic indicators—is that it is far too early to tell, I would argue, what many of the real economic consequences will be. Our analysis was very much that there would be lower growth relative to what there would have been had Brexit not occurred. The combination of the exchange rate, the interest rate and the fiscal environment from the Government will play a significant part, as will the openness with which the Government feel they are able to express their views of the negotiations as they unfold, and their position regarding the UK and the rest of the world outside the EU.

**Q11 Lord Desai:** Given how important passport rights are, what would be the effect on different sorts of firms in the City of losing passport rights? Does it depend on the legal structure, what product they are selling and so on? What can the UK do if we cannot arrange access? It is the worst-case scenario. If so, do we diversify and go somewhere else?

**Anthony Browne:** It is no exaggeration to say that London’s role as Europe’s financial centre has been very dependent on access to passporting rights. Both UK banks and, perhaps more significantly, the international banks based in London serve customers across Europe using
the passports that are granted by the various European treaties—whether it is to sell securities or to do corporate lending, trade finance, hedging et cetera.

In the worst-case scenario to which you referred, we would end up without an agreement with the EU and with an agreement based on World Trade Organization rules—the so-called "naked exit" of the EU. There is very little provision for financial services under World Trade Organization rules and agreements. There are limited business lines that UK-based banks could carry on offering European clients and the other way around.

As you know and as your previous witnesses said, there are various equivalence regimes that exist under existing regulations. They are relatively untried and untested. They are uncertain and limited in scope, in the sense that a lot of activities are not covered by them. Classic corporate banking—deposit-taking and lending to companies—is not covered by them. There is also uncertainty and unpredictability about them. They can be removed at relatively short notice and could be subject to change in future, if there are changes to regulation on either side of the channel.

I can give you one concrete example, just to bring it to life. If a German company was trying to raise €500 million for an investment to build a factory, it might do so by raising a bond with, in addition, a syndicated loan, and then hedge that in respect of foreign exchange payments, currency risk and interest rate risk. Those are three different products. The company would come to London for that. All of that is based on passporting rights. If passporting rights were lost, the company would not be able to come to London for bonds, for a syndicated debt or for hedging foreign exchange or interest rate risk. If we got equivalence, under MiFID and EMIR, it might be able to come for the bond and to get some hedging, under EMIR, but it would not be able to get the syndicated debt, because there is no provision for lending under any of the existing regulations. So banks based in London would only be able to provide a narrower range of services. They would not be able to be the sort of one-stop shop that they are at the moment.

**George Hay:** The way to think about passporting is that you have to have it in order to have the automatic right to do cross-border business on the continent. That is what we have at the moment. How badly it affects individual firms will depend on how much cross-border business they want to do and where they are starting from. A company like Lloyds Bank does most of its business here. It wants the current system to continue, but it would not necessarily be hit too badly if it did not, because most of its business is in the UK.

The other issue is whether you have a subsidiary in continental Europe. Provided that we get equivalence, having a subsidiary would allow you to continue doing business there, but it depends critically on the equivalence that we get. That is all in the lap of Europe, when we do the negotiations.

**Andrew Gray:** I will add a few points. Across the sector—in banking, insurance and asset management—by and large, retail businesses providing retail products are conducted across Europe by local subsidiaries that are locally capitalised and locally regulated. On the
whole, the impact on those businesses would be minimal—which is not to say that it would not have some impact.

When you come to corporate banking, corporate insurance and arrangements like that, as well as Lloyd’s of London, the institutional nature of the business means that, typically, it is international and cross-border in nature. The impact of losing passporting would be that you would not be able to conduct business on a cross-border basis with certainty, at this stage. While there is talk of equivalence, there are no equivalent arrangements set up to enable firms to do that. It is possible that there will be in the future.

That is why many firms are looking to set up new subsidiary structures in one or more European locations. But doing so increases the cost of financial services and industry. It requires additional capital and a fragmentation of liquidity, as well as a number of additional incremental investments to support a more complex business model. Ultimately, those costs would be borne by the users or shareholders of financial services.

Q12 Lord Woolmer of Leeds: Could I turn away from the corporate sector? What are the risks facing UK and EU retail customers and investors if final access arrangements affect the operations of private wealth management firms and European payment systems? Mr Browne, you may have an interest in that.

Anthony Browne: Absolutely. I echo the point that Andrew has just made. If you are a UK-only retail bank whose customers are in the UK, obviously you will be far less affected than if you are a cross-border, international bank. There are aspects of retail banking that might be affected. There is EU regulation that affects retail banking. One area that you mentioned is payments, particularly cross-border payments. We are members of the single euro payments area, which reduces the cost of international payments and makes them easier to do in euros. If we left that, transferring money in euros to mainland Europe would become more expensive.

You mentioned private banking for high net worth individuals. They are often serviced internationally. They are customers across Europe of private banks based in the UK. They use a wide range of services—not just payments, lending and deposit-taking but more sophisticated investment services. A lot of those would not be covered by any equivalence regime, even if we got such a regime, because they are classified as retail customers and, basically, the equivalence regime covers only corporate and institutional customers. Things like UCITS, for example, are covered by the equivalence regime, but only for corporate customers. High net worth individuals from Germany, France or Italy who are customers of private banks based in the UK would no longer be able to access those services—so it would definitely be more limited.

George Hay: That is certainly right. They count as retail clients. Equivalence is quite complex. Even if there is a third-country equivalence regime, which Anthony was talking about, for all the more corporate, wholesale clients, it will take some time for Europeans to work out whether they want to give us that equivalence. For retail, there is not even that regime in place, so you would have to create one. It is not
impossible to do that, but it would probably take time, which feeds into the lack of certainty about where we go for both clients and businesses.

**Anthony Browne:** There is also a lack of clarity about what private banks will be able to say to their customers in other EU countries. There is a view that they would only be able to do marketing. Private banks in London could market to customers in Germany, France or Italy, but could not actually sell to them. That is the problem.

You asked the previous witnesses about Switzerland. Clearly, there is a big private banking industry in Switzerland. There are very many constraints on what those banks can and cannot say to their customers when their customers are in the EU—either when they physically visit them or when they speak to them over the telephone. I know that from some meetings that I had recently in Geneva. Obviously, Geneva has a border with France. If they are speaking on the phone to a customer who is driving along, as soon as the customer crosses the border into Switzerland, they are allowed to say and do different things. They can actually sell things, which they cannot do if the customer crosses the border back into France, where they are in the EU. Depending on the sort of arrangement that we have, there could end up being similar sorts of constraints here.

**Andrew Gray:** I will add one specific thing. We have focused on private banking and wealth management, but my point relates to payment systems. The payment services directive is a new piece of legislation that is coming in. It will enable certain aspects of new technologies to be deployed across Europe to make payments. Some of that initiative has been driven by the fintech industry in the UK. The UK would not be able to participate in some of the opportunities that that will provide in the future to have a more seamless payments infrastructure across Europe.

**Q13 Lord Shutt of Greetland:** What do you believe to be the most important priorities for the UK financial services sector in both the withdrawal negotiations and in negotiating a fresh future relationship for the UK with the EU? Where does free movement of people fit in with this?

**Andrew Gray:** The key thing we have already touched on—I know that it was discussed with the previous panel as well—is, effectively, a right of access to European markets that is of equivalent standing to the current passporting arrangements, without which there would be major disruption to the way in which financial services could be provided. That looks remarkably like we are saying that it is business as usual. To be honest, the financial services industry has grown up in London over many years, is a very complex environment and has adapted very well to the current regulatory arrangements by which it gains access. So removing that access right will increase costs and provide disruption to the financial services industry.

In addition to access directly to customers, access to clearing systems and other market infrastructure is a fundamentally important part of the way in which the industry operates. Fragmenting that infrastructure will also result in incremental costs to the industry.
There is an additional point about immigration. It is an international industry and one that uses talent from across Europe and, indeed, more widely. It is also an industry that is used to moving its people internationally and doing so quickly. Again, there would be impediments to that movement.

Finally, on the certainty and speed of transition, it is recognised that a two-year period for the Article 50 process is an unrealistic timeframe for the financial services industry to be able to plan and migrate to a future model without knowing what that future model is.

George Hay: That is definitely true. Something has changed since the immediate aftermath of the referendum. At that point, a lot of people in the financial sector were saying, “We need an EEA model. We need a Norway model. Basically, we need free movement, which would allow us to keep access to the single market and pretty much to keep the passport that we have”. Now there is probably a bit more realism that that is not going to be possible. There will have to be some kind of action on restricting on freedom of movement.

That takes you immediately into the equivalence conversation. That is more of an unknown quantity. Bluntly, we do not really know Europe’s position. You can certainly make the argument that European corporates use London as a place to do their financial services and to get cheap financial services, so you could say that we have some kind of leverage over them, but I would not push that too far. The dynamics of it will inevitably have some repercussions for the kind of deal that we get.

Anthony Browne: As I said earlier, the priority as regards the end state is to have the fullest possible two-way access between the UK and the EU markets, similar to what we have now. On the journey there, the priorities have to be having an orderly transition, avoiding financial instability and avoiding cliff-edge effects. Our concern about entering the Article 50 negotiations without any political framework or agreement is that you then enter a two-year period at the end of which we face losing pretty much all access rights if we do not get agreement. Businesses need to be able to plan. As we said earlier, that planning takes a lot of time. If they end up needing to move operations, it can take two, three or more years. We certainly think that there should be some form of transitional arrangements that would enable them to plan and to ensure that they could continue providing services to their customers.

George Hay: I can provide one detail on equivalence and how long it takes to get anywhere. The US and the EU were negotiating on equivalence for things called CCPs, which are big clearing houses. That took three years, at least, and there were no fundamental political disagreements between the US and the EU about whether there should be equivalence in that case. So you have to start with that and potentially add a bit more to reflect the political uncertainties and the fact that the EU may want to teach us a lesson for leaving.

Anthony Browne: The process of negotiation is absolutely critical here, to ensure that there is an orderly transition. There is a view, which you sometimes hear, that there will be no negotiation before the UK triggers Article 50—Article 50 is the divorce agreement, as it were—and that only
when we have left the EU can we start negotiating the future arrangement. The trouble with that for the UK—and, indeed, the EU—is that it would mean that at the end of the Article 50 negotiation we would fall back to World Trade Organization rules. As I said, that would mean dislocation between the European economy and its financial centre, which would be incredibly disruptive. So we certainly think that you need to be able to negotiate in parallel what the arrangements should be for the new partnership between the UK and the EU at the same time as the Article 50 negotiations, to make sure that you do not have that extreme cliff-edge effect at the end.

**Andrew Gray:** One thing that would be helpful is a strong and better mutual understanding of some of the economic benefits that are shared by both the UK and the rest of Europe around having a single global financial centre within the European area. As Anthony said earlier, the failure of an investment bank in London to provide a German corporate with the right financial structuring would inevitably be a direct cost on the German corporate, as well as a loss of revenue for the English subsidiary of the particular institution. Some of the wider costs that would impact on both the UK and Europe should be more fully understood before negotiating positions get too hard.

**Lord Haskins:** In your position, there is a contradiction. On the one hand, you are saying that prolonged uncertainty is very unhealthy. I agree. On the other hand, you are saying that prolonged transition is very necessary. There is a contradiction there.

**Anthony Browne:** Having transitional arrangements should help to remove the uncertainty. We are not saying that the negotiation should necessarily take longer; it is just that you need some sort of framework so that banks and their customers know that they can continue operating throughout the negotiation process and between when the negotiations end and when the new partnership comes into play. The whole point of that is to reduce uncertainty rather than to prolong it.

**George Hay:** Your point relates to the propensity of the Europeans to give us a long transition. The longer the transition we have, the better it is for our negotiating position, I suppose. If the Europeans know that we have a hard stop and we have to cobble something together by then, it helps them in forcing through whatever their agenda is. So, yes, there is a bit of a tension.

**Lord Haskins:** Our colleagues in Europe will be keen to avoid that long transition.

**Andrew Gray:** Except for my previous point, which we have mentioned a few times. The cost of disruption to financial services will be borne by both the UK and Europe. It is in nobody’s interests for financial services to be artificially fragmented in a way that has not been fully thought through, so that institutions that actually provide the financial services cannot plan in a reasonable timeframe to be able to deliver the solutions in a cost-effective way that will service the ultimate consumers of financial services in the right way.

**George Hay:** That is definitely true. If everything was rational, that would be exactly right. Unfortunately, I am not particularly confident that
this will be a massively rational process. With the French and German elections next year, there will be a lot of grandstanding and positioning. That will affect this process as well.

**Lord Skidelsky:** You mentioned the German and French elections. Are you not avoiding domestic political repercussions of these different options? After all, there was a vote in favour of leaving. If you do not invoke Article 50, nothing happens. Will people not feel that the vote means absolutely nothing and that everything is the same? Everything is going to be negotiated now. Who knows what the results of the negotiations will be? Maybe we will go to the electorate again and say, “Look, we have these terms. What is the point of leaving?” I would have thought that there would be a huge amount of political opposition to that approach. What people who voted to leave will probably expect is a rapid triggering of Article 50, as a sign that something has changed. That is all.

**Anthony Browne:** I totally accept that. I go back to my opening statement, where I said that we completely accept the verdict of the British electorate and we want to make Brexit a success. However, it is better to take your time and make sure that we get it right, so that it is a success, than to rush and get it wrong. Even the most committed Brexiteers would accept that.

We want to work with the Government to make this work. But saying that you need a negotiating plan in place before triggering the negotiations does not in any way mean that we do not leave the EU. In the referendum debate a lot of issues were raised, but I do not think that there were many people who said, “We want restrictions or barriers put up to the trade in financial services between the UK and the EU”. That was not a political commitment from anyone on any side.

**George Hay:** As we have touched on, it is a given that there will be restrictions on freedom of movement. Increasingly, that seems to be part of the dynamic. That speaks to what the majority of people may have voted for on 23 June. The interesting question is how you manage what that means for the City. As I said, the difference between now and two months ago is that fewer people seem to think that the EEA option, where not much changes on freedom of movement, is going to happen.

**Lord Skidelsky:** Do you think that the restrictions on movement that people are expecting will take place without our triggering Article 50?

**Anthony Browne:** To clarify, we are not arguing against triggering Article 50.

**Lord Skidelsky:** I mean a rapid triggering of Article 50.

**Lord Desai:** One difficulty here is that people say, “Of course, Brexit is Brexit”, but they want nothing to change. That is not what the British public voted for. Does the financial industry realise that it is not the most popular thing in the whole world? Some of the Brexiteers resented very much the behaviour of banks and the way they had to be rescued. I do not think that the banks’ interests will necessarily be prioritised unless something is done.

**Anthony Browne:** Absolutely. I am fully aware of the politics of all of this. You say that the banks and financial services are not necessarily the
British Bankers’ Association, PricewaterhouseCoopers (PwC) and Reuters – Oral evidence (QQ10-17)

most popular section of the economy. What I said earlier is that people voted for a lot of different reasons, but during the referendum campaign I do not remember there being a big campaign about putting up barriers to the trade in financial services. That is the only thing. I am speaking only for financial services. We totally accept that the UK is leaving the EU and that there will need to be changes in other areas. You talk about freedom of movement of labour, for example. Obviously there are concerns in the industry about that, but we accept the verdict of the British public.

Andrew Gray: We are not advocating a speedy or a not-speedy invoking of Article 50—or, indeed, the quantum of change that may be negotiated. The key thing at this point is to highlight some of the consequences of different scenarios that may be possible. One of those is the speed at which Article 50 is triggered, without the provision of measures to defer the implementation of new rules that are not yet clear. That is a risk. We need to highlight it as a risk.

Q14 Earl of Lindsay: Can I take you back to what might be achieved through the third-country equivalence regime, to which you referred in other answers? Do you think that it might be possible to have a very satisfactory outcome from equivalence negotiations? I want to quote from a BBA document, which states: “The EU and the UK should build on the precedent established by existing third-country frameworks to develop a uniquely ambitious, broad and far-reaching new form of bilateral agreement”. Might it be possible to achieve that? How realistic do you think that aspiration is for the outcome of third-country equivalence negotiations with Europe?

How much do you think politics may get in the way of negotiating satisfactory, desirable objectives through equivalence regime negotiations? You have already mentioned that retail products and services are not covered by current equivalence regime arrangements. Are there other areas, shortcomings and difficulties that you think may emerge and remain a problem if we rely very much on equivalence regime negotiations to achieve a new arrangement for financial services?

Anthony Browne: One thing that I think is certain is that the future partnership between the UK and the EU will be unique. It will be a British solution. It is a fact of history that what is happening is unprecedented. We had a territory agreement, but a country has never left the EU before. Never before has a country and economy as integrated with the EU 27 as the UK separated.

We have had discussions about equivalence. It is a matter of fact that, in a practical sense, we are completely equivalent at the moment, because we have the same financial services regulation as the rest of the EU—certainly as regards EU regulation. It is unprecedented, and I think that the future partnership between the UK and the EU will be unprecedented.

The important thing is to make sure that it works in a way that is of interest to both sides—both the UK and the EU. We should not look at all of this as being about what is in our own national interests. It has to be in their interests as well. The point that I made earlier was that we believe that it is in the interests of a lot of customers across Europe to be able to
continue to have access to the services that London offers. It is not in the interests of either side to sever that in some way and to put up barriers.

There is one really fundamental difference between what we are doing now and normal trade negotiations. Normally, in trade negotiations, you have barriers that already exist—largely, tariff barriers—and you are talking about reducing them to create trade that did not exist before. What we have now is in fact the direct opposite of that. We have virtually no barriers between the UK and the EU at the moment. There is a lot of trade there—£20 billion a year of service exports from the UK to the EU 27 in 2014. We have the trade and do not have barriers. We are now talking about what barriers go up. We would urge that we should minimise the number of barriers that go up and the number of restrictions that are put on trade.

George Hay: If you wanted to be optimistic, in technical terms, there is no reason why Europe should not grant us equivalence. In many cases, our financial regulation is tougher than theirs. We are super-equivalent to them in quite a few bits of City regulation.

To your point, though, the problem is politics. We have talked about the political situation next year, with the elections. That will act as a check on being too generous to the UK. The only way to make it potentially more positive, perhaps, is if the political situation in France and Germany supports some kind of restriction on freedom of movement. That might change the dynamic in some way—but that is hoping a bit.

Andrew Gray: On equivalence, specifically, as was mentioned, at this point we are already equivalent—indeed, more than equivalent. In a number of cases, either the European regulation has been driven by requirements that originated from the UK or, when the UK has come to implement the regulations, it has implemented them to a higher standard. An example is the senior management regime, where requirements exist within the UK regulatory environment that are additional to those that exist in many other European countries.

That is one key aspect. There is also a question mark about remaining equivalent. Once we leave the EU, the direction in which future EU regulations move may well be inconsistent with what the UK wants, because we do not have a seat at that table. So there are some question marks about looking into the future and how you preserve an equivalence regime without necessarily having to implement everything that the Europeans want to come up with in the future, which may suit their business environment in ways that are not suited to the UK environment.

Q15 Lord Skidelsky: I would like to raise again an issue that I raised last time—the question of what influence we will have on the future of the financial system as it develops in Europe. It seems to me that there are a couple of contradictory pressures here. On the one hand, there is quite strong opposition within the EU, in some countries, to what was called by one of the last witnesses the liberal Anglo-American financial system. It may be that, as a result of Brexit, the City will lose influence on financial supervision and regulation within Europe.

On the other hand, there is the long-standing historical debate within the
British Bankers’ Association, PricewaterhouseCoopers (PwC) and Reuters – Oral evidence (QQ10-17)

UK on what the role of the financial system should be—the old debate between finance and industry. I am a historian by training. I remember Churchill’s famous remark when he was Chancellor of the Exchequer in 1925. He said, “I would rather see finance less proud and industry more content”. The two things interweave. Basically, how do you think those tensions will be resolved, both vis-à-vis Europe and vis-à-vis the internal debate in this country? I am sorry. It is a large question.

**Anthony Browne**: It comes back to the issue we touched on several times earlier—the influence that we may have on future regulation, once we have a new arrangement between the UK and the EU. There certainly are concerns, both among regulators—they have said it very publicly—and in the industry about having to accept regulation we have no influence over as a result of leaving the EU.

That can happen in various forms. You heard from previous witnesses that one consideration about the existing equivalence regimes is whether that means that we simply have to adopt new EU regulations in order to maintain equivalence—regulations over which we had no influence and that may be very uncomfortable for us in different ways. Whatever the new arrangements for the partnership that the UK has with the EU, we will want to make sure that the UK maintains some sort of influence on its financial services regulation. There is no doubt about that.

**Andrew Gray**: On the point about the UK’s role, the UK is a member of the FSB, the G20, the Basel Committee on Banking Supervision and CPMI-IOSCO for market infrastructure, which are the bodies that set the highest level of direction for the regulation of the financial services industry. Our participation there is very important and will continue. Clearly, there are risks around the UK providing input into European regulation and the way in which the European regulatory authorities take down the guidance from the FSB, for example, and translate it into specific regulation. The future of how we provide an influence when we do not have a full seat at the table is an open question and one that needs to be thought through very carefully.

**Anthony Browne**: It is worth adding that we have been quite public in saying that we do not want a bonfire of regulations. We are not looking to repeal this, that and the other because we do not like it—for various reasons, but for two in particular. If we go down that route—which I know some people are pushing—it could potentially threaten our access to equivalence and to providing services to the EU market. Also, we are committed as a country to implementing the global standards that Andrew mentioned, through the Financial Stability Board, the G20, Basel et cetera. We would implement them—quite rightly—anyway. At the moment they are implemented largely through EU regulation. So even if we did not have EU regulations we would want to do it nationally in a very similar way. We tend to be super-equivalent and to have the most advanced and safest regulation, compared with the EU.

**George Hay**: On your point, if the UK wanted to pivot towards a more manufacturing-focused economy, it would be good for the UK’s democratically elected Government to say, “Let us do this”, and for people to agree with it, rather than for the financial part of the economy just to collapse in on itself because we had got a really rubbish deal from
the EU. The financial sector provides £60-odd billion in tax. That helps the UK. If that is chipped away at, the money will have to come from somewhere else. It could, but it should come from a democratically elected Government saying, "Let us do this", rather than the opposite.

**Anthony Browne:** It is worth noting that financial and related professional services pay over £60 billion a year in tax. Of that, banks pay about £31 billion. Of that £31 billion, slightly over half—about £15 billion a year in tax, in the last year for which we provided the figures—is paid by foreign banks based here. It is worth noting that that is bigger than the entire UK net contribution to the EU budget.

**George Hay:** A key point is that a big part of that £30 billion is bankers paying tax, rather than banks. So even if you still have a lot of banks based here, but they move thousands and thousands of people to subsidiaries in Ireland, France or wherever, that will probably have an effect on us. It would be better if it did not happen.

**The Chairman:** The more they earn, the more tax they pay.

**George Hay:** Yes.

Q16 **Lord Woolmer of Leeds:** A previous witness, Professor Ferran, talked of a bespoke free trade agreement. Mr Browne, you talked about a unique trading arrangement—I think that was the expression that you used—between the EU and the UK. I have two or three questions. Could you spell out the main features of such a unique arrangement between the EU and the UK? Secondly, which elements of that arrangement would be the most difficult to achieve with what are currently our EU partners and which would be the most likely to be acceptable to them?

**Anthony Browne:** Presumably—we do not know—the agreement would cover a whole range of different things: manufacturing, agriculture, fisheries, security, defence et cetera. I would not presume to comment on the rest of those. I will stick to my little financial services brief.

As I said, what we want is basically some version of the passporting regime that we have—in the sense that, bilaterally, banks based in the UK can serve customers in Europe and vice versa—as well as some influence over future rule-making, and some predictability. One of the downsides of the equivalence regime that exists under current regulations, is that it can be withdrawn unilaterally at fairly short notice, without much warning. That is not a good basis for planning for businesses.

**Lord Woolmer of Leeds:** So that would be your statement of the unique trading arrangement between the UK and the EU. This is not a political point, but I do not think that the public would understand that. They were talking about taking back control and so on. What are the key features of an arrangement?

**Anthony Browne:** I am talking only about the narrow area of banking—from my point of view—not about fisheries policy, agricultural policy or, indeed, freedom of movement of labour, although obviously we have an interest in that.

**Andrew Gray:** One point about taking control is that the regulation that would actually apply to UK banks would need to come from UK regulatory
British Bankers’ Association, PricewaterhouseCoopers (PwC) and Reuters – Oral evidence (QQ10-17)

authorities—or, indeed, the Government. To that extent, it would be local control within the UK of the extent to which we regulated our own financial services industry. The challenge comes where you want to export part of that financial services industry and to earn export earnings. Then you will need to play in a way that your trade counterparties recognise is acceptable to them as well. It is a difficult balance to achieve. While you nevertheless control, you also need to recognise the global nature of financial services.

George Hay: I realise that the “taking back control” thing probably applies to everything, but it would seem to me to apply particularly to freedom of movement. What we want from these negotiations appears to be restrictions on freedom of movement. We will have to give up something in return for that. That something is access to the single market—passporting and what we have just been talking about. I imagine that we will get some kind of restriction on freedom of movement, which will be enough to make people think that we have taken back control. In my view, the success of the negotiation will be whether we get a workable, bespoke equivalence regime. If we can get that, we will have succeeded.

Andrew Gray: There is an interesting observation about the way in which UK financial services firms access US financial markets. As part of that, the US imposes what are called extraterritorial requirements—for example, Dodd-Frank. If you want to participate in the US market, you need to comply with US regulations. We do not set those in the UK. Individual institutions that want to trade in the US markets will do so, but only on the basis that they implement those US regulations.

Q17 Lord Haskins: You have answered my question about uncertainty, but I would like to ask another. The City seems to be accepting the result of the referendum. You have said that. I am not hearing anything except that your objective must be to minimise the damage as a result of the referendum. I am not hearing anything serious about any benefits arising from Brexit.

Secondly, what worries me about the debate is that the City has a very strong influence on what is happening. I live in Yorkshire. There are huge problems there, too, which have to be balanced. There is a danger, if we are not careful, that there will be a trade-off, to the disadvantage of one or the other. How do you see us avoiding that?

Anthony Browne: To your first point, clearly there will be a new arrangement for the UK. We will have a new trade policy. We have a Department for International Trade. Trade agreements historically have not covered financial services in any great depth. There is a reason for that. It is a very heavily regulated industry, to ensure financial stability and consumer protection. You get trade in financial services across borders only if you have very equivalent standards and trust between regulators. There are hurdles that do not apply to exporting manufactured products to quite the same extent. Now that the UK has left the EU, clearly there will be opportunities—I know that the Government are looking at that—and ways in which we could promote exports of financial services to the rest of the world, not just the EU.
Lord Haskins: It will be a long haul.

Anthony Browne: Absolutely; it will. There is no doubt about that. There are lots of very big barriers. But historically we have been a global trading nation. We should explore all opportunities for that. We fully support that, and financial services will be part of it.

It is worth remembering that London is a global financial centre as well. We do not serve just the UK and the EU. Banks and other businesses operating out of London serve economies and businesses around the world. There are certain barriers to that. There may be ways to make it easier, but it is a very complex industry. It will be a long haul, as you say.

However, there are opportunities. As a country, we have been exploring renminbi trading, for example. I know that there has been a certain amount of progress in that area. Fintech is an absolutely fascinating area that is growing very rapidly and where London has a lot of comparative advantages. We could see that grow quite rapidly in the years to come. We fully support and endorse that. Maybe there are other opportunities. We are absolutely open to that. But the direction of questions has been about the relationship between the UK and the EU.

George Hay: Some people have talked about the opportunity for a bonfire of regulation and more regulatory openness. I do not really see that as a thing at all. As I said, we are super-equivalent in most regulations. There is an opportunity, if we are not in the EU and not in the single market, to reduce the bonus cap, but I do not think that that will be a vote-winner for anyone to roll out. So from a regulatory perspective, certainly, it is minimal.

Lord Haskins: It is very likely that in a lot of EU regulation we will just knock out “EU” and put in “UK” instead.

Anthony Browne: One of the huge programmes of work—not just in financial services but elsewhere—will be the transposition of EU regulations into UK law. That is an absolutely enormous project. Clearly, the Government are having to think about how we do that. There are various options. You can just transpose the whole lot, or you can proceed on a regulation-by-regulation basis. As we said earlier, we are not looking for a bonfire of regulations. We accept and fully support the high global standards the UK is signed up to, for both financial stability reasons and consumer protection reasons. We are not seeking to change that.

The Chairman: Would not the simple way to deal with that be to follow what the 1972 Act did? You say, “The EU regulations are UK law, except for the ones that we remove”. Then you start from the other end, as it were, and make the task simpler.

Anthony Browne: That is absolutely one of the options. I am sure that the Government are considering that.

The Chairman: Thank you very much for your very interesting answers this morning. Is there anything that any of you would like to say without which your evidence would not be complete?

Andrew Gray: One final point—it has already been raised a bit, but I want to reinforce it—is not to forget the interconnectedness of financial
services. It is not just about banking in isolation or asset management in isolation. You need to look at financial services holistically and to recognise that its existing holistic nature is of a global nature and that any forms of fragmentation of the existing way in which financial services are structured will have implications. You need to be clear about what those implications are before decisions are made.

**The Chairman:** Mr Gray, Mr Browne and Mr Hay, thank you very much for your evidence today. That concludes today’s public evidence sessions. The Committee will now continue its meeting in private.
A. Key interests for the UK and EU in financial services

- How important is maintaining the financial services ‘passport’ for the health and growth of both the UK and EU financial services sector?

London is a global and regional financial centre that provides wholesale services to the European financial sector and wider economy. A prime example is a competitive forex market (both cash and derivatives), which makes forex trading (including hedging positions) possible at low costs for financial firms and corporates.

The main wholesale financial markets in London cover:
   a) Derivatives
   b) Foreign exchange trading
   c) Private and public bond trading
   d) Equity trading
   e) Commodities trading

Deep and liquid wholesale markets are important for both the UK and EU financial services sector. Fragmentation of financial markets may raise the cost of finance and thus harm corporates in the UK and the EU.

- What key arrangements need to be preserved so that market infrastructure providers in the UK can continue to provide their services to EU clients and vice versa?

Two arrangements are very important (Schoenmaker, 2016b):
   1) The passport for the single market
   2) Clearing and settlement in the euro

- How important is the principle of free movement of people for the UK and EU financial services sector?

For the financial services sector, free movement of people is helpful but not key. Both in the UK and the rest of the EU, the financial services sector employs non-EU individuals. This shows that the financial services sector is able to attract and employ talent from inside and outside the EU alike. However, the free movement of people will be part of the overall negotiations on the internal market, which has the so-called 'four freedoms' in goods, services, capital and people (Pisani-Ferry et al, 2016).

- What transitional arrangements would provide certainty to financial services and markets in the period between the UK’s withdrawal terms and its future relationship with the EU?

A key element in the transition is grandfather clauses and a sufficiently long grace period. Grandfathering allows a smooth transition from the old to the new
Bruegel – Written evidence (BFS0001)

regime. It means that a licence received under the old regime remains valid under the new regime (i.e. is grandfathered).

Another element is the legal form of the partnership between the EU and the UK. The more this relationship is hard-wired in a Treaty, the less scope there is for changing parts of the relationship in the future. This provides more certainty for financial services providers.

Nevertheless, it will be difficult to address the uncertainty on the outcome during the negotiations. A clear and joint vision on the desired outcome from the outset and a relatively speedily negotiation are helpful to keep this uncertainty to a minimum.

B. Constraints and opportunities for a future relationship with the EU in financial services

- Can you describe in detail the degree of market access provided by the EU to financial sectors in non-EU member states (i.e. Norway model, Switzerland model, Turkey model, Canada model, the WTO model)? What do these models tell us about how the UK may be able to negotiate a bespoke relationship?

The details of the different models are provided in some background papers (Pisani-Ferry et al, 2016; Schoenmaker, 2016a, b). A key issue is whether the UK wants to remain in the single market. An important requirement for staying within the internal market is the acceptance of the supranational institutions (the European Commission and the European Court of Justice) which uphold the appropriate functioning of the internal market. Pisani-Ferry et al (2016) have made a proposal for a continental partnership, whereby the UK would have a say on EU policies but ultimate formal authority would remain with the EU.

- Referring to the aforementioned models, which financial activities would be most ‘at risk’ from Brexit?

First, the activities that need a passport are most at risk. Examples are (retail) banking (CRD IV), insurance (Solvency II), and investment services (MIFID). Second, the financial activities that rely on euro clearing and settlement are at risk, as the ECB might want to limit euro clearing and settlement to the EU/EEA under the so-called location requirement (Schoenmaker, 2016b).

- What are the shortcomings or issues associated with the EU’s equivalence regime?

The equivalence regime allows access to an EU country from third countries if the EU (the European Commission and/or relevant supervisors) deem the supervision of the third country equivalent (Goodhart and Schoenmaker, 2016). Nevertheless, the relevant supervisor(s) in the EU country can still impose regulatory and supervisory requirements. Moreover, the third country licence does not provide the passport to do business across the EU.
C. Means by which the key interests could be realised

- Which arrangements for UK access to EU financial markets are most likely to be acceptable to EU negotiators?

An important element is the continuing acceptance of the supranational institutions of the EU that guard the single market (i.e. the European Commission and the European Court of Justice).

- What steps are financial market sectors most likely to take preserve their position in the absence of full market access?

Financial services providers will seek a licence in one of the EU countries and will use that licence as passport for market access to the EU/EEA markets.

- How could the UK financial services sector thrive outside of the EU?

The UK financial services sector faces a fundamental choice between global and EU business. On the one hand, London can position itself as an international financial centre with light-touch regulation and supervision to try to gain extra global business. But under that model, the equivalence of UK regulation and supervision will come under pressure, which makes access to the EU more difficult and cumbersome (extra regulatory and supervisory requirements from the EU). On the other hand, the UK can choose to remain close (i.e. equivalent) to EU legislation and thus favour its regional business in the EU. Under this model, London can still attract global business, as it does currently.

References


September 2016
The Chairman: Welcome to Mr Simon Gleeson from Clifford Chance and Mr Peter Snowdon from Norton Rose Fulbright. Thank you for attending our inquiry into the implications of Brexit for the financial services sector. You have a list of interests that have been declared by Committee Members. This is a formal evidence-taking session of the Committee and a full transcript will be taken. This will be put on the public record in printed form and on the Parliament website. You will be sent a copy of the transcript and you will be able to revise any minor errors. The session is on the record. It is being webcast live and will subsequently be accessible via the Parliament website. Would you like to make any brief opening remarks or shall we go directly to questions?

Simon Gleeson: We can go directly to questions, I think.

Peter Snowdon: I am very happy to go directly to questions.

The Chairman: Thank you very much. I will kick off by reminding Mr Gleeson that we had an initial go about the implications of Brexit when we met on 6 July. Now that there has been sufficient time for reflection and we have a clearer idea of how the negotiations will be embarked upon, what is your reaction to the prolonged political uncertainty? How does that affect your day-to-day operations? From your perspectives, what do you think the new as well as existing challenges are going to be, given the information we now have? Mr Gleeson, please could you kick off.

Simon Gleeson: Thank you very much. I am not sure that we know a great deal more now, at least on the public side, than we did slightly earlier on. The important thing, and this goes to some of the issues that will arise out of the later questions, is that the industry certainly knows a lot more about its position because ever since the referendum it has been engaged in very detailed analysis along the lines of: what happens? In my experience—Peter’s may well be different—the industry has embarked on a fairly intensive exercising of asking: if we did nothing, what would the impact be? Only once it has managed to answer that question can it go on
to the “and what should we do about it?” part of the analysis. The key point is that historically the industry by and large has not thought about its business in terms of regulatory permissions. So the process of working out which activities, transactions and relationships we would no longer be able to manage has been extremely complex. It is also very legally intensive. I am not convinced that any institution feels it is in a position to give a hard answer to that. Where we are at the moment is at the end of a preliminary period of analysis where I think we can begin to quantify what the impact would be if no mitigatory measures were taken. I think that stage 2—working out what the mitigation measures would be and how much they would cost—is in the future.

*Peter Snowdon*: I agree. People have been mapping what they do. I know that for some of the European banks, their regulators are asking them to map what they do, to work out exactly what it means for them. A vast range of firms are active in this country—local firms, obviously, but also firms coming in from the European Union and third countries—so the geography is quite mixed. They provide many different types of products and services and they are subject to various different pieces of European legislation. It is hitting people in many different ways. When it comes to mapping exactly what people do, obviously, firms focus on the business. As Simon said, they are not necessarily focusing on regulation. So they will often discover that they need permission to do something and had not realised it. That adds a complication as well.

Q28  *The Chairman*: Are you aware of your clients deciding to relocate—we will come later to passporting and so on—at this point in time, ahead even of triggering Article 50?

*Peter Snowdon*: My experience is that people are looking at it. Anecdotally one hears that some people have pretty much decided to shift. But my general experience is that people are looking at it and thinking where they might go. They are thinking about whether they have another entity within their group that might be able to be upgraded or whether they need to find another jurisdiction and seek authorisation and so on. As you know, that process takes time.

*Lord Butler of Brockwell*: Could I ask for a definition of “people”? You say “people are looking at it”. I am not asking for specific examples but what categories are most looking at moving?

*Peter Snowdon*: In UK terms, it is third-country institutions which have come to the UK to get access to the European Union and which are concerned that they will not have the sort of access they anticipated when they first came here. That is the first group. The second group—again, UK-focused—are UK-owned firms, if I can put it that way, which are considering how they would carry on their European business in future.

*Simon Gleeson*: I think that pretty much every firm of any significant size is making sure that it has an EU-authorised subsidiary somewhere, which is up and running and to which it could transfer business if the necessity arose. Not having that in place as an available alternative would be a very strange management decision. A lot of the activity that is going on at the moment is the establishment and re-permissioning of those
entities, but it is still some way away from the actual moving of activity, staff or business.

Q29  **Lord Desai:** There are all these regulatory dossiers around. If we were to lose passporting, how much would these things allow us still to do business? Are they really suitable for non-EU countries?

**Simon Gleeson:** There are some European directives—MiFID, AIFMD and EMIR—that have what are effectively equivalence provisions built into them. They say that firms based outside the EU can do business inside the EU provided that the EU is satisfied that the regulations in the country concerned are equivalent to European regulations. That is true of only some directives. The most important ones that have no such provisions are the Capital Adequacy Directive, which governs the provision of banking services—lending, deposit-taking and things like that—and the UCITS directive, which covers retail asset management. The general view—certainly of the clients whom I have spoken to about this—is that those regimes are possibly useful bridges but they do not form a basis for any sort of business planning. The point there is that equivalence determinations are fundamentally political and are regarded as precarious. They can be removed at very short notice, they cannot be counted on and they can potentially disappear as soon as either side introduces a new legislative provision that is not matched on the other side. So certainly the view among the institutions that I have spoken to is that, although possibly useful in the short term, those measures, even where available, do not form a useful basis for any sort of commercial planning.

**The Chairman:** I wonder whether I can pick you up on that. You said that in your view equivalence decisions are fundamentally political; nevertheless, they are justiciable, are they not?

**Simon Gleeson:** They are certainly justiciable. The most prominent equivalence determination of the last few years has been the discussion about whether US derivatives clearing houses are equivalent to the European regime. In that determination it was fairly notorious that the regulatory experts took less than six months to conclude that they broadly were, and there was then two and a half years of discussion before the recognition was actually made. I think it is fair to say that that discussion happened almost entirely at a political rather than a technical level.

**Peter Snowdon:** To pick up on a point that Simon made, equivalence is a dynamic concept, so it can change and there can be challenges. Because European law will obviously move on, there will continue to be European court judgments, and ESMA and so on will produce guidance. You may well be equivalent on day one and, before very long, find that you are either forced to adopt a piece of European legislation or a decision or you will lose equivalence.

Q30  **Earl of Lindsay:** If the current definition, understanding and practice of equivalence is not, as it were, a route that would inspire certainty and confidence in the sector as the future means by which UK-based financial services could access the European single market, what is the answer?
**Simon Gleeson**: The answer in the broadest possible terms is some sort of binding international arrangement. I am choosing my words very carefully here because we have to avoid the word “treaty”. But it would be some sort of binding international arrangement that gave confidence to the market that mutual rights of access—we are talking “mutual” here; this is not about the UK accessing Europe, it is about the continuation of a single European continental financial market—would continue to exist for an extended period. As Peter says, the only way that that can happen is if it involves some sort of commitment by both sides to maintain their legislation in at least a co-ordinated fashion. As soon as one side goes off and does something radical, any sort of co-operation must necessarily fail at that point.

I would like to say one thing to follow that up. For policy reasons, it is a terrible mistake to look at this as being primarily about market access. The most important thing as far as the financial markets are concerned—this will unquestionably remain post Brexit—is ensuring appropriate regulation, supervision and enforcement. After the G20, it was absolutely clear to everybody that there was only one way in which you could deal with the largest international banks and financial firms: their regulation and supervision should, as far as possible, happen on an integrated basis across all the major markets in which they operated. If that could be achieved through some sort of relatively binding agreement between the UK and the EU, the rights of access problem would to some extent solve itself. If we have a relatively integrated regulatory and supervisory mechanism, the obstacles to access within that mechanism should to some extent fall away. The core answer to your question is that, whatever that is, it has to be embodied in some sort of international instrument that the market has a reasonable degree of confidence will endure for some time and will not disappear tomorrow morning.

**Earl of Lindsay**: Are there no existing instruments—albeit rather modest in their current guise—or protocols or agreements between regulators that could be wrapped up as an alternative to creating a fresh treaty from scratch?

**Simon Gleeson**: There are all sorts of agreements, memoranda of understanding and other bits and pieces, but the difficulty with inter-regulatory agreements is that they are necessarily trumped by intergovernmental agreements. Regulators are very limited in what they can agree with each other without legal backing and justification.

**Peter Snowdon**: Many of the MOUs focus on information exchanges rather than hard issues, but there is a kernel of a possibility of developing some co-operation between regulators from those sorts of agreements. For example, we have a number of non-EU banks with branches in the UK—American banks, for example—and that works because there is confidence in what the Fed does, and the Fed is relatively confident about what the PRA does. That is obviously essentially a working arrangement between regulators but it might be possible to build on that at, say, a European level. We are helped there in the sense that at least the eurozone has one institution which is ultimately responsible for prudential regulation—that is, the ECB.

**Earl of Lindsay**: There is one further angle to equivalence and how it
might impact if it becomes a major part of a Brexit negotiation. You have already touched on some of the challenges, but would you also see the way that equivalence operates as being potentially constraining, especially for a financial industry in this country that has tended to be quite innovative? I suppose you might argue that the creativity around the regulation of the financial sector in the UK has also been innovative. Do you see a possibility that equivalence could stifle that innovation?

**Simon Gleeson**: That is unquestionably correct. Any enduring equivalence arrangement would have to be based on some sort of agreement between the UK and the EU not to diverge too radically from each other’s regulatory structures. You are quite right: the UK has pretty much dictated regulation in Europe since the early 1990s. When that stops, it is likely that regulatory change in Europe will slow down to a trickle, whereas regulatory change in the UK will continue to develop. So it is absolutely right that if the UK entered into an agreement to maintain strict equivalence, the problem it would face would be the difficulty of changing its own rules in order to accommodate the markets as they developed.

In the United States, for example, it is famously extremely difficult to change the legislative structures under which US financial regulation operates. There are a number of areas where businesses have migrated to London simply because the Americans have found it impossible to change their regulatory structure sufficiently to accommodate business as it develops, so I agree that that is potentially a real problem.

**Q31 Lord Haskins**: Earlier this morning we heard from three distinguished witnesses who took us back to look at the broader picture. All three made the argument that there is a financial ecosystem based in London and we should not take pieces away from it because that may affect its whole structure. On the other hand lawyers, being what they are—wonderful people—see opportunities in clients rushing to them asking about the legislative issues that they should be dealing with. There is a danger that the lawyers will approach this in a piecemeal way whereas the big players such as the banks we talked to earlier are saying, “Let us understand the broader picture”. They were rather dismissive when talking about passporting. They said that it is one part of this and equivalence is another, but if you get into that detail you miss the bigger picture. I hear lots of people saying that they are concerned and they should get the lawyers to take a look. The Government would love to rush down that route without standing back and asking about the fundamental issues here for the City and the financial services of this country.

**Simon Gleeson**: First, I entirely agree with the point about ecosystems. Part of the reason that it has been so difficult to do an analysis of the impact of losing any particular passport is that you can talk to the man who covers, for example, Siemens as a corporate client and ask, “What do you sell?”. The answer is, “I sell the entirety of the product range of the bank, everything from payment systems to lending to foreign exchange hedging, you name it. I cannot tell you what my position would be if I lost the right to offer one of those products but not the others”. It really comes down to the point that banks are a service industry which provide bundles of services. Certainly, our attempts to take businesses
apart passport by passport have proved to be extremely difficult because we are now aware in a way that I do not think we were beforehand of just how poorly the passporting and legal structure maps on to the commercial business of the banks.

**Peter Snowdon**: Also, there is an interrelationship between firms that come into the UK. For example, white labelling services might be offered to a foreign bank coming into the UK. If that bank goes, that hits the UK institution. What worries me is that we might almost have death by a thousand cuts because bits and pieces will go, but the accelerator effect on the financial services businesses that remain will be significant because they will be losing clients and the people who they can sell their services to.

**Lord Haskins**: Is that not a bit premature? You are saying that clients may be making up their minds about what they are going to do now, almost to get a competitive advantage. Would you not say that is a bit previous, as we say in the north of Ireland?

**Simon Gleeson**: Certainly it is today. The key point here is that clients can move their business from one bank to another considerably faster than a bank can relocate its business from one country to another. The clients have the option here. They can afford to wait until the last possible moment because if their relationship bank cannot service them, moving is easy. The challenges for the relationship bank is how to configure itself to deliver those universal services.

**Peter Snowdon**: The legal process for taking clients from one institution to another is lengthy. We have that facility within UK legislation, but it may not apply in all situations and it is a court process. It takes time, requires a lot of planning and is expensive.

**Lord Haskins**: So what you are really saying is that the Government should be talking to the clients to find out what they are going to do and how they are going to behave, or will the clients not give them an answer?

**Simon Gleeson**: Why should they? The attitude of the clients of financial services to the financial services industry has always been extremely straightforward: you make your dispositions, we will look at them and tell you whether we like them or not.

**The Chairman**: Mr Snowdon, given that you serve on the committee of the Association of Foreign Banks, are you able to tell us what is going on in the EU 27 and the non-EU financial services firms in terms of their planning and the impact that that will have?

**Peter Snowdon**: I know that the AFB has done a very good survey, which I think it is going to share with this Committee. Some of the responses are interesting. I think that a lot of people are waiting to see what they are going to do. There are some red lines, one of which is clear: if branches of EU banks are forced to capitalise here, that is pretty much a red line for many of them. Quite a lot of work has been done by the Boston Consulting Group and others as to what the cost of that would be, but it will be many billions of euros across the piece. That is one issue.
Interestingly, some of the third country banks are not too concerned because they come to London for other reasons. It is not just European business that people come to London for. But I think that we should not underestimate the potential consequences for EU banks of being unable to access London as well. They do not come here just to do UK business, it is also a way for them to access third-country markets. So there are consequences. Certainly, looking at the survey, a lot of them are waiting to see what happens. Of course the bigger ones may not have that luxury because the consequences of it not going in a way that suits them would result in an awful lot of work for them in restructuring their businesses.

**The Chairman:** Are they starting to restructure already?

**Peter Snowdon:** Some of them are thinking about it. This is to some extent anecdotal, of course. We meet clients and discuss it with them. They are certainly thinking about it.

**The Chairman:** And this survey will be shared with us.

**Peter Snowdon:** Yes, I believe so.

Q32  **Lord Shutt of Greetland:** Earlier in our deliberations you told us that clients have already been setting up subsidiaries in other places. What sorts of costs are involved in all this given the various legal, operational and regulatory differences? When you say that people are setting up subsidiaries, will one of them do in that it would then have passporting rights everywhere else? Could there even be benefits in that in terms of the regulations in a particular country where they intend to pitch? Would you like to discuss this with us in terms of costs in particular as well as any other relevant important matters?

**Simon Gleeson:** It is a very big subject. The short summary is that setting up a legal entity and getting it authorised is not in itself a particularly expensive exercise. The issues arise if you go to a country and say, “I want to get a small subsidiary authorised to do financial regulation”. The first question the regulator will ask is, “What level of business are you going to do in it?”. If it is a few tens of thousands of pounds it is very easy, but if you are talking about moving billions-worth of capital and hundreds of billions-worth of trading volume into the entity, the regulator in that country—this is almost universally true—will say, “I want to see management, the systems, the controls and the staff actually physically in this country”. There is a sort of fantasy that floats around from time to time that it is possible to channel business through a brass plate entity without incurring significant costs. That may have been true at some point 20 years ago, but no European supervisor is fool enough to fall for that today. The way that the analysis works is that you look at the volume of business you want to transfer. You then have to ask, “How would I go about moving everything related to that business to the place I am moving to?”. That is where the costs move out of the millions and into the measurable fractions of billions. It is a very expensive business. In the words of the old joke, the way that the financial system works is if the management tells the staff where to go, the staff will tend to tell the management where to go. This is not the sort of industry in which you can say, “You are going to relocate to Poland tomorrow morning”. So there are physical problems and financial problems.
As far as regulation is concerned, because you are talking about moving to somewhere in the EU, wherever you move you will be broadly subject to MiFID, CRD—whatever it may be. There is relatively little difference in regulatory structures between one European country and another. In some respects, the selection is easier than it might otherwise have been. But it is still the case that the attitude of the local regulator is probably the most important thing to a bank that is considering relocating a substantial part of its business elsewhere.

Lastly, Canary Wharf may well be the most expensive place in London to keep employees so many banks have been moving activities out of London for some time but those have generally been back-office and service activities. Moving significant front-office activities around is something that we are going to have find out how to do and how much it will cost because it is not something anybody has done for a very long time.

**Peter Snowdon**: There has been a lot of talk about different jurisdictions but they are not necessarily blessed with regulators that have the experience of regulating some of these businesses. We are very lucky in the UK—although industry does not always think so—in that we have two really good regulators. That is not necessarily the case in some of the jurisdictions that have been put forward as possible relocation sites. For example, some of the Irish law firms that are quite active in London at the moment accept that some types of investment banking just would not fit in Dublin. They do not have the expertise there to regulate them.

Q33 **Lord Butler of Brockwell**: Previous witnesses have emphasised that London financial services are interconnected—it is an ecosystem. It has been suggested that in many ways that is a great asset to the UK, not just to our economy but in this negotiation. It is almost the case that the European businesses are the *demandeurs* that want to continue to get access to this structure for the purpose of raising finance. Do you regard it in that way, and is that likely to be an advantage for us in the negotiations?

**Simon Gleeson**: That is absolutely right. If you perform the thought experiment of assuming that everything collapses in ruins and Europe decides that it wants to create a rival financial centre to the City of London, is that achievable? The answer is: probably not, precisely because of that ecosystem—an asset manager employs half a dozen portfolio managers; there are 200 skilled people ranging from accountants to consultants to lawyers. The fact that you have a big pool of those to draw on means that that is where you put the business. So the fundamental position that, almost whatever happens, London will remain the financial centre of the continent of Europe precisely because of the depth of that pool is correct. Therefore, it is also correct that that should be an important factor for the European Union in discussing future arrangements.

Another way of looking at it is that when the UK leaves the European Union, the European Union will lose completely any voice in the regulation of its own financial centre. That should be, post-financial crisis, a fairly terrifying position for any government entity to be in. So if everybody
behaved in a way that was informed only by adult self-interest, there would be a fairly obvious deal, for want of a better word, to be done, where the UK agrees to co-operate closely with Europe on the regulation of this centre and to ensure that European businesses can continue to access it fully in exchange for ensuring that business is subject to that regulation and servicing firms are allowed to operate freely in the EU. If everybody thought about it rationally and acted in their own interests, that would be a relatively easy deal to do.

Lord Butler of Brockwell: I have the impression that the “if” at the beginning of your sentence is significant. Do you think there is a danger that people will not behave rationally, that politics will get in the way of economic self-interest?

Simon Gleeson: Yes. To be fair, we do not even know whom we are going to be negotiating with.

Peter Snowdon: I agree. I think the risk is that emotion will take over from rational thinking. That has to be a danger for us, I think.

Q34 Lord Butler of Brockwell: Are there particular activities which, if London were to lose them, would be particularly damaging? For example, Professor Charlie Bean said last week that he was absolutely certain that we would lose the euro clearing arrangements. I am not absolutely sure what that means because one of our witnesses today said, “Well, you can always clear everything through London”. Do you think that that is a danger and would be particularly damaging?

Simon Gleeson: I am afraid that I have to recuse myself on anything to do with euro clearing because of professional commitments.

Peter Snowdon: I think there is a risk there. It is still possible for non-euro institutions to be direct members. If the rules were to change—if euro clearing shifted to the continent—in the future, that would be one risk. There are precedents elsewhere. The other risk is that once the centre of gravity has moved somewhere else, it is possible that firms will follow because it is easier to be wherever it is taking place. I do not think that it would be an overnight phenomenon. As I said earlier, what concerns me about this whole area is that it will be death by 1,000 cuts—one thing moves, something else follows, et cetera; rules get changed and suddenly we find over time that things are much worse from the UK’s perspective.

Lord Butler of Brockwell: Are there any other functions like euro clearing that you regard as particularly vulnerable?

Simon Gleeson: There is an issue about how much anybody cares. The point is occasionally made that if you look at the euro bond market that exists almost exclusively in London, the two clearing entities for that market are located in Luxembourg and Belgium respectively and that has absolutely no impact on the fact that trading, settlement and all the rest of it happens here. So it is not necessarily the case that the movement of infrastructure or trading venues has any impact at all on the broad balance of what is done where.

The Chairman: Lord Lindsay, have we exhausted equivalence?
Earl of Lindsay: We have.

Q35 The Chairman: I would like to move on to trade-offs—regulatory equivalence with the EU versus seizing opportunities and staying competitive in other parts of the world. Is that equivalent? Are there likely to be scenarios where opportunities outweigh the challenges or the potential losses?

Peter Snowdon: There are a number of opportunities. They may not necessarily be new market opportunities but there may be ways in which we can adapt regulation, which I will come back to in a moment. From my experience of talking to clients, I do not think that they see the European market and other markets as alternatives; they are different arms of their businesses. Some focus more on non-European business, some focus more on European business. They are not necessarily alternatives. There will be opportunities in some areas and there will be possibilities at home to be more flexible; for example, perhaps with regard to capital requirements on challenger banks. It is an area that could be explored. There are certain pitfalls in doing that, but there are also possibilities. There are similar ones in other areas. The United States, for example, takes a different prudential approach to international banks from its approach to purely domestic banks, and there may be similar opportunities in other areas here as well.

Simon Gleeson: I would say two things in response to your question. First, many of the banks that I have talked to have a real fear of a policy of deregulation in the UK. The idea of the UK becoming a lightly regulated offshore centre would, they feel, be the kiss of death to their business. The industry is in the slightly unusual position of wanting to ensure that UK regulation remains as vigorous and as credible as possible on an international level.

Interestingly, there are certainly areas where there is a strong view in the UK that the European regulatory authorities have got it wrong. There is one that occurs from time to time: the extraordinarily rigid approach that the European banking authority has taken to the “skin in the game” retention rules surrounding securitisations has, to a large extent, strangled the European securitisation market. As you will have seen in the Capital Markets Union papers, there is a generally held view that encouraging the development of securitisation is an important mechanism for reducing the cost of funding and capital to industry. In that area, you could undoubtedly create a consensus within the UK regulatory establishment that this should be done differently, but you would then run into the fact that, if you did that, the resulting securitisations would not be capable of being sold to European investors. The question then becomes, “Is that game worth that candle?”.

I think that there are very few areas where what would be regarded as a change in regulation intended to improve outcomes would not have compensating negative impacts on the saleability of the resulting products. That balancing act is a very hard one. There are certainly no visible easy wins that I am aware of.

Q36 The Chairman: Moving briefly to transitional arrangements, once we
know the terms of the deal, in terms of your sector what sort of period and what arrangements would you wish to see on a wish list before there was a final break?

**Peter Snowdon**: I caught the tail end of the last session and I would agree with what was said there. The idea that this could all be done in two years is not really feasible. In terms of how long it would take, my view is that a transitional arrangement to cover everything could take 10 years.

**The Chairman**: That is really helpful. Mr Gleeson.

**Simon Gleeson**: There is a general rule of thumb that it would take two years to move a significant part of the business of an investment bank. In a perfect world, the industry would be able to look at the final agreement made between the EU and the UK and decide on the basis of knowledge of that agreement how it wanted to restructure itself. The way that we think about it is that in a perfect world we would have a transitional period of at least two years after the reaching of the final terms of the agreement.

**The Chairman**: In terms of regulatory certainty and stability in the short to medium term, what would you want to hear from government?

**Simon Gleeson**: In a perfect world, we would have a joint declaration from the UK Government and the European Commission that there would be a transitional period after the end of the agreement. The problem we have is that, given that two-year rule of thumb period, in the absence of any reassurance at all a rational bank should start moving its business on the day that the Article 50 notice is signed. That is an entirely irrational way to run the world but, if there were nothing at all for bank managements to go on, they would be really derelict in their duty as stewards of the companies if they did not start at least planning for that. If somebody tells you, "We've started a two-year period", you have to work within that.

**The Chairman**: Would you agree, Mr Snowdon?

**Peter Snowdon**: I would. You just do not have the time to do it at the end of that period.

**The Chairman**: So you think that there should be a joint declaration.

**Peter Snowdon**: Yes, I do.

**The Chairman**: And is that a conversation that you are aware that the Vadera group or your own institutions have had with senior Ministers?

**Peter Snowdon**: I am not aware of that.

**Simon Gleeson**: Practically every senior leader within the industry thinks that there should be a discussion about the desirability of an interim period, but I do not think that anybody has a strong opinion on what the views of Ministers might be.

**Lord Haskins**: What concerns me about all this is that you and previous witnesses have talked about their clients. I run a local enterprise partnership in Yorkshire. I already have potential investors from outside quietly—without saying anything—stopping and going somewhere else.
The danger is that we spend a whole lot of time trying to protect the financial sector when the financial sector’s customers have made up their own minds about where they are going to go. The Government have to make sure that they understand what your clients think. That is almost your biggest job: to explain to government what your clients are likely to think.

**Peter Snowdon**: That must be right—I would certainly agree with that. It is this lack of certainty that is the key risk.

**Lord Haskins**: And they can do it just like that.

**Peter Snowdon**: Yes.

Q37

**Lord Butler of Brockwell**: Are there any pluses that you see for the UK in regaining its independence from the EU as a regulatory power and reaching agreements with other regimes, free of the EU, that would be advantageous for British financial business?

**Simon Gleeson**: Broadly, no. You will have seen the note from the Japanese recently explaining their views, but the vast majority of non-UK Governments perceive this as a source of risk for their institutions. The opportunity—this is something that has been floating around for a very long time now—is for closer co-operation with the United States. The United States has always taken the view that it has a high level of confidence in the UK authorities as regulators but, because the UK operated within the European Union context, the EU took the view that the United States had to deal at the EU and not the UK level. The US position, in saloon bar terms, was, “We’ll recognise the PRA as equivalent but we certainly won’t recognise the Bulgarian equivalent”.

That constraint has gone away, so in theory it is now possible for the UK and the US authorities to co-operate much more closely than they have in the past and to develop substitute compliance and other approaches. The extent to which that might be considered to be exchanging a veto from Brussels with a veto from Washington is one of the things that would have to be discussed. But that is the major opportunity, I think.

**Lord Butler of Brockwell**: And do you see the possibility of material advantages from that?

**Simon Gleeson**: I am tempted to say rather cattily that US international co-operation has always been heavily to the benefit of US firms.

**Peter Snowdon**: I think that that is right. I cannot see enormous opportunities there. To come back to a point raised earlier, we have regulators with very strong reputations internationally and they are very active in the supranational bodies as well. Arguably, those will become more important, because if you can make much tighter policy at that sort of level, that may help prevent some of the risks that Simon outlined earlier—that the EU goes off on some sort of frolic in new regulation without the UK there to dampen its enthusiasm. So those supranational bodies become much more important for the UK.

**Lord Butler of Brockwell**: Thank you.

**Lord Haskins**: It is becoming clearer that the Norwegian, Swiss and WTO
options are being parked. I think that that is probably the case and therefore we are talking about a bespoke option for the UK. What do you think are the non-negotiable issues for a UK Government going into a bespoke deal as far as financial services are concerned?

**Simon Gleeson:** The core non-negotiable issue for the UK would have to be the retention of ultimate regulatory independence. This really goes to systemic risk as much as anything else. For as long as the UK remains the base for the European financial services sector, it will be much more exposed than any other Government, in relative terms, to the way in which that sector is regulated. I would expect the UK Government to take the view that they would be prepared to agree to try to co-operate to the greatest extent possible, but they would have to retain, if you like, a right to regulate unilaterally just on the basis of their significantly greater exposure to systemic risks resulting from the fact that they were the home of that market. But beyond that restraint the UK has a very strong commitment to the idea that regulation should be global and relatively coherent from jurisdiction to jurisdiction, and that enforcement and supervision should be as seamless as possible. All those should be common aims between both sides. So I think that there are fewer red lines than agreed starting points.

**Peter Snowdon:** I agree with that. I think that systemic risk is key. If we go back a few years and remember the Icelandic banks, in a world where we were not within the EU we would want to be able to do a lot more about that than perhaps we could initially.

**Lord Haskins:** So you are saying that on the one hand we must retain our regulatory independence but, at the same time, the regulatory regime that has emerged over the last 10 years should remain in place and nothing changes.

**Simon Gleeson:** Yes. To be fair, that regime in Europe was largely written by the UK anyway, so it should not be a surprise that we are in favour of its continuation.

**The Chairman:** Are there any other questions from members of the Committee? If you have any other views, you know that we would welcome any written follow-up thoughts. Thank you very much indeed. That concludes today’s public evidence sessions. The Committee will now continue its meeting in private.
Professor Eilís Ferran, University of Cambridge and Professor Sir Charles Bean, London School of Economics and Political Science – Oral evidence (QQ1-9)

Transcript can be found under Professor Sir Charles Bean, London School of Economics and Political Science and Professor Eilís Ferran, University of Cambridge – Oral evidence (QQ1-9)
Financial Conduct Authority – Written evidence (BFS0003)

Financial Conduct Authority (FCA) written submission to the House of Lords European Affairs Sub-Committee on Financial Services

Inquiry exploring the future of financial services in the UK following the vote to leave the European Union.

Introduction

1. The role of the Financial Conduct Authority (FCA), as set by Parliament, is to ensure that the relevant markets function well. This means securing an appropriate degree of protection for consumers, protecting and enhancing the integrity of the UK financial markets and promoting competition in the interests of consumers. We are the conduct regulator for 56,000 financial services firms and financial markets in the UK and the prudential regulator for over 24,000 of those firms.

2. As the UK transitions to a new relationship with the EU, this new environment will have important implications for the markets and firms we regulate. As these implications become clearer, we will need to consider what they mean for the future of regulation in the UK. We will also ensure that any risks to our objectives are well understood, appropriately recognised and, wherever possible, mitigated.

3. As we seek to ensure continuity in the delivery of our objectives, we continue to attach importance to a number of principles regardless of the shape of the new relationship with the EU and its member states. These principles include:

   - Avoiding sudden or unanticipated changes to the regulatory framework that might harm market integrity. We will seek to ensure that the market is aware of any upcoming changes to that framework in a timely manner, wherever possible;

   - Open markets are an important enabler of healthy competition, supporting FCA objectives, where they are underpinned by appropriate standards. We consider a market to be ‘open’ where there are no undue or unreasonable barriers to entry;

   - Continuing support for the principle of consistent global standards, where markets have international reach. Financial markets are increasingly cross-border and it is important that, as far as possible, regulatory standards are consistent both in respect of policy and implementation, while ensuring that supervision can be undertaken effectively; and

   - Cooperation between regulatory authorities and standard setting bodies. Close contact and collaboration between regulatory authorities remains essential to ensure that appropriate regulatory standards and outcomes are met and enforced. The FCA benefits greatly from cooperation with our regulatory partners in Europe and more widely. We will work to ensure
that arrangements are retained, or established where necessary, to ensure efficient information sharing and collaboration.

4. We continue to offer the Government technical advice drawn from our supervisory and regulatory experience as part of the withdrawal process. We also seek to ensure continuity in the delivery of our objectives throughout.

Key interests

What key risks are presented to consumer protection and the functioning of financial markets by the various potential models for the UK’s future relationship with the EU (eg. EEA, Swiss model, Canada model, WTO)?

5. The future relationship between the UK and the EU will result from Government’s negotiations with the EU. While the models below have been discussed, they may not reflect the final outcome of those negotiations.

6. Risks to consumer protection and market integrity will always be present to some extent in a free-market economy. In such an economy the regulator does not directly control the supply of financial products and services; rather, the regulator seeks to ensure that the rules, the balance of incentives and market dynamics within the sector promote outcomes that are consistent with our objectives.

EEA

7. Subject to its fulfilment of conditions under the relevant single market directive, a firm authorised in a European Economic Area (EEA) member state is entitled to carry on permitted activities in any other EEA state by exercising either the right of establishment (of a branch and/or agents) or providing cross-border services. The exercise of this right is known as ‘passporting’.

8. The activities that are 'passportable' are set out in the relevant EU single market directives. They require authorisation by a competent authority in one member state followed by a notification to the competent authority in the member state in which the firm wishes to do business. Not all activities are 'passportable'; conversely, some do not require authorisation at all (Spot FX trading within the UK for example).

9. The EEA provides a framework which has given firms certainty by establishing the same rules on authorisation and home and host supervision powers across the European market. Changes in the status of the UK vis-à-vis the EEA may present certain challenges. Any changes to the framework governing how authorisations are made and reciprocally recognised, for example, may present transitional risks for regulators and firms. There would also be a risk of diminished UK influence on legislation and regulation developed at EU level.

Other non-EEA trade agreements: Swiss Model & Canadian Model
10. The risks presented by a Free Trade Agreement (FTA) to the FCA’s objectives would depend on the final terms of the agreement. We have considered briefly below risks which might arise under the Swiss and Canadian models.

11. Switzerland has a web of bilateral agreements with the EU that grant its firms certain rights to access the single market, though not quite on the same terms as EEA members. These bilateral agreements do not generally cover the provision of financial services. An exception is in respect of non-life insurance, where a bilateral agreement between the EU and Switzerland provides rights to set up establishments in EU member states, although this is not equivalent to the passporting mechanism.

12. The EU-Canada Comprehensive Economic & Trade Agreement (CETA) enhances scope for trade in financial services based on the principles of the World Trade Organisation (WTO) General Agreement on Trade in Services (GATS). Nevertheless, it does not provide access equivalent to the EU passporting mechanism; in particular, licensing and authorisation requirements continue to apply. Therefore, Canadian financial services firms operating in EU member states will be subject to the same authorisation requirements as other ‘third country’ firms.

13. Under those models, direct access by UK firms would likely be more constrained because authorisation requirements will be required. This could for example, depending on the outcome of negotiations, be the case for products and services under the Markets in Financial Instruments Directive, Alternative Investment Fund Managers Directive (AIFMD) and the Insurance Distribution Directive. Depending on the outcome of the UK’s bilateral agreement(s), it could therefore lead to less choice for consumers, which is an important driver of competition.

14. There may be risks to market integrity, particularly if the price formation process were rendered less efficient if, in the transition, market liquidity fragmented between the UK and EU27 financial centres. This would be a risk both for the UK and the EU27 as this fragmentation could lead to systemic risk. Finally, any outcome that undermines cooperation between regulators could lead to consumer detriment. The FCA has a strong history of effective cooperation with other regulators and we would seek to ensure that any new agreements allow for continuity in information sharing and supervisory cooperation between regulators.

**WTO**

15. The GATS is the overarching framework which governs international trade in services between WTO member signatories.

16. One distinguishing feature of financial services is that the provision of most services is subject to authorisation by a statutory regulator. GATS does not override authorisation requirements so firms may, in the vast majority of cases, require authorisation from the regulator of the jurisdiction into which they seek market entry. The GATS also contains a
‘prudential carve out’ that allows signatories to restrict market access on the grounds of prudential concerns.

Does cross-border trade in financial services help to ensure healthy competition in UK financial markets, and if so how?

17. Yes, we believe that cross-border trade in financial services supports healthy competition in UK financial markets so long as this is underpinned by globally-agreed standards to reduce the risks of regulatory arbitrage and poor consumer outcomes. High levels of competition within markets can improve outcomes by promoting innovation, encouraging tighter pricing and offering a wider range of choice.

18. Healthy competition arising from cross-border trade also relies on ensuring we retain strong ties with our regulatory counterparts in Europe and that we continue to engage effectively with our counterparts in other jurisdictions. The FCA has a strong history of participation in setting global standards and in cooperating with other regulators. This will not change as the UK withdraws from the EU.

How will Brexit change the way the FCA approaches its objective of promoting competition in the interests of consumers?

19. Withdrawal from the EU does not alter the FCA’s objectives; these are statutory and can only be changed by an Act of Parliament.

20. However, we recognise that the process of withdrawing from the EU and the withdrawal itself will have implications for the markets we regulate and, consequently, for us as a regulator of those markets.

21. As the new relationship between the UK and the EU becomes clearer, the FCA’s approach may also need to evolve, in order to ensure that markets continue to function well, that consumers continue to receive an appropriate degree of protection, and to protect and enhance the integrity of the UK financial markets and ensure that effective competition is maintained. However, it is too early for us to comment on what such changes might look like.

22. Separately from the referendum outcome however, we have already started thinking about our role as conduct regulator and how we can best respond to the challenges that consumers and markets are facing in 2016 and the years to come. In July 2016 our CEO Andrew Bailey announced that the FCA will be publishing a new document to provide greater clarity about our strategic choices. This document will not focus on Brexit but the effect of the decision to withdraw from the European Union on financial services is one of many issues we will be considering.

What transitional arrangements, if any, will be needed to provide regulatory stability and certainty to financial services and markets, in the period between the UK’s withdrawal and confirmation of its future relationship with the EU?
23. The negotiations on EU withdrawal are a matter for the Government. The question of whether to have transitional arrangements beyond the Article 50 period is a matter for the UK Government and the EU 27.

24. Regardless of the arrangements ultimately agreed, a key concern will be to avoid a situation where authorisations lose validity suddenly. This would happen where the EU Treaties and relevant single market legislation, which provide for the passporting arrangements whereby ‘host’ authorities recognise the authorisations of ‘home’ authorities, abruptly ceased to apply in the UK. This may mean that firms conducting cross-border business to and from the UK and the EU27 would be doing so unlawfully (in breach of applicable legislation in EU27 member states). Hence, the establishment of transitional provisions to prevent such a ‘sudden stop’ may be important. Avoiding such a situation may help to mitigate risks to consumer protection and market integrity arising from a sudden withdrawal from the EU. It is clear that regulators and firms will need time to resolve such issues to ensure that sufficient legal certainty is provided.

25. A transitional arrangement that provides some short and medium term certainty as the UK and the EU design their new relationship should mitigate risks to market integrity and provide time for firms and the regulator to adjust to the new arrangements.

26. In the meantime, we continue to engage with firms to understand their concerns and the plans they are considering as part of our continuing supervision. It is our role to consider whether the arrangements, both in the application of rules and any rights to passport, will create new or additional risks to the integrity of UK markets and the participants in these markets.

Constraints and opportunities

How does the EU’s regulatory equivalence regime work? What operational intricacies are involved in the EU’s assessment of a third country’s supervisory and enforcement regime?

27. Equivalence frameworks in the EU are permitted under some, but not all, pieces of financial services legislation. They can allow, for example, financial institutions based in jurisdictions that have been determined as equivalent to the specific EU regime to provide their products or services in the EU or to act as recognised parties across the EU (for example, this is the case for recognised stock exchanges). The European Supervisory Authorities (ESAs) are often tasked with performing the technical analysis underlying the equivalence decision but the final outcome often rests with the European Commission.

28. The criteria that are taken into account in an equivalence assessment vary across the different pieces of legislation but often rely on two principles:

- the third country assessed has a regulatory framework with legally binding requirements that are similar, or achieve a similar outcome, to those required of EU firms in the specific Directives and Regulations; and
there is evidence that the third country regulator will be able and willing to collaborate effectively with national regulators of EU member states for supervisory purposes.

29. In most circumstances, the decision to grant equivalence also rests on the access provided to EU firms in the third country being assessed (this is often referred to as ‘reciprocity’).

30. Specific details on the different methodologies that have been used for equivalence assessments can be found on ESMA’s website\(^6\) – for example for European Market Infrastructure Regulation or AIFMD\(^7\) third country provisions.

31. It is also worth noting that equivalence assessments may provide access without further requirements for wholesale business but competent authorities may have more discretion to superimpose national requirements to retail business by third country firms, or to prohibit it.

**How could the UK develop parallel EU and non-EU compliant frameworks to maximise the flexibility of the UK as a financial centre?**

32. We note that the UK financial sector is large, complex and interconnected. Segregating certain sectors and/or firms from the rest of the system may present challenges and a number of risks to our objectives. Such considerations would need to be addressed carefully. We also note that legislative decisions around the regulatory framework are a matter for the Government and Parliament.

**Within the context of a future relationship with the EU, how can a balance be achieved between establishing strong regulations and promoting international competitiveness? How would you describe the relationship between promoting competitiveness and maintaining ‘equivalence’?**

33. We understand the term ‘competitiveness’ to be broadly in line with the definition offered by the World Economic Forum: ‘the set of institutions, policies, and factors that determine the level of productivity of an economy’.\(^8\) If this definition is accepted, it is clear that competitiveness rests on a range of complex factors, only one of which will be financial regulation.

34. The FCA does not have a duty to have regard to the competitiveness of the UK’s financial services sector; such a duty was previously held by the FSA. Regulation in line with the principles of good regulation supports sustainable economic growth and recognises the diverse nature and objectives of businesses and the principle of consumer responsibility. It also helps to foster legal certainty and trust in financial markets. In this sense, it may help to promote competitiveness.

\(^6\) https://www.esma.europa.eu/
35. Strong regulation and competitiveness are not, therefore, mutually exclusive or necessarily opposed to each other. Proportionate regulation can help nurture and develop markets and, by building up trust in financial services markets, consumers are encouraged to become confident in exercising choice, thus driving competition. Similarly, we do not necessarily see equivalence determinations as antagonistic to competitiveness, where equivalence determinations are based on global standards and focused on ensuring substantially similar regulatory outcomes, rather than demanding line-by-line replication. 

**What steps might financial market sectors take to preserve their position in the absence of full market access to the EU? Do any of these present regulatory challenges?**

36. The steps financial market sectors can take to preserve their position in the absence of full market access will be dependent on the outcome of the negotiations between the Government and the EU27. Until there is greater clarity it is hard to reach strong conclusions on this point. There is a risk that firms may make decisions based on certain assumptions about the future framework that may or may not ultimately prove correct.

37. To the extent that the new relationship between the UK and the EU creates changes for the way firms currently operate and the processes they are subject to, this could present operational challenges both for regulators in the UK and the EU. This challenge could be amplified if firms and regulatory authorities are not given enough time to adjust to the new framework.

**How might the UK financial services sector promote its activities in individual Member States, under national regimes, where these are available?**

38. The way the UK financial services sector promotes its activities in individual member states in the future will in part depend on the outcome of the Government’s negotiations and the shape of the future relationship between the UK and the EU.

39. Equally, the UK financial services sector will need to consider whether it is in their commercial interest to set up subsidiaries in other countries and operate within their jurisdictions based on the outcome of those negotiations.

40. It is, however, worth noting that, while national regimes are predominantly within the competence of individual member states, there are sometimes minimum requirements established at EU level before third country firms can make use of national regimes (for example memoranda of understanding between regulators; applying certain EU rules). As such, the future relationship will also affect the type of activities UK financial services firms can engage in and how they can do it.

17 October 2016
HSBC, Allianz Global Investors and Bank of America Merrill Lynch – Oral evidence (QQ18-26)

Transcript can be found under Allianz Global Investors, Bank of America Merrill Lynch and HSBC – Oral evidence (QQ18-26)
Innovate Finance, Abundance Investment and Zopa – Oral evidence (QQ75-80)

Transcript can be found under Abundance Investment, Innovate Finance and Zopa – Oral evidence (QQ75-80)
Examination of witness

Mr Xavier Rolet KBE. Chief Executive, London Stock Exchange Group.

Q66  **The Chairman:** Good morning, Mr Xavier Rolet, chief executive of the London Stock Exchange Group. Welcome to our inquiry on Brexit and its impact on financial services. I have to go through some housekeeping points. You have a list of interests that have been declared by Committee members. This is a formal evidence-taking session of the Committee. The full transcript will be taken. This will be put on the public record in printed form and on the parliamentary website. You will be sent a copy of the transcript and you will be able to revise it in terms of any minor errors. The session is on the record. It is being webcast live and will subsequently be accessible via the parliamentary website. Would you like to make any introductory remarks?

**Xavier Rolet:** Thank you very much for giving me an opportunity to present some evidence. I will be very brief. Since the 2008 financial crisis the world’s regulatory environment has changed substantially with regard to past ways of carrying out financial activities that we at the London Stock Exchange believe should remain at the service of the real economy—that is actually what we do as an infrastructure company. New regulations here in the UK, in Europe, in the US and around the world have put renewed emphasis and even renewed importance on financial infrastructure in general, particularly services like clearing or settlement that enable banks and other financial market participants, including asset management companies, to optimise the balance sheets and—this is key—reduce systemic risk in the financial services industry. It is in that context that I will also provide evidence to you this morning.

**The Chairman:** Thank you. You do a vast range of different activities across different locations. Would you be able to go into slightly more granular detail about which aspects of your business will be affected by Brexit, and how?

**Xavier Rolet:** London Stock Exchange Group, in terms of its activities today, is characterised by three core product areas. The first is the provision of intellectual property. This is a quantitative set of products—for example, indices and benchmarks—that enable asset managers, corporate issuers and other economic players to monitor, control, hedge
and benchmark their risks in financial markets. That accounts for slightly over 30% of our revenues.

The second important and possibly better-known aspect of our activities is what we call our capital formation activities, where providers and users of capital meet. Of course our equities business is very well known; it is very global. As a centre for primary issuance for both equity and debt, London Stock Exchange is one of the global leaders. There is also a range of other services in commodities and products from the trading of electricity to derivatives covering basically the complete gamut of listed derivatives, as well as cash products. Capital formation funds enterprise in the real economy. That represents about one-quarter of our revenues.

The third area of our revenues, which is about one-third of our revenues, is an area that in our jargon—I apologise; I appear before you today as a technician—we call "post-trade". This is what I referred to earlier and is probably the most significantly impacted activity in the context of the outcome of the British referendum on the EU. It is an activity whereby we provide relief to our customers—corporate insurers, banks, broker-dealers, asset managers—with regard to their balance sheets, by collecting the exposure that they have to each other in areas ranging from securities to what we call notional products—over-the-counter derivatives that are not securities per se but contractual obligations that financial market participants contract to each other. By collecting that financial exposure by netting, or compression, we are able to reduce it very substantially—the numbers are very large; we are talking about hundreds of trillions of US dollars of underlying securities or notional exposure—across the world’s 17 largest currencies. That is our clearing business. It is underpinned by the activities of companies like LCH, which no doubt is well known to many people in the City. We operate other clearing houses around the world, particularly in the EU. This also involves settlement, depository and custodial activities. Here again the numbers are quite large and range within the trillions of euros, sterling or other securities, where we effectively act as a settlement agent and a custodian. These are the three core areas. There is a small area of activity in terms of revenues that none the less is important for the UK globally: our technology activities. We offer to a range of countries, exchanges and financial market participants around the world our know-how through the provision of dedicated technological expertise in trading, clearing and settlement. We have signed in excess of 50 global relationships.

I apologise for this slightly lengthy presentation of the Group, but it is helpful to put this in context. We are far more than UK equities, although that business is very dear to us. The Group today operates as physical offices in more than 26 countries. We market our products in 95 countries. Our revenues are equally balanced between North America—that makes up about 25% of our revenues, particularly the United States—the UK and the rest of Europe, which represent about approximately 25% of our revenues each, China, the emerging markets and a range of other revenue sources in areas like Central Asia, Africa and Latin America. We are a very diversified group internationally from a revenue standpoint.

Q67 The Chairman: Thank you, that is very helpful. I wonder if you could
elaborate a bit more on the third part that you spoke about, which you identified as being most affected by Brexit—your clearing, your technology, your netting compression activities and so on. Why is Brexit detrimental to your role in that regard?

**Xavier Rolet:** That is indeed the most potentially impacted area of activity. To put things in context, LSEG via its clearing operations—it is really clearing that we are talking about for the moment—over the past couple of years, through innovative services such as the compression service that I mentioned earlier, has developed unique global expertise across the 17 most important currencies in the world today—Asian, European, including sterling, and North American—and, through innovation, has seized a very large share of this global market. The core service and benefits that we offer to customers today—I will give you a few numbers that are a matter of public record—is by collecting the exposure that banks and asset managers have to each other in product areas such as interest rate swaps, credit default swaps and foreign exchange. For example, LCH is a global leader and a commercial success, which by the way is very important to financial services in the UK and to the real economy. Other services like repo transaction, particularly in the eurozone, we offer through that central clearing service, which handles short-dated as well as long-dated products—in some cases going all the way out to 50 years, so very long-term commitments in terms of financial obligations. That is a massive amount of risk reduction. I will give you some numbers to put this in context.

Last year, our interest rate swap engine, called SwapClear—these are public numbers; you might appreciate that I am also making comments in the context of being under the takeover code and UK panel rules, so I must stick to publicly disclosed information—cleared the equivalent in US dollars across 17 currencies of $555 trillion of interest rate swaps. Through its compression service, which is done across all these currencies, it compressed $328 trillion, which enabled LCH to eliminate $110 trillion net of risk. These clearing houses are of course regularly rated by central banks. So the financial economy saw a physical risk elimination of $110 trillion net worth of risk—or the equivalent across all these currencies. That saved our customer base. I must highlight here again that whatever impact there may be from Brexit or, frankly, any other regulatory decisions, we are always at the service of our customers. It is our customers who tell us how and where they want to move the business. Still, that saved our customers the equivalent of $25 billion of regulatory capital. This was a substantive competitive achievement for UK financial services, because our business is run globally.

On the potential impact, it is important to point out in the context of new regulation in the form of the mandate for clearing in asset classes like interest swaps, which has come out in the EU in the EMIR directive and in the US with the Dodd-Frank Act—there is now a mandate, a regulatory requirement, to clear the securities—that we at LCH were able to achieve that competitive excellence due to the benefit of global compression services. In our view it is also significant, while of course the framework around the Brexit negotiation remains unknown for the time being, that some, including at the highest level of the political apparatus of some states, have claimed clearing, pointing out the importance of that
business. It is quite relevant that some outside the UK will have seen an immediate opportunity to claim that business for their own in the context of the projected separation of the UK from the EU. While clearing is not mandated in all asset classes, there are other providers. It is quite a competitive environment and there are certain financial services transactions that are in fact uncleared, so it is quite an open competitive layout. What has been achieved here in the UK is obviously the object of great interest to other nations that would be very keen, if they could, to see the migration of that business.

I would make one short comment in that respect. These numbers are of course very large; frankly, they exceed the consideration that is normally attached to financial services. These businesses are also systemically relevant, and the migration of such businesses, while technically possible, also entails a number of non-financial risks, particularly operational ones, of a systemic nature that must be taken into consideration by all policy stakeholders.

Q68 Lord Woolmer of Leeds: There has been some talk of a bespoke agreement coming out of discussions and negotiations. In your view, what features of a bespoke agreement would be most helpful to the interests of the UK financial sector and, of course, of your own group?

Xavier Rolet: Again, I speak as a technician in the clearing and infrastructure area, so I feel that I can comment specifically for that industry. It is clear today that a very important feature in our view must be secured if we want to convince our customers that it is safe to continue to clear and assign the clearing of these transactions to the UK for the long term, given the very short timeline linked to Article 50. When you are looking at booking a 10-year, 20-year, 30-year or even 50-year swap or credit product in a location that may be challenged from a compliance standpoint within a very short period, two and a half years, it is really important that two elements that are linked to each other—again as far as the clearing industry is concerned—be maintained. One is equivalency. The UK benefits from its current membership of the EU not only from equivalency and access to euro-denominated securities but from another important element that is sometimes overlooked: it also has access to the United States market. LCH today clears in the region of 90% of the domestic US dollar interest-rate swap market, benefiting from the equivalency and mutual recognition of clearing houses between the EU and the US. That element is obviously very important for continued equivalency, which leads then to the right to passport those activities—namely, to have access to EU-based as well as US-based asset management and banking organisations. Equivalency leads to effective clearing businesses.

Passporting is also very important to maintain—I want to be very specific about the way I phrase this—the predictability of an operational environment that reassures our clients that they can continue to do their business in the way that they have for the past few years with us right here in the UK, without the need for taking alternative measures—either asking us to offer alternatives to UK-based clearing houses or, potentially, giving the business away to competitors.
**Lord Woolmer of Leeds:** I think others will follow up the question of equivalence and passport. Are there any other features of a bespoke agreement that would be important for not only your own business but your various customers?

**Xavier Rolet:** Yes. That is the question that as an infrastructure company at the service of others—we are more like a motorway company or an airport, so others can basically use our services—we ask ourselves every day. One would be the ability for the world’s banks and broker-dealers, in addition to UK banks and institutions that operate in London or in the wider UK, to continue to service European-based customers, US-based and beyond, particularly in the case of the Brexit debate. The implementation of new European legislation—MiFID, the Markets in Financial Instruments Directive—creates a potential criminal liability for any broker or any other financial service’s participants who would cover EU-based customers and offer financial services to them—for example, brokerage services, but there are many others. We consider in everything that we do and represent publicly the importance for our customer base that today uses the UK, and London in particular, to access and service European-based customers and be able to maintain that access through continued passporting. That is very important. London, as your Lordships well know, is the number one global centre for international financial services as the biggest portfolio of global banks and broker-dealers bar none, leading the biggest financial centres in the United States and elsewhere in Europe and Asia. For our capital formation businesses, whether it is access to customers or the ability through our primary markets to raise debt and equity, for not only British companies but global insurers—London, for example, is the global offshore centre for the raising of green finance, green debt, Indian masala bonds and Chinese dim sum bonds—it is a really big international business. It is important that we can continue to distribute these products at the point of primary insurance from London to the customer base, and there is of course a substantial customer base in the European Union. On the trading side, we consider these issues and they are very important to us.

On the third area, which I have not mentioned so far, intellectual property—indices and benchmarks—today London Stock Exchange Group, through its acquisition of FTSE, Russell and other companies has achieved a leading global position. Assets under management on the benchmarks are in excess of $10 trillion or equivalent. It has coverage of a full range of markets; for example, LSEG operates the most liquid domestic Chinese index future contract, the so-called A50 contract. It operates the leading indices in Europe: the famous FTSE indices and the Russell family of indices, which are very important benchmarks in the US. It is important in the context of a distribution that these products continue to operate. Although they are not as regulated today as clearing houses or our trading activities are, there is clearly a very strong impulse coming out of the EU—from other jurisdictions too, but led by the EU—to seek to increasingly regulate these activities. Currently all these global indices are operated and managed out of the UK, with a local presence, but we also have to think about whether in the medium-term future we will be able to continue. We must think of the future and our ability to continue to offer these services. The group computes and calculates almost 1 million
indices every day, underpinning, as I said, over $10 trillion of assets on
the benchmarks globally. It is important also to protect the future in
terms of maintaining access, from the UK or elsewhere, to our European
client base.

Q69 Lord De Mauley: Several witnesses have said that, regardless of the
stipulated two-year period, in reality the negotiation between Britain and
the EU could take longer. Whether or not that is the case, what
transitional arrangements, if any, would help to tackle volatility and
mitigate risk in financial services and markets in the period until the
terms are agreed?

Xavier Rolet: That is a key question. I should disclose that we are very
supportive of the concept of securing transitional arrangements so that
the necessary negotiations, which appear quite complex, can be carried
out. The flip side is that it seems to us that Article 50 was designed with
exactly the opposite set of objectives in mind—that is, to impose and
enforce such a reduced timeline to raise the cost of exiting the EU and
make it punitive, or to create a level of uncertainty. This is our number
one concern. Given the decision that has been made, there is no doubt
that ultimately Governments will sit down and negotiate agreements and
it is not for us to opine on this; we shall just enforce whatever regulations
are given to us. However, the primary cause of potential instability or
migration of business would come from your Lordships’ earlier questions:
if our customers are faced with an uncertain outcome within, say, the
next two and a half years, for the protection of their own customers and
shareholders they likely have to start today to think, plan and execute
alternative arrangements. They might come to us and say, “We
understand that there will be a deal but we don’t know what it will be, so
offer us alternatives”. Our business is and can only be customer-driven;
they are ultimately the ones who will make these decisions for us,
whether on clearing, trading arrangements or financial services. Say there
is a leasing capability attached to a car manufacturer exporting a
substantial amount of the cars that are manufactured to the EU using a
UK leasing-based company. If it is possible that in two years’ time that
leasing company may no longer be authorised to offer those essential
leasing services from the UK to its customers, it needs to start taking
action today to apply for a licence to continue. Hence the real difficulty:
for most financial securities and licences, the delays in securing a licence
easily exceed a year; 18 to 24 months is the norm, particularly since in
most cases the regulatory environment in Europe is less global,
sophisticated and deep than it is in the UK. So the ability to process
multiple applications takes time. This is the issue that financial services
participants face in the UK: customer behaviour today is forced by the
very short timeline that you referred to and the necessity to plan for the
very worst outcome. In that context, any messaging of a political nature
tends to shift behaviour a little more to one side or the other. That is the
key. It is about ensuring that our customers will not be in a situation in
the next two years where all of a sudden they have large amounts of risk
or activities that are non-compliant. In that context, new regulations such
as MiFID or Dodd-Frank in the US provide an environment that is new.
Obviously it has been here for a few years, but it does not have the
flexibility that financial services markets might have displayed 10 or 15
years ago when this sort of mutual access was far easier. It is far more regulated today and more complex to plan for that kind of change.

**Lord De Mauley:** Can I press you a bit? You have very helpfully hinted at what participants in the market might do, as it were, during the transitional phase. What could our Government do in their negotiations that might be helpful?

**Xavier Rolet:** Going back to Lord Woolmer’s earlier question, in any negotiations one wants to keep some elements of them close, but there are two elements. One is messaging that helps to reassure the client base in general that making an early move could be the wrong decision—that in the end there would be very significant costs, not just to UK participants but to those in the rest of the EU, of disagreeable, contested or difficult agreements leading to the risks of migration and dislocation. This is a very sensitive and sophisticated industry, as I think the past as shown, which at times, particularly when leverage is too much, is prone to accidents. It is in everyone’s interests to preserve the benefits of what London has achieved, including for the rest of the EU. Independent studies, not linked to the London Stock Exchange, have shown that the disaggregation of the euro component of our clearing engine—which, as I referred to earlier, covers 17 currencies in a single default fund here—would cost the financial services industry $77 billion of additional margin. That is a very substantial cost to the balance sheets of banks that remain quite highly leveraged. So there are advantages and benefits to both sides in having an agreement that ultimately ensures that financial flow and the real economy can continue to operate in an optimised environment. Any messages—from either side, by the way, not just from the UK Government, to answer your question, so also from the European side—that that overriding commercial and economic optimisation will be central to the agreement would help to reassure, investors customers and companies that ultimately things will end well and that commercial and economic arguments are likely to win the day. Of course, we cannot eliminate all that uncertainty.

Another element, which I think is a temporary one, is of course that the other side of the European negotiating table currently has Governments who are facing imminent elections and substantive outcomes. There is the very important referendum on 4 December in Italy, which the Renzi Government are prosecuting not just with a view to get governance improvements but to modernise, reform and improve the performance of the Italian economy, for the interest and benefit of everyone. There will be elections in the Netherlands, France and Germany. So obviously the other side of the negotiating table today is uncertain. In my personal opinion, the real negotiations are more likely to start when the Governments that have been newly elected and effectively have a number of years ahead of them, and perhaps will take an appeasing approach to the overall political applications of leaving the EU, take their place at the negotiating table. I believe that will facilitate a more commercial, economically minded negotiation. We are still in a period where there is a great deal of uncertainty as to who is going to be on the other side of the table, and the priorities today of some of these Governments may change. So from a negotiating standpoint, this is also something that hopefully—
The Chairman: Forgive me, Mr Rolet, we are well aware of the political context in Europe. We were wanting to know from you whether there is something specific that, from where you sit, you might wish the Government to take on board in their negotiations. If you do not have any specific issues and it is only about messaging and the context of the negotiations, I would like to move on and bring in Lord Skidelsky.

Lord Skidelsky: You mentioned Dodd-Frank. In that context, I think you said that the new regulatory environment has made the financial system less flexible, and of course that may also be true of the new European regulatory regime. The purpose of these regulations is to reduce risk and in particular to prevent the kind of correlated financial flows that led to the crash of 2008. Is your argument really “the less regulation, the less risk”? Is it that the financial services sector is the best judge of the risks that it runs, and that the success of the London financial services sector is due to the light-touch regulatory environment that it has enjoyed?

Xavier Rolet: Your question gives me an opportunity to clarify my earlier statement. That is not at all what was implied in my comment. I think the days of light-touch are long gone. The reason why these regulations were set up, as a result of political and regulatory decisions, was to move from a world where financial services participants would deal with each other and accumulate a lot of balance-sheet exposure without visibility, transparency or the netting and compression benefits that LCH has provided for. The point I was making was that the new regulations, Dodd-Frank and EMIR, codify—this has been for the better; the recent financial market instability has been handled very well by clearing houses—far more strictly than in the past access to the market. It is an access point. If you wish to offer services in the US or the EU, you have to be compliant with a stricter framework that has been extremely beneficial to resilience in financial services but also codifies access in a far stricter way than in the past. So my point was not about light-touch versus heavier-touch but about the fact that—this is my answer to your earlier question, Chairman—from a clearing standpoint and an infrastructure standpoint, we seek to maintain equivalency and maintain passporting as a key negotiating ask, together with the supportive messaging in terms of the relevance of economic issues.

Lord Skidelsky: But if the regulatory regimes diverge, will it be more difficult to maintain equivalence?

Xavier Rolet: Certainly. This fact is not necessarily advertised enough but currently there is mutual equivalency recognition between the US and the European regime, specifically in our business for clearing houses. Although the rules are not 100% identical they have been deemed by regulators to be equivalent, thus giving access to European London-based clearing houses to the US market, and vice versa.

Earl of Lindsay: I want to carry on from where you have just been—the absolute importance of retaining post-Brexit equivalence and passporting rights. We have had witnesses suggest that the way third-country equivalence works within the EU regime as it is designed and operated is not a wholly satisfactory process. There are uncertainties over how equivalence is judged and when and how it might be removed, and there
is the potential for constraints on, shall we say, the UK regulatory regime’s innovating the regulatory arrangements so that it is always fit for purpose or perhaps innovating financial products. Do you share those concerns, or do you think it should be an absolute requirement that third-country equivalence as currently defined and operated should be the objective of the UK negotiation over Brexit?

**Xavier Rolet:** I can only offer an opinion, since London Stock Exchange Group has no regulatory powers whatever. These decisions and analyses are solely within the power of regulatory entities—the FCA, the central banks and the Bank of England, as well as their equivalents in the EU and the US. It is clear that an equivalence process is very complex because it requires the assessment, by prudential as well as conduct regulators, that two regulatory environments, even if they are not 100% identical, are roughly equivalent in the sense that they provide the same high-quality standards of conduct and prudential regulation, including the balance sheet as managed by the central banks. We, as a regulated entity, apply and enforce the rules that they give us. I would say as a personal opinion that on average—I am not speaking on behalf of London Stock Exchange Group because we have no opinion beyond enforcing what the regulators tell us are the rules—the equivalence process between mature markets, the EU, including the UK, and the US has worked well. Could more be done? Certainly, but this is something that parliaments as well as regulators are looking at.

I also think, and this is something we have said publicly, that with regard to wholesale businesses, these efficiencies and savings that clearing houses offer, in terms of a reduction in margins and the elimination of risk, are very important for banks and investment management institutions because relief on their balance sheet and the elimination of risk means that they can invest more in the real economy. They can either deleverage, in the case of companies that are too leveraged, or they can deploy their balance sheet more advantageously for the benefit of the real economy. Because business is so globalised—particularly for the blue-chips, which export and import—efficiencies, as I showed in the case of the SwapClear example, cannot be achieved as much, certainly in the context of the single currency or a single market, as if you put several currencies together. So we view the equivalence process—mutual recognition in some cases, and passporting—as very advantageous to economic growth. It is a process that in some cases, once the decision is made, sometimes requires several years of implementation. It is not a 100% perfect process but one that is certainly advantageous to the UK economy and its partners, and which fundamentally we support.

Q72 **Earl of Lindsay:** Some fears have been expressed to us that the EU third-country equivalence process is ultimately subject to political decision-making—that there may be a technical interpretation as part of an assessment, but actually the decision on equivalence is a political one. Those who have expressed concerns about the way this works in the EU have suggested that the global equivalence arrangements—the protocols and understandings—will ultimately become the most important drivers and dynamics. Would you agree with that assessment? If you do, to what extent should EU equivalence none the less remain a sought-after
negotiating goal?

Xavier Rolet: I agree that global equivalence is effectively the Holy Grail, particularly in financial services regulation. The events of 2008 have shown that no country on its own—even the largest financial services market in the world today, the US—can handle on its own, within its own border, a systemic event, given the correlations and interrelations between the financial services industries, which generally reflect the way the global economy works. So yes, I support the assessment of those who ultimately believe in a global equivalence. Of course for markets that are like-minded you need to set a high bar of regulation, a high standard, rather than loosening up the standards to increase membership. Once those high standards are underpinned—for example, by regulation such as EMIR, MiFID or Dodd-Frank, including over time more countries to widen the benefits of the economy—and once you have set the right standards of systemic resilience and conduct authority or behaviour, then you put yourself in a good position to help the economy to grow a lot faster.

On the other part of your question, the EU’s own equivalency and the way it has been done—potentially the political overtones—we never look at a regulatory decision through a political filter. Again, we are technicians; we look at the impact on our customers’ activities and how we are going to comply with the decisions as quickly as possible. It would probably be unrealistic to expect that regulation of an industry as vital and publicly visible as financial services could be completely isolated from the political process anywhere, nor would this be desirable since the public have to have a big say. In our view, this happens pretty much everywhere around the world where sophisticated economies reach a size where the public, through their elected representatives, the Executive and other political stakeholders want to have a say, so we regard this as totally legitimate.

Lord Shutt of Greetland: I have a series of questions. The heading really is, “Is clearing to clear off?” You have said it would be difficult for euro-denominated clearing to move from the UK as it is deeply embedded in the City. Why is that, and is it really the case? In your introductory remarks you mentioned people circling around looking for this work. What are the technical complexities in determining how Brexit might affect the clearing system? Is it possible for financial centres such as Paris or Frankfurt to take over the City’s role in this work, or will it go to the USA? You may recall that we had a visitor a fortnight ago, Mr Simon Kirby, the Economic Secretary to the Treasury. He said, “There is a lot of noise about clearing”. He went on to say, “Is it the most important element? Probably not, but it is a significant consideration”. That suggests that it does not give you absolute confidence that it might be uppermost in minds at the Treasury.

You have also said that there are a minimum of 100,000 jobs at risk if clearing were to relocate. I am assuming that these are quite well-paid jobs, and it could be that the people doing those jobs are supporting other members of the community such as spouses and family, so we are talking about a minimum figure of 400,000 people. We are talking about one in 150 people in the UK being affected if that job has gone. How likely
is that job to be lost? Do you have a schedule of these 100,000 jobs so that we can weigh up the importance of this? I am sorry that this has been lengthy, but that is the package of questions.

**Xavier Rolet:** I will try to answer every one of them in sequence. If I do not give you a full answer or miss a point, feel free to interject. Clearing is indeed embedded in the City. I like your headline, “Clearing to clear off”; that might become a headline in the UK press but I hope not. It is clear that the fundamental appeal and relevance of what has been accomplished, particularly by LCH, are those embedded efficiencies of having a global business that includes a very important component of euro-denominated securities. Last year LCH as a group cleared in excess of €320 trillion in securities across repos, credit default swaps, foreign exchange and so on. The fact that it is embedded with other currencies and yields these enormous, substantial commercial benefits to the industry is obviously an argument against undoing this or, if it were to come undone—and it could; there is a risk, owing to the potentially changing regulatory framework—that could have a significant economic impact on our customers, banks and asset managers that post margin. As I mentioned earlier, that independent study by the Clarus Financial Technology group estimated an extra $77 billion of margin would be required if the euro component of a clearing engine were separated by fragmentation. That would reduce the compression benefit. That would be the immediate cost to industry in general and financial services participants and banks in terms of a higher regulatory capital haircut. So owing to the innovation of the last few years, the compression service and the global nature of that business, it is indeed economically embedded in the City and an advantage and an economic success that the City and the UK can be proud of. After all, it is something that has been achieved in the face of substantial global competition, not just in Europe but in the US and elsewhere. It is an economic benefit that is worth protecting and worth considering the impact of if it were to leave our shores because, frankly, it would be very unlikely ever to come back.

The technical complexities—again, I speak as a technician—are real. These are not businesses that are set up without a deep set of regulatory discussions, including with central banks. We are of course regulated by the Bank of England and the FCA but we also operate clearing entities in Europe regulated by various central banks. We are regulated in the US by the SEC, the CFTC and directly by the Fed. All these discussions are underpinned by lengthy multiyear discussions.

**The Chairman:** So if Paris or Frankfurt were rivals for this business, how long in your estimation would it take for them to reach the level of business activity that the UK has at the moment?

**Xavier Rolet:** I have said publicly that while there was keen interest in other European capitals to try to seize that business—particularly in France, as we have heard from political pronouncements—we also look at New York. Our customers are telling us that New York today is also a key potential competitor, given the global nature of financial services business carried out in Europe. They are clearly areas of expertise and efficiencies—

**The Chairman:** What are the timelines?
**Xavier Rolet:** The timeline depends on the regulatory discussions and again, because this boils down to the customer, customer desire to potentially hedge a negative outcome. We have never spoken about timelines. We have expressed risk in terms of hundreds and we stick by that estimate. We expect that in due course that there will be further technical information that will be available and will be provided to this Committee, but we do not have a timeline. It depends on the customer.

**The Chairman:** So you are expecting the impact to be quite drawn out over time?

**Xavier Rolet:** Again, we cannot be certain. It can depend, for example, on declarations made, including in the UK, as to whether this business is viewed as valuable or not. That impacts customer behaviour. Of course we do not control these affirmations of interest or lack thereof in this business. But we stand by our estimate of 100,000 jobs, which was carried out with the numbers that are available to us. To put it in a broader context, whereas there are so many industries and areas of economic activity that are potentially impacted by Brexit, whichever way one seeks to determine that they will be, the fact that clearing was raised immediately by some as an area that they saw as vital to repatriate or migrate out of the UK shows the importance of that business. It is not by chance that the subject of clearing came up so quickly, within a few days of the outcome of the referendum.

**Lord Shutt of Greetland:** But can you assemble these 100,000-plus figures? It is easy to say that there are 100,000, but where are they all? Can you say that there are 1,000 there, 3,000 there and so on? We really need to know what this amounts to.

**Xavier Rolet:** We will provide a more detailed estimate. I can give you an insight. We are doing work with external auditors and parties whose job it is to go through this line by line. We have obviously done the calculation.

**The Chairman:** When are you expecting more details?

**Xavier Rolet:** Reasonably shortly.

**The Chairman:** Would you be able to provide them to the Committee?

**Xavier Rolet:** We certainly will. If I may briefly respond to Lord Shutt’s question, when you think of clearing there are of course the individuals involved in clearing. Among the client base are banks, asset managers and corporate insurers who have to post collateral. They have to compute their risk so you have the risk management entity, you have the Treasury function, and the risk management functions that then post collateral. You have all of the trading syndication. You have middle office and back office and a range of, as you pointed out, non-financial services that support these financial services. If I can put this in a broad context, just to give an example about how this could play geographically, there are 2.2 million financial services jobs in the UK today. Only about a third are based in the Greater London area. For clearing, we will provide more information in due course, but you are likely to see the same sort of geographical distribution.

**The Chairman:** We are slightly tight on time.
**Lord Skidelsky:** This is related to the 100,000 jobs. The headline: “The boss of the London Stock Exchange says Brexit could cost the UK a £440 billion per day business”. Presumably that is the maximum—the extreme. It will not be as much as that, will it? Some of the business will be retained. Is that not rather an alarmist figure?

**Xavier Rolet:** I do not think so and I think all the statements that we have made, particularly - given the takeover panel, have been carefully calibrated. I have not specifically said £440 billion, because that is a notional amount. But on the basis of what we have done last year on clearing, if the clearing business were to leave—and I highlight that point—we cannot separate the euro-denominated component from the other currencies. If through regulation and lack of access to the eurozone we lose the capacity to clear the euro business in London, the whole engine has to move because otherwise we lose the compression benefit, hence the potential appeal of a financial centre like New York. I believe that the £440 billion was inferred by a journalist in terms of the £555 trillion annual cleared in interest rate swap reduced to a daily notional. That is how they got the numbers. That is how it was based, but I have not personally said £440 billion. However, it is based on notional consideration cleared. If you take the £555 trillion annually divided by 250, and you add repos and you add forex, you get to these numbers and levels. These are not alarmist statements. They are based on last year’s statistics, and on the hypothetical assumption that—were we to lose or were our customers to tell us that they cannot wait for the outcome of the decision and they need alternatives, they need to clear outside of the UK—that whole engine is at risk. It is at risk not just for euros but dollars—Canadian, Singapore, Hong Kong—and Japanese Yen et cetera. These are real numbers. They are not calibrated to create either a conservative approach or an alarmist approach. They are based on last year’s activity—on 2015 numbers.

**Lord Woolmer of Leeds:** I think you said that there might be a move of clearing to New York rather than staying in London. What would be the advantage of that? When some European member states talk of euro clearing in the eurozone rather than just Europe, would that imply that all the rest of the clearing activities that you do, for example in London, are at risk of moving to New York? How many other countries in the world seek to ensure that any clearing involving their currency can take place only in their country? What other countries in the world have such a policy?

**Xavier Rolet:** That last point is very important. To go back to the question the Chairman asked me earlier about what we would ask of the UK Government, we would say that it is possible, today, to clear euro-denominated securities in the United States, so why should the UK settle for less than is available to the US? Actually, if you look at the reality—and that point is very important—while of course every nation in the world wishes as much clearing to happen within its shores for its national currency, the reality is that euros, dollars and sterling are cleared in a whole range of jurisdictions. This notion that euro-denominated securities could be cleared only inside the eurozone is not consistent with current practice as agreed by the European authorities, not just as it concerns the UK but as it concerns US and other Asian jurisdictions that are benefiting
from mutual recognition. I mentioned Japan, for example, not that there is much activity. For us it is important that that framework objective, economically sustainable today, be recognised. On the other part of your question about clearing, I apologise for labouring the point but it is important to understand that the economic benefits afforded to clients of the London Clearing House, particularly on swap, forex, CDS and other over-the-counter derivatives, come from compression of cost securities. Again, if we start fragmenting and putting the US back in the US and the euro back in the eurozone, those benefits disappear. Customers would lose—banks, corporate insurers and asset management companies. That is why I always said that it is not our desire or our customers’ desire, but were we to be put in a situation where we have no choice owing to decisions made at a political and regulatory level, and our customers—it is all driven by customers—were to tell us to move otherwise they would do business elsewhere, we would certainly move. Financial centres in Europe have their own expertise, but let us not forget the power of New York as well to offer a global framework for business.

**Lord Woolmer of Leeds:** So if the European Union sought to ensure that euro clearing was done only within the European Union that would also have to apply to New York?

**Xavier Rolet:** Absolutely, and to other countries.

**Lord Woolmer of Leeds:** They would also have to prevent euro clearing in New York.

**Xavier Rolet:** Correct. They would seek either to prevent or to limit it, which is why I understand some discussions have already originated in the EU for limiting the ability of US-based clearing houses to clear euros in denominated securities—so capping or somehow restricting their ability to engage meaningfully in that business. That would not be consistent with the existing agreement around equivalency in mutual recognition.

**The Chairman:** As a final point, would there be value in the UK leveraging with the US to have a better negotiating position?

**Xavier Rolet:** I certainly would not want to comment on what the negotiating position of the UK authorities should be.

**The Chairman:** We have been trying to get you to do that all morning.

**Xavier Rolet:** I am a technical and commercial operator.

**The Chairman:** But you would wish us to have the same treatment at the moment that is accorded to Wall Street?

**Xavier Rolet:** To answer your question, it certainly would not seem judicious or advantageous for the UK authorities to settle for less than what the US and other countries in Asia have already achieved, which seems reasonable.

**The Chairman:** Thank you. That concludes today’s first public evidence session.
London Stock Exchange Group – Supplementary Written evidence (BFS0006)

Thank you for the opportunity to speak in front of your Committee last week on the inquiry into Brexit: financial services. I do hope my evidence was helpful to the inquiry.

During the session, I promised to follow up with the Committee with further details and analysis on the impact to the UK economy if euro-denominated clearing were to leave the UK.

Please find enclosed a report by EY on Brexit: Impact on UK economy of loss of clearing activities.

The analysis is modelled under the Brexit scenario condition in which euro-denominated clearing is lost from the UK and financial institutions may consider relocating services due to a less competitive UK clearing regime and a lack of confidence in being able to sustainably conduct EU business from the UK.

The report estimates that up to 232,000 combined UK financial and non-financial job throughout the UK could be lost.

We hope this is a helpful report and piece of evidence, showing the critical importance of retaining the euro-denominated clearing in the UK for the real economy in the context of Brexit.

I would of course be happy to discuss any aspect of this report with you or your committee members.

11 November
Norton Rose Fulbright and Clifford Chance – Oral evidence (QQ27-37)

Transcript can be found under Clifford Chance and Norton Rose Fulbright – Oral evidence (QQ27-37)
PricewaterhouseCoopers (PwC), British Bankers’ Association and Reuters – Oral evidence (QQ10-17)

Transcript can be found under British Bankers’ Association, PricewaterhouseCoopers (PwC) and Reuters – Oral evidence (QQ10-17)
Reuters, British Bankers’ Association and PricewaterhouseCoopers – Oral evidence (QQ10-17)

Transcript can be found under British Bankers’ Association, PricewaterhouseCoopers and Reuters – Oral evidence (QQ10-17)
Scottish Financial Enterprise represents Scotland's financial services industry. It is funded by its members, which are drawn from all sectors of the industry as well as from professional bodies. Common to all members is an interest in promoting and supporting the continued success of our industry in Scotland and around the world.

Financial Services is one of Scotland’s biggest industries, and second only to London in the UK as a financial centre. The UK has the largest financial services industry in the EU and London is the biggest and most international financial centre in the world. The relationship between the financial centres of London and Scotland is very close and being part of same jurisdiction as London, is a big strength for Scotland’s financial services industry. The current picture of financial services in Scotland, as in the rest of the UK and around the World, is of an increasingly digitised industry which is strongly focused on the growing Fintech sector.

I have addressed the two key themes of your questions broadly, rather than addressing each question individually. As I mention above, Scotland is part of the UK and the financial services industry is a UK-wide industry, therefore the impact of Brexit on specific sectors will be largely the same regardless of location within the UK. Scotland is, however, over-indexed in financial services and should the Brexit negotiations result in particularly damaging terms for the industry, Scotland could be disproportionately and adversely affected.

Key interests for Scotland’s financial services firms.

The industry based in Scotland accesses the EU and adheres to EU regulation in the same way as the rest of the UK. Therefore, the consequences of Brexit for the different sectors within financial services will be the same in Scotland as in the rest of the UK. What exactly these effects will be will depend largely on the deal which is struck for the UK post Brexit.

The priorities SFE members have raised so far are:

- Secure single market access on terms that resemble as closely as possible the access we currently have in place. As part of this, passporting arrangements are maintained or a proxy is established offering the closest mechanism to that which is currently in place.
- All companies are seeking greater clarity. Before assessing in detail what Brexit means for their businesses, the Government needs to outline the framework it intends to negotiate for and how it sees the UK’s relationship with the EU post Brexit.
- Retention and recruitment of international staff. Scotland’s financial services industry currently attracts high quality international talent. To maintain and further develop the industry in Scotland, we need to be able to continue to attract the best talent from the UK, EU and the rest of the world. Restrictions on employing EU nationals would have a major impact on the talent pool available to the industry.
• Agreed transitional agreements. This is essential to help provide stability and allow companies to adjust their operating models and avoid disruption in their ability to distribute products and services to customers.
• More so now than ever before, there needs to be a coherent pitch highlighting the UK and Scotland as being “open for business”. It is essential that there is a deep partnership between governments, regulators and the industry to accentuate the positives for trade and investment.

Constraints and opportunities for a future relationship with the EU in financial services.

The industry in Scotland, and throughout the UK, seeks an exit process which is as orderly as possible to ensure financial stability. The mix of financial services sectors varies in each part of the UK, with the percentage, or even existence, of each sector varying considerably depending on location. Scotland has a very diverse financial services industry, with strong representation in banking, asset management, asset servicing, insurance, pensions and wealth management. The specific, sectorial effects of Brexit will apply across the UK, where we may see differences will be where the effect has a particular impact on a specific sector. Locations, therefore, with a disproportionate concentration on that sector will experience a greater impact. Finally, it is worth bearing in mind that the underlying operating models of FS companies do vary greatly and until there is clarity over the negotiating position and framework for Brexit; it is not possible to assess how different locations and individual companies in Scotland and the UK will be affected.

12 October 2016
Swiss Bankers’ Association, Association of British Insurers and TheCityUK – Oral evidence (QQ48-56)

Swiss Bankers’ Association, Association of British Insurers and TheCityUK – Oral evidence (QQ48-56)

Transcript can be found under Association of British Insurers, Swiss Bankers’ Association and TheCityUK – Oral evidence (QQ48-56)
Simon Kirby, Economic Secretary to the Treasury, welcome to the EU Financial Affairs Committee’s inquiry into Brexit and its impact on financial services. We note that you are accompanied by Katharine Braddock and Lowri Khan, both from Her Majesty’s Treasury.

I need to make some housekeeping announcements. You have a list of interests that have been declared by Committee Members. This is a formal evidence-taking session of the Committee and a full transcript will be taken. This will be put on the public record in printed form and will be on the parliamentary website. You will be sent a copy of the transcript and you will be able to revise it for any minor errors. The session is on the record. It is being webcast live and will be subsequently available through the parliamentary website.

Minister, would you like to make any opening remarks?

Simon Kirby: Yes, I would, if I may. Thank you very much indeed for inviting me here today. It is a great pleasure to be here. You have introduced my two officials, but it might be useful for the Committee to know that Lowri Khan is the Treasury’s Director of Financial Stability, whereas Katharine Braddock is the Treasury’s Director of Financial Services. Between the two of them they have quite a lot of expertise.

I am looking forward very much to this morning’s discussion and I welcome the Sub-Committee’s work. It is a very important area and a key area of UK economic policy. I hope that it will be interesting and constructive for all of us.

We all know that UK financial services play a vital role in the UK, European and global economies. That is an important point. It is very easy just to focus on the UK perspective. What we do in this country benefits customers across the globe. Last year, we exported some £63.7 billion in financial services—insurance and pensions, exports—and we are a global hub for a whole range of different currencies: green finance, fintech, for instance.

There are five facts that I think are of significance about financial services in the UK as a whole. Financial services contribute more than 7% of UK
GDP, and around half of that comes from outside London. They employ more than 1 million people, two-thirds of whom are outside London. I will talk about that later, if I may. Importantly, from a Treasury perspective, it is estimated that financial services contributed some £66.5 billion in taxes in 2014-15. It is also estimated that they provide savings for regulatory capital of some £16.7 billion. Financial services as exports, as a percentage of GDP, have increased from 1.6% in 1991 to 3.5% in 2015. This is an important part of our economy. We are determined through the Brexit process to deliver the change that people want and to secure the best possible economic relationship with the rest of Europe and get the best possible deal. We are aware that we do not want to disrupt financial services or drive up costs. We do not want negatively to impact the world economy, because we are a significant player in that. We are looking to make the financial services sector robust, highly competitive and open for business whatever the end result of negotiations may be. We are convinced that the best result, not only for us but for all 27 European neighbours, will be free trade between our countries, with London remaining as a global economic centre. We have a strong position to start with. There will be movement up and down ahead, but we are in exciting times that represent an opportunity for us as a country. I very much look forward to your questions.

**Q58 The Chairman:** Thank you very much. There has been a lot of media speculation about the Government’s negotiating strategy, and indeed as to which departments are leading it. Could you talk us through the process and timings by which the Government will determine their negotiating strategy?

**Simon Kirby:** There is an awful lot of noise. It is difficult to know who to believe and which newspaper is telling the truth, if indeed any of them are. At the end of the day, the Prime Minister is very clear that it is our intention to invoke Article 50 at the latest by the end of March next year. There have been extensive consultations not only at Treasury level but across government with interested stakeholders. We are very much in listening mode. We can speculate about the negotiations, but it is probably too early to say quite where we are. I can reassure you that the Government as a whole, with all their separate parts, are intent on getting the very best possible deal for Britain. I am here to talk about financial services, and it is very clear to everyone that that is an important part of the solution.

**The Chairman:** Minister, you mentioned Article 50 at the end of March at the latest. This is an aside, but it is a relevant aside. You will be aware that the treaty of Rome European summit in Rome to commemorate 60 years of the treaty of Rome will take place on 25 March. If I were in your negotiating position I would not file Article 50 around that particular date. Assuming that you do it mid-March or so, we understand that departments have been asked to come up with their draft negotiating positions by the end of December. I wonder whether you would be able to tell us how much preparation there is in the Treasury in that regard—something a bit firmer than the overarching reassurances that you have given. If I can dig a little deeper, is the Treasury the department that is leading on the negotiations to do with financial services? One again hears
contrary arguments in that case. I suspect you will tell us that the Treasury is, but in that case how will responsibility be shared across the three departments that are impacted: Treasury, DExEU and International Trade?

**Simon Kirby:** That is a very good question. I regularly meet many people who are all desperate to know what is going to happen. I say to all of them that I do not have a crystal ball and that it is too early to give a firm indication. What I can say is that the Treasury is very much responsible for financial services. It has been very clear that this represents an important part of the solution, whatever that solution might finally appear as. The whole of Government are working together to get the best possible deal for Britain. It is easy to suppose that there are more conflicting views than are there in reality. It is in everyone's interest that, on the one hand, we deliver what the British people decided on 23 June but, on the other hand, make sure that we continue as a strong economy providing jobs for people up and down the country.

That is perhaps not the firm answer that you were seeking, but I assure you that the departments are all working closely together, through No. 10, with the common objective to make sure we get the best possible deal.

**The Chairman:** Are you providing input through briefings to the Cabinet Committee chaired by the Prime Minister?

**Simon Kirby:** The Chancellor of the Exchequer sits on the Cabinet Committee. He has met, as I have, with many interested parties in financial services. We have listened very carefully to their concerns, and he has made the case loud and clear at the Cabinet Committee. I do not think you should put too much weight on what you read in the newspapers. The Treasury, No. 10 and all the other departments are there to get the best possible deal, and that is what we are going to do.

**Lord Butler of Brockwell:** Let me press you just a little further on that. Are you really telling us that it has not been decided which department in the Government will lead on the negotiations on financial services?

**Simon Kirby:** The Treasury is responsible for financial services. It would be reasonable to suppose that the Treasury would lead on the negotiations for financial services, but the deal is there to be done. It is not appropriate to comment or to prioritise what is important or more important or less important. The whole point is, as you will understand, Lord Butler, to get the best possible deal not only across government but for every person and business in the UK. I will be as helpful as I can, but as much as I would like to sit here and give you detail, insight, gossip and intrigue, I am not in a position to do that because it is too early to say exactly where we are. That does not mean we are not organised, engaged, listening and preparing for Article 50 to be triggered, but it is too early to give you the detail today.

**Lord Butler of Brockwell:** You say there is a deal to be done, and I am not asking for the details of the deal. What I am asking is whether you are talking about a deal inside the Government with other departments and which department is going to be the lead in these negotiations.
Simon Kirby: The Treasury is responsible for financial services, and you might suppose that it would have a very strong interest in the negotiations that directly affected that policy area.

The Chairman: Mr Kirby, by saying “you might suppose”, the inference to anyone who is listening to this is that the Treasury is not leading. The question is quite simple. Is the Treasury leading on negotiations on Brexit as applied to financial services?

Simon Kirby: Yes, it is.

The Chairman: Thank you. Are you co-ordinating the work being done on this at the moment across government departments and across stakeholders?

Simon Kirby: As far as financial services are concerned, the Treasury is co-ordinating the work. It is listening carefully to a whole load of very different opinions within the industry and it is co-operating and co-ordinating with other departments across government.

Lord Skidelsky: Do you have a clear idea who you will be negotiating with on financial services?

Simon Kirby: I think there will be a great number of people who have considerable interest in the area of financial services. It is very easy to suppose that there is a desire to break up financial services and redistribute them across Europe. Actually, it is in everyone’s interest for London to remain a strong centre of financial services and to continue to provide the excellent service it does not only for the UK but across Europe and around the world. There is no simple answer. It is a difficult conundrum. We will be listening and negotiating with whoever it takes to get the best possible deal.

Lord Shutt of Greetland: You mentioned being in listening mode. Listening is a rather good thing, but how long will listening be going on?

Simon Kirby: When Article 50 is triggered, it will be the start of the formal renegotiations. Clearly the Government are preparing now, while listening and considering the best possible way forward, to achieve the best possible outcome. We will be listening throughout the process. We would be foolish to do anything other than that.

Lord De Mauley: Minister, in your introductory words you gave us an outline of the Treasury’s current assessment of the contribution of the financial services sector to our economy and to the public finances. As an aside, you referred to 7% of GDP, and I should say that we have seen higher figures, but you are a Conservative. Are you modelling the impact on those figures of various Brexit scenarios, and how much can you tell us about your findings in that work?

Simon Kirby: There will be an awful lot of figures. Figures come out on a regular basis and there will be movement or adjustment ahead. It is about choosing figures that are appropriate to current planning and the future renegotiations. We are listening carefully and we are looking at a whole range of different figures.

Lord De Mauley: Are you modelling the impact of different outcomes for Brexit?
Simon Kirby: It is not an easy thing to do, but we are looking carefully at a whole range of different scenarios based on the changing environment that we will be moving through.

Lord De Mauley: Will you be making public the results of those sorts of deliberations?

Simon Kirby: I do not think we will. The Prime Minister has been very clear that we will not provide a running commentary on the negotiations. To get the very best possible deal, we cannot show our cards face up on the table. I understand this causes some uncertainty, but to get the very best possible deal the Government have to get on with it. Even if I was in possession of all the facts and could share all of them with you today, it would put us in a weaker negotiating position.

Lord De Mauley: You refer to uncertainty. How concerned are you about the effects of that uncertainty on financial stability?

Lowri Khan: Obviously it is too soon to know what the ultimate outcome of the negotiations will be. As regards our concerns about financial stability, the important thing is clearly that the transition is achieved in an orderly way and that we have continuity of services to the real economy, and so that firms can adapt to the new relationship that we have with the EU.

Perhaps I could point you to some of the comments that have been made by the FPC—the Financial Policy Committee of the Bank of England—which has been assessing some of the broader risks to stability now. The work the Bank has done at international level, and to improve the resilience of the financial system domestically, puts us in a very good place. We have much stronger banks. They are being stress-tested to a high degree by the Bank of England as well, so the UK is very resilient in that space. When you spoke to Sir Jon Cunliffe a few days ago, he pointed out some of the steps that they have taken. We are obviously vigilant to the financial stability risks, but we are prepared and we have contingencies, as ever, that are in place.

Simon Kirby: It is also important to say that we are in a strong position because we made the difficult decisions back in 2010. The deficit has been reduced by two-thirds. Had that not been the case, we might be in a worse place. We are in a strong position to get a good deal because of those difficult decisions.

Lord Woolmer of Leeds: Lord De Mauley asked whether or not you were undertaking estimates or calculations of the effect of different possible outcomes. I am not asking you at the moment to say what those estimates might be, but surely you need those estimates to inform a negotiating position; otherwise you would be saying, “It does not matter what it costs; whatever the outcome, we will accept it”. It might be a bad deal. Do you have any view as to how major an impact a deal might have that would make a deal not a good deal? You keep talking about getting the best, but surely you need some estimate, otherwise you do not know the cost of one settlement as opposed to another settlement. When are you going to come to a view about the costs of different negotiating arguments?
Simon Kirby: That is a very good question. I will ask Katharine to give you some data, although I will come back afterwards.

Katharine Braddick: I am conscious that there have been several questions about the Treasury’s analytical work, so I will try to describe that. We are doing very detailed analysis, sector by sector, of the impacts of different scenarios for the financial services sector—the impacts in relation to revenue, employment and tax receipts. We are engaging very closely with the industry to try to inform that. It is quite a complicated thing to do because the fiscal framework uses a different taxonomy from the ones firms themselves use in running their business. That is separate again from the regulatory structure of passports. Connecting particular business functions with specific passports and then Exchequer receipts and jobs is quite challenging.

There has been some cross-industry work that we are using as well. That work will inform, among other things, our input for the DExEU process. We have been working closely, and at least from my perspective very collaboratively and effectively, with DExEU officials to respond to their commissions for this kind of analysis. That analysis will inform the Cabinet Committee process. It is already quite a complicated analytical task but we are undertaking it and we will meet all the deadlines.

The more difficult piece as regards quantification is what are sometimes described as the ecosystem effects, or the network effects of having a concentration of financial services in the UK. That has defied quantitative analysis for a very long time. The industry can explain how it works, but we find it difficult to translate that into what the impact scenarios would look like. That is more difficult, and I do not think it is a nut we can crack analytically for these purposes and in this timescale. For the rest of it, we are doing that analysis and it absolutely informs the Cabinet Committee’s work.

Lord Skidelsky: What confidence do you place in the forecasts of the effects of different scenarios? I am using the word “confidence” in perhaps a more technical sense. Are these exercises reliable in any way? These sorts of things have had rather low reliability in the past. I am thinking of a number of them.

Simon Kirby: I will make a general observation, and then Katharine might be able to give some detail. The problem if you are seeking a bespoke solution—we are not talking about hard Brexit or soft Brexit but a bespoke solution that gives us the best possible deal—is that by its very nature it is very difficult to try to predict what the effect will be, because it is a moving target. I think Katharine would probably agree with me.

Katharine Braddick: That is absolutely right. There are two challenges in relation to confidence ranges. One is exactly as the Minister said. If we are having a bespoke arrangement, it is quite hard to model. The other is that firms themselves are in a dynamic environment in terms of their profit and business models. They already have plans for location and structure. Distinguishing effects to do with altering our relationship with Europe from planning that firms were doing in any case is quite difficult, both in real time and to forecast. The studies that I have seen vary. Some
are more thoroughgoing than others. Oliver Wyman published some work a couple of weeks ago.

**The Chairman:** Yes, the Committee has had sight of that.

**Katharine Braddick:** It is quite developed and draws on their proprietary data as well as publicly available data. That is one of the most developed analyses I have seen, but they themselves have been quite clear about the limitations of the methodology.

**Lord Skidelsky:** It depends on the assumptions.

**Katharine Braddick:** Always.

**Simon Kirby:** One of the misconceptions—although I am sure not here—is that financial services are all in the City of London. Although I am the City Minister, I am also very conscious that JP Morgan employs 4,000 people in Bournemouth, for instance, and another 1,400 in Glasgow. I have a list here. Bank of America employs 3,500 people in Chester. In my constituency of Brighton Kemptown, we have the American Express European headquarters. There is Deutsche Bank in Birmingham and CitiGroup in Belfast. Sometimes when we look at analysis about the UK, it is easy to look at it from just a London perspective. It is really important to realise that people up and down the country, across the breadth of the UK, benefit from having that strong sector.

**The Chairman:** That is very much on our minds.

**Lord Desai:** We have had conflicting evidence about what will happen to clearing houses. Have you analysed what would happen if the clearing houses relocate? Is that technically feasible?

**Simon Kirby:** There is a lot of noise about clearing. The whole of Europe, the UK included, would be worse off if that particular part of the financial services that London offers was dismantled and redistributed across Europe.

**Lord Desai:** Do you know how much worse off?

**Simon Kirby:** There are lots of different possibilities. Some people would have you believe that it would not go to Europe at all and that it would end up in New York, which would be a very bad place for all of us, not only in the UK but for everyone in Europe. You can talk about elements of the negotiations, and you can try to prioritise, pick out or rank things in order. I do not think we are there yet in preparing for the negotiations. It is, if you will excuse the expression, clearly something that a number of people in part of financial services have expressed an opinion about. It is an element of the negotiations. Is it the most important element? Probably not, but it is a significant consideration. It is currently too early to say, but as things develop and when we are in a stronger place and have listened, and understood exactly what we are seeking, it will become more apparent how important that particular element is. It is not a red herring. It is clearly an important element, but it is not everything.

**Lord Desai:** One thing we are told is that the EU27 need us more as regards financial services. Do you have any estimate of how much business we do with them?
**Simon Kirby:** I think we do, do we not? It is remarkable, because it is easy to think it is a one-way street. It is very much a two-way street and we have some statistics.

**Katharine Braddick:** We have some somewhat scattered statistics, but it is clear that banks based in the UK lend very material quantities into the real economy in European member states. It is also clear that the asset management industry in the UK manages very significant proportions of the funds of investors who are based in the EU. The London market in specialist and commercial insurance is the European hub for that kind of insurance. The kind of infrastructure you were just talking about—CCPs in particular, because they offer the benefit of concentrating the way trading works between a number of currencies—offers a very cost-efficient and low-friction way for capital to move and trades to occur in Europe.

There are other ways financial services deliver for Europe. We are trying to collate the most robust data we can to evidence that. It is easier in some areas than in others, but it is very clear that there are benefits to do with both the relatively low-cost access to a wide range of services and the positive reinforcement of having a concentration of expertise and intellectual capital in one hub, which improves the quality of products and services offered over the EU.

**Simon Kirby:** It is also fair to say that, with the time zone and language, there are many softer things that the UK and London have to offer. It is easy to forget that. We are where we are for a very good reason.

**Lord Haskins:** As our inquiry has gone on, it has become apparent that our negotiating position on financial services is probably stronger than was originally thought. That is fine, but I am interested in the non-financial services—the manufacturing side. Again, the Treasury has to come into this. The danger is that on financial services you are really only negotiating with Frankfurt, Paris and maybe Dublin a bit; you mentioned New York, but not seriously. In the motor car industry, you are negotiating with 27 different countries. It would concern me if we did not use our strength in financial services, because of what we contribute, to make sure that we minimise our weaknesses in the negotiation for something like the car industry.

**Simon Kirby:** That is a very sensible suggestion, and I am sure it is somewhere near where we will end up. It is interesting to note that other parts of Europe are inextricably affected by the whole financial stability argument. Some of the banks in Italy are weak. Greece is obviously Greece. There are places across Europe that perhaps do not have an immediate benefit from London and the UK, but are very focused on our not having financial instability because it would be absolutely the last thing they would want.

**Lowri Khan:** On Lord Haskins's point, there is quite a lot of interdependency between some of the industrial sectors and the financial sector. To take motor manufacturing as an example, the German motor manufacturers have very large finance companies attached to them, so these issues will inevitably come together. Industry does not segment itself neatly into the buckets that policy necessarily does.
Simon Kirby: It is fair to say, with particular reference to the German motor manufacturers, that nearly all their leasing and finance arrangements are UK-based; it is quite a surprise, but they are. The whole thing is complex and multidimensional. People want to try to simplify it and say it is one thing or the other, but it is never going to be a binary choice. It is going to be a complicated set of negotiations that achieves the best possible deal. We will all have to wait and see what that deal ultimately looks like.

Lord Butler of Brockwell: We have had uneven evidence on passporting arrangements. Some witnesses emphasised the number of firms that have passporting arrangements and how important those are. Others said that they attach less importance to it. Has the Treasury made an assessment of which sectors of the financial services industry are most dependent on passporting?

Simon Kirby: Passporting is a very interesting thing. You can look at the numbers of passports, both for us to operate in Europe or for firms in Europe to operate here, but some of those passports are redundant or unused and the numbers do not demonstrate any kind of volume. There might be a whole load of them—I am sure there is a whole load of them—where there is not a lot of activity at all. Actually getting to a position where we can realistically assess the impact is not quite as straightforward as you might first think, even in banking. You would think banks were all concerned about passporting, but there is a very different opinion, for example, in the challenger banks and the big banks. If you speak to some of the American investment banks, obviously access to the 27 countries is important to them. If you talk to the insurance industry, there is a spectrum of opinion. It is something that is very important to some and less important to others. For a lot of domestic-facing financial services companies, it is not at all important. That is not to say that we will not seek to get the best possible deal on it. I do not think we rule anything in or anything out. Where we are currently is understanding and getting the most accurate information to make the best possible decisions.

Lord Butler of Brockwell: You have talked about banking and insurance. Is there anything you would like to say about other sectors of the financial services industry?

Katharine Braddick: I will say a bit about asset management. The bringing together of investment banking with asset management is the core of the concentration of activity we have in the UK. Particularly in the context of your question about passporting, because asset management has a structure whereby you can locate a fund in one jurisdiction and manage it in another under current European legislation, there are many asset managers who, with some administrative overhead, which in some cases could be considerable, can structure in a way that does not disrupt their current business model very much. The absence of a passport, for example, for UCITS funds, which are the retail funds, may not be as material for some as it initially appears. Certainly between those two big concentrations of, on the one hand, investors and, on the other hand, trading capability, it seems that it is in the investment banking sector
where the ability directly to access European clients currently achieved through the passport is most relevant.

Q63 **Lord Butler of Brockwell:** What weight do you put on maintaining equivalence? Again, we have been told that equivalence is an unreliable thing, because of course it is discretionary and can be removed, and regulations change. Would you tell us how important you regard achieving equivalence?

**Simon Kirby:** As the Prime Minister said, the UK is leaving the EU but it is not turning its back on Europe. Clearly, international finance regulation is something that the UK has taken, and will wish to take, a leading role in developing. I spoke earlier about the importance of the 27 EU member states appreciating that there is considerable value to them in maintaining open access between our financial markets. It is something that we have listened to carefully. I have met a number of people who thought it might be a possible solution, but today I do not think we are ruling anything in or ruling anything out. What we want to do is get the best possible deal, and included in that best possible deal is access for our businesses, our jobs and our tax take across Europe. We will have to wait and see how we do the detail of that.

**Earl of Lindsay:** Would that best possible deal, in terms of having some sort of equivalency, include third country equivalence as it is currently designed and defined within the EU?

**Katharine Braddick:** We have heard from the industry very similar things to those that this Committee has heard from the industry. Opinions vary. It is clear that equivalence is not the same as passporting. Specifically, it is not the same as passporting because it does not provide the same scope, so there are not third country regimes for all the activities for which firms use the passport; and the process is different. Indeed, the process for deciding equivalence differs from one piece of legislation to the next. Part of the analysis we need to do is to understand the impact of that difference both in scope and operability as regards the legal effect—what it makes it legally possible to do—and what is commercially viable and reliable. That is an analysis we are doing in combination with the other analysis I attempted to describe: where the acute impacts are and where access is material for the sector and for the UK economy.

**Earl of Lindsay:** Most of our witnesses have expressed some reservations about their understanding of how third country equivalence would work for the UK financial services, should we adopt the current pattern and definition. One of our witnesses referred to super-equivalence. Might that be closer to what you have just described, in that it is a more bespoke and tailored arrangement that varies according to which type of market one is seeking equivalence within?

**Katharine Braddick:** One of the challenges that we have in assessing the value of equivalence is that most of the equivalence regimes in existing legislation are pretty new. They postdate the financial crisis and a lot of them have not yet been used. One of the most important areas of equivalence, if we were to go down that road, would be in MiFID II,
because that determines the regime for so much export activity in cross-border business by investment banks.

That is a Commission decision. The parameters for that decision are not terribly clear; they are quite open. The way the Commission can make the decision is open to interpretation. There are no time limits for how long the Commission has to take to make a decision. Then there is a further process where, if it wants to give equivalence, it has to go through a committee of member states, and then the European Securities and Markets Authority has to grant each individual firm from that jurisdiction. They do not approve them but they have to register them. That registration can be withdrawn and the equivalence can be withdrawn.

A lot of elements of that process are so far untested. That is why some firms are concerned about its reliability, whereas others see that the UK is currently regulating and supervising an enormous portion of this market in the EU under EU legislation, and therefore logically in substance cannot not be equivalent. It is judging how that would work both at the point at which the UK withdraws and as a steady state for doing business. It is not that those are imponderable questions, but they are quite hard to judge. That is the process problem. Then we come back to the question of whether the scope is sufficient for what the industry needs to do.

**Earl of Lindsay:** I will follow up with a further question. Equivalence really rests on judgment on regulation, supervision and enforcement. In recent years, the United Kingdom has tended to lead in developing fit-for-purpose, and very often innovative, new arrangements in order to keep pace with the financial services sector. We have led both within Europe and possibly internationally very often. Post-Brexit, how do you see the United Kingdom continuing to be influential and at the forefront of modern fit-for-purpose regulation, supervision and enforcement?

**Simon Kirby:** It is very difficult today to commit or even comment necessarily on individual elements of what the post-Brexit world will look like. It is clearly in our strong interest to have an input. If we are to be a global financial centre with a very strong reputation for financial regulation, we would want that to continue and it is an important part of the way forward. I cannot comment today on quite how that is achieved and quite what priority we might give to that, but we are listening carefully. Katharine has alluded to a variety of different opinions on the subject. We will endeavour to maintain our position and get the best possible deal we can. That is where we are.

**Katharine Braddick:** Lowri has insight into this through work on resolution. On my side of the house, I think the UK’s ability to influence is not solely determined by its membership of the European Union. We have massive intellectual capital through the regulation and supervision of some of the most complex markets in the world. That has given us a lot of influence in international fora.

The regulators in the UK have very effective bilateral relationships with their counterparts in some of the key jurisdictions in the US, in a number of Asian jurisdictions and elsewhere. Those are the means by which we influence, and by which we learn and engage sufficiently to influence
these standards. The Chancellor has been clear that there will be no stepping back from that international standard-setting process.

**Lowri Khan:** I very much share that assessment. We engage intensively with the Bank of England and the FCA in particular and the UK authorities engage very actively in the international standard setters—the Basel Committee and the Financial Stability Board, et cetera—where we are members. There is no sense at all that we will need to step back from that. We are still very engaged. We have a huge asset in the form of some very intellectually strong contributions that the UK is able to make in those fora. I very much agree with your assessment that we have led a lot of the agenda on the post-crisis reforms. I do not see that that should stop just because we are not in the EU. The quality of our relationships and the intellectual leadership will continue. You heard from Jon Cunliffe. He was very clear that the Bank would be redoubling its efforts in this sphere. That is the way to go.

**Q64 Lord Skidelsky:** One effect of Brexit has already been felt. That is the depreciation of sterling by 16% or 17% since the vote. Of course, I know that it is notoriously difficult to forecast what the value of sterling will be in a year or two years, but taking its present value and assuming that that will not change very much in the course of the negotiations, what effect do you expect it to have on the export of financial services? What effect do you think it might have on our negotiating position? On the second question, I think that, although it might give us additional strength in negotiation because of the greater penetration of export services that it will enable in Europe, it might invite retaliation. These are all things that must be in someone’s mind. I just wonder what the Treasury’s assessment of that will be.

**Lowri Khan:** It is somewhat beyond my brief, but obviously there have been some fairly substantial movements in the currency markets. We do not have a target for the exchange rate. We have the Bank of England with its inflation target, but we do not target the exchange rate. That is set by the market.

As far as the influence on the financial sector is concerned, clearly there will be a whole range of transmission channels from different levels of the exchange rate through to the financial sector and the way it operates. From my perspective I am clear that the financial sector is very robust. We have had stress tests that have stressed it to a far greater degree than some of the exchange rate movements we have seen recently.

I am less clear about the commercial impacts. That is an interesting question.

**Simon Kirby:** I do not think it is necessarily appropriate for me to comment on the level of the exchange rate. The road ahead will have ups and downs. Markets move up and markets move down. I do not necessarily agree with your assumption that we will end up with a similar exchange rate in two years’ time, or indeed in two weeks’ time. Who knows? That is what markets do.

It might be useful to say that, in my meetings with a large number of financial services people, I hear a mixed view on exchange rates. Whatever the exchange rate, it has an impact on some people positively
and an impact on other people negatively. It is not something that we seek to influence from a government perspective. We fully expect markets to see a movement as we proceed down the road.

**Lord Skidelsky:** I am not saying that the Government in any way seek to influence the exchange rate, but there are consequences of different levels of exchange rate on financial services, on the economy in general and on negotiation. One thing people do not like the prospect of is any kind of currency war. That might make all these analytics redundant in a way. It seems to me a key point.

**Simon Kirby:** That is a fair point, but it is only one of the dimensions in the multidimensional problem or opportunity that we face. The underlying economy of the UK is strong. We made the difficult decisions over the past six years. Financial services in particular are held in high regard around the world. Whatever the exchange rate, it is in Europe’s interest to get the best possible deal as well. I have reiterated that two or three times. We are not in this alone. It is not us turning our back on Europe. We are just leaving the EU, and we should be confident, optimistic and positive about the opportunities that presents.

**The Chairman:** Minister, can I interject on timing? Would you be able to give us a few minutes beyond 12 o’clock?

**Simon Kirby:** Sadly, and it is quite a good excuse, I have a UQ in the Commons.

**The Chairman:** We literally have a few minutes. In that case, I turn to Lord Haskins and I will then come in with a final question.

**Lord Haskins:** What we have been getting all the time are the concerns that everybody has about uncertainty. David Davis said it will take two and a half years to complete the project, and Article 50 suggests that. During that period decisions will have to be made. Currency has been mentioned as one degree of uncertainty. There is uncertainty about trade negotiations and where they are going to be over that period. It must be a concern to the Treasury to have to satisfy those who are uncertain. Certain of the uncertainties are unavoidable. You cannot clear up the complexity of financial services overnight. On one hand, people do not want uncertainty, but on the other hand we need a robust system going forward. After two and a half years there will still be a period of transition, particularly on trade negotiation. We have been told that trade negotiation could take between five and 10 years. How will the Government attack the issue of uncertainty?

**Simon Kirby:** I would say that there are two things. The first is that we have listened very carefully to people who are concerned about transitional arrangements. Some people are more concerned than others. It is important that we make sure that there is as smooth a journey ahead as possible and as little disruption as we can manage. Secondly, I am a businessman and business is all about managing uncertainty. We would all like to know exactly what the future will bring, but businesses make money by analysing the risks, preparing contingency plans and making the best possible decision for their shareholders or owners. I do not think in any environment you can ever remove uncertainty.
Lord Haskins: But this is uncertainty with a big capital U.

Simon Kirby: The Government have a task and a responsibility to make the future as certain and as successful as possible. It is in our interests and in the interests of businesses that employ people to do so. We are looking for a smooth and trouble-free exit that gets the best possible deal.

Q65 The Chairman: Thank you, Minister. My eyes are on the clock. You said that you have not ruled anything out and you have not ruled anything in. You said that several times in the course of the last hour. Have you ruled out access to the single market as an option? A yes/no answer would be fine.

Simon Kirby: We are definitely leaving the EU, but we do not rule anything in and we do not rule anything out.

The Chairman: Thank you very much indeed. This concludes today’s public evidence session. The Committee will now continue its meeting in private. Minister, Ms Braddick and Ms Khan, thank you very much for coming in. We have found your evidence session very fruitful. We have some supplementary questions and we will put them to you in writing.

Simon Kirby: Thank you very much indeed.
Thank you for providing me with supplementary questions to the evidence session that I and my officials attended on 19 October 2016. It was a pleasure to attend the evidence session and to answer the Sub-Committee’s questions and I am grateful for the follow up questions, which I am very pleased to respond to.

Please find answers to each question set out below. An amended version of the transcript of 19 October is also attached.

1) What analysis have you made of the ability of the financial services industry to recruit and retain suitably qualified staff following Brexit? Are you considering mitigating action, and, if so, what?

- We are clear that we fully expect the legal rights of EU nationals already in the UK to be properly protected. They make a huge contribution to our country, including in the financial services industry. But we need to win the same rights for British nationals living in European countries.

- We’re confident we’ll be able to reach an agreement protecting the rights of EU nationals here and our citizens in Europe, and securing such an agreement will be a priority for the Prime Minister in our EU negotiations.

- We have been clear that one of our priorities in the negotiation is to get control on the numbers of people who come here from Europe but that the UK will continue to welcome the best and brightest talent from around the world. As the Chancellor has said “We need to reassure the financial services sector but also others, such as the tech sector, that in fact, if they look at our track record of how we manage migration from outside the EEA, we already have a regime that readily facilitates people coming from outside Europe to work in financial services businesses and other people with high skills coming to work in the UK. That is not where the problem lies and that should not be where the concern of business is.”

2) Are there any factors that affect the financial services industry in Scotland or other parts of the UK differently from London?

- Financial services are an important part of regional economies across the UK. We recognise the importance of the breadth and depth of the sector in Scotland. The Prime Minister has been clear that the Government will negotiate the best deal for the UK as a whole and we are working closely with the devolved administrations to do that. We are also engaging with businesses across the UK to understand their needs and requirements.

3) What options are you considering to reduce uncertainty for businesses during the negotiations? Have you reached any conclusions on transitional arrangements?

- Inevitably, there will be a period of uncertainty throughout this process and as negotiations with the EU evolve. Many businesses have suggested some
kind of transitional period as mitigation for this, in order that businesses have time to adjust to the outcome of these negotiations. The government will continue to assess different options to mitigate this uncertainty, but will not be providing a running commentary on the negotiations.

- We will push for a solution that does not disrupt how financial services are delivered, drive up costs or act as a drag on the world economy. We want to make sure the UK financial sector remains robust, highly competitive and open for business. And there is clearly a shared interest - not just with our EU neighbours, but globally - in avoiding any risks to financial stability; we will continue to act in a manner which underpins financial stability and does not challenge it.

4) What consultation has the Treasury undertaken on the possible impact of Brexit on financial services?

- Treasury Ministers and officials have meetings with a wide variety of organisations in the public and private sectors as part of the process of policy development and delivery.

- Details of ministerial and permanent secretary meetings with external organisations on departmental business are published on a quarterly basis and are available at:


I trust that this will be useful in the Sub-Committee’s deliberations and would be very happy to provide further evidence as required.

9 November 2016
Zopa, Abundance Investment and Innovate Finance – Oral evidence (QQ75-80)

Transcript can be found under Abundance Investment, Innovate Finance – Oral evidence (QQ75-80)