Government response to the House of Lords European Union Committee Report, 'Brexit: The Future of Financial Regulation and Supervision'

Introduction

The House of Lords European Union Committee published its Report, '*Brexit: The Future of Financial Regulation and Supervision*', on 27 January 2018. This document sets out the Government response to the conclusions and recommendations in that report.

The Government welcomes the Financial Affairs Sub-Committee's important work on this vital area of UK economic policy. We find their report to be a helpful contribution to the wider ongoing debate on financial services and the UK's withdrawal from the EU. The Government is keen to engage with as diverse of a group of stakeholders on the issue of the UK's withdrawal from the EU and we are thankful to the wide array of individuals who have provided written and oral evidence to the committee in preparation for the publishing of this report.

The financial services sector is of significant importance to the economy of the UK, employing 1.1 million people (source: TheCityUK). Total tax contributions in 2017 were £72.1 billion for the year to 31 March 2017 - 11% of Government receipts (source: The City of London Corporation). The UK is home to the world's preeminent global financial centre, as well as the location of a world-class professional services sector, and a global tech cluster. The UK's position as a world leading financial centre has been cemented in part because of flexible and smart regulation and supervision that has tread the careful line between allowing businesses to flourish and protecting consumers and financial stability.

An integral part of maintaining the competitiveness of the UK's financial centre into the future will be ensuring the UK's withdrawal from the EU is smooth and the withdrawal deal works for the sector. The Government is seeking an ambitious economic partnership with the EU on financial services. This will give UK firms access to the EU market, and EU investors access to the UK market. In part, this includes securing an implementation period that will enable firms to only make one set of changes and avoids any cliff-edge risks. The Government has also been clear that there will be no regulatory race for the bottom following our withdrawal from the EU.

The Government recognises the recommendations made in the report as, by and large, sensible and broadly in line with action already being taken by HMG. However, the final shape of the UK's future financial regulatory and supervisory framework is, to some degree, dependent on the outcome of negotiations with the EU. The sub-Committee will understand that in some of these areas the nature of ongoing negotiations means that the Government cannot respond fully to the detail of the recommendations.

The recommendations fall under the following six categories:

1. **The origins of regulation and supervision**. The committee should be assured that the UK will continue to be a global leader on regulatory standards, promoting open global markets and high international regulatory standards. This will not change as we withdraw from the EU.

2. **Incorporating the EU *acquis* in financial services**. Action is already being taken on this through the EU Withdrawal Bill, as the report notes. This will ensure our statute book is ready to function as intended following our withdrawal from the EU.

3. **Possibilities for a transition period**. The UK has made clear its ambition to promptly agree an implementation period. The draft UK and EU legal texts on the period demonstrate the broad alignment between the UK and EU positions, with only a small number of areas requiring discussion. This reflects the desire of both parties to provide certainty as swiftly as possible to individuals and businesses in the UK and across the EU about the arrangements that will apply from the point of the UK's withdrawal.

4. **Alignment and market access.** The exact structure of market access remains a matter for negotiation. The committee should be assured that the Government's priority is to secure market access for financial services as part of an economic partnership with the EU.

5. **Supervisory co-operation**. The Government welcomes the report's clear-sighted recommendations on supervisory co-operation, and will integrate these into its on-going work on the issues mentioned in the report.

6. **Regulatory innovation, FinTech and the future**. The Government is committed to strengthening the UK's already world-leading positions in the markets of the future, whether in FinTech, green and sustainable finance, or rupee and renminbi products.

The individual recommendations are addressed in turn, below.

Recommendations and Responses

1. <u>The origins of regulation and supervision</u>

Senior leadership at the regulators

1. **Recommendation: UK regulators have been highly influential at both technical and political levels within the international standards-setting bodies. The backbone of this engagement is personnel: without the right people in place, the UK will not be able to exercise the same clout. It is important that the UK's financial services industry is reassured that regulators are adequately resourced and supported. The Government should, furthermore, take decisions about key leadership positions as early as practicable.**

Response: The Government believes that it is important that UK regulators continue to be influential within international standards-setting bodies. The Government will therefore take decisions on key leadership positions as early as practicable following fair and impartial recruitment processes. These processes will be underpinned by the principles set out in the Cabinet Office's Governance Code on Public Appointments[1]. These principles include merit, openness, diversity and fairness. The Government's public appointments process is designed to ensure that the best people, from the widest possible pool of candidates, are appointed.

The legislative framework provides for the financial regulators to be operationally independent from Government. The regulators are funded via levies on financial services firms, which are set by the regulators to cover their funding requirements each year following consultation. The Government is confident that the regulators are adequately resourced to carry out their work effectively and independently.

International regulatory fora

2. **Recommendation: The UK's domestic regime for the regulation of financial services is largely, and increasingly, shaped by the context of international standards and EU law. The UK has been highly influential in shaping the form of supranational regulation, both at the international and EU levels. The UK has also shown leadership in areas of regulation in which it is not constrained by international standards, such as conduct and FinTech; these measures have subsequently served as models for other countries to follow. While leaving the EU may provide opportunities for the UK to tailor its regulation to domestic needs, such opportunities will be necessarily constrained by the UK's continued participation in international fora.**

Response: The Government agrees that the UK has shown leadership in international bodies and some, such as the International Monetary Fund (IMF), have commended the UK's post crisis work, and recognised our leading role in the global regulatory reform agenda. Continued engagement in international fora – such as the Financial Stability Board (FSB), which coordinates standard setters and national authorities – is vital to

[1] https://www.gov.uk/government/publications/governance-code-for-public-appointments

ensure that international standards are effective in supporting financial stability and, at the same time, are suitable to the UK's domestic needs. It is important that the regulatory framework keeps pace with a changing financial system, and in this regard where changes to international standards are required, the UK will continue to use its leading international role and expertise.

In addition to complying with international standards, the Government has already introduced domestic reforms to support financial stability. For example, the ring-fencing regime requires the UK's largest banks to separate their retail and investment banking from 1 January 2019. This will insulate core UK retail services from global financial shocks; and will make banking groups easier to resolve in the event that part of the bank fails. In addition, the UK is pushing ahead domestically on the implementation of the leverage ratio two years ahead of the date set by Basel III, and has pushed for amendments in the European legislation to bring the European leverage ratio to the standard of that in the UK - specifically the exclusion of central bank reserves from the leverage ratio exposure measure.

Continued commitment to international standards

3. **Recommendation: It is imperative that the UK continues to devote sufficient resources to engagement with international standards-setters. The Government should continue, as a minimum, to adhere to international standards, and to work vigorously to shape them in future, especially if there is a risk of them being undermined by other states. It is crucial that such standards remain the base of the UK's domestic regime, and that the UK acts to ensure that they are properly implemented worldwide.**

Response: The Government is committed to the full, timely and consistent implementation of agreed international standards. The UK has continued to push this message in fora such as the G20, recognising the need to avoid rolling back on reforms that could lead to a race to the bottom.

The UK is an active member of several international standard setters, including the International Monetary Fund, Financial Stability Board, Bank for International Settlements, Basel Committee on Banking Supervision, International Organisation of Securities Commissions and the International Association of Insurance Supervisors. The Government believes that continued participation in these organisations is essential to ensure the consistent adoption of international regulatory standards, as common adherence to international standards supports open and resilient markets, ensures a level playing field and reduced opportunities for regulatory arbitrage.

New opportunities for international regulatory influence

4. **Recommendation: The Government should also seek to develop new international relationships, to fortify the extant engagement taking place within formal standards-setting bodies and more broadly. This may include considering ways in which further cooperation can be sought within a bilateral context, including setting up joint fora to monitor regulatory developments. Embedding a network of global cooperation via these means could help to synchronise standards within and beyond the EU.**

Response: While standard setters, such as the Financial Stability Board play a key role in enhancing cooperation and synchronising standards, the Government recognises the value of developing international relationships outside of these fora. Because of this, the Government has continued to develop Economic & Financial Dialogues with China, India and Brazil as a means of strengthening the UK's economic relationships with increasingly important emerging markets. These have deepened cooperation across aspects of our trade, investment and economic policy relationships.

Regulations and financial stability

5. **Recommendation: Post-crisis changes have served to promote financial stability and the Government should continue to advocate these reforms. This is especially the case if faced with initiatives by the EU that in fact lead to market fragmentation and a reversal of the post-crisis commitments—such as is the case with current proposals that would potentially require CCPs to relocate within the EU.**

Response: The Government agrees with this assessment. The post-crisis changes – including the agreement amongst G20 leaders in 2009 to reform derivatives markets, the introduction of international regulatory principles for market infrastructures ("the Principles for Market Infrastructures") and, in the EU, the implementation of the European Market Infrastructure Regulation (EMIR) – have played a key role in making global derivatives markets more transparent and resilient since the global financial crisis. We are deeply concerned with current proposals by the Commission that would reverse the globalisation of CCPs in favour of a regional approach, causing market fragmentation. The fragmentation of global derivatives markets would undermine international efforts to improve the resilience of financial markets and significantly increase the cost of clearing.

2. <u>Incorporating the EU *acquis* in financial services</u>

Third country agreements and firms

6. **Recommendation: A crucial element of the EU (Withdrawal) Bill process will lie in the resolution of 'inoperables': references to, for example, EU bodies that will no longer have jurisdiction after Brexit. Translating the *acquis* will also require dealing with the agreements the EU has with third countries. These cover areas such as equivalence rulings with non-EU members (for example the agreement with the US under EMIR, which allows EU clearing members to use US CCPs). The UK will need to decide how to incorporate these agreements. UK regulators have also begun to make statements regarding their proposed treatment of EU businesses within the UK. The clarity that these decisions will ultimately provide is very much to be welcomed. However, insofar as there is a risk to UK financial stability in granting access to third country firms, a new domestic permissions regime must be carefully managed.**

Response: The announcements by UK authorities in December 2017 regarding the treatment of EEA businesses operating here demonstrate the Government's commitment to the UK remaining a global financial services centre that is open for business, while maintaining a leading role in strengthening regulatory and supervisory standards. The City's success is based on being the most open and dynamic financial centre in the world operating within a robust regulatory framework that prioritises financial stability. Ensuring EEA financial firms continue to operate here will help maintain this status, protect jobs and preserve tax revenues. Such firms can be assured that the Government is prepared to act, if necessary, to ensure that they can continue to meet their obligations to UK consumers under a range of scenarios.

Future regulatory architecture

7. **Recommendation: The Government will need to adopt a nuanced approach towards the translation of EU regulation into domestic law. In future, some rules will need to be enshrined in statute, which could be effected using powers contained in the European Union (Withdrawal) Bill. However, it may be more appropriate, where it is important that rules be flexible and dynamic, or where they concern more technical areas, for regulators to issue guidance and set standards. The Government should develop an appropriate architecture for the future domestic regulation of financial services.**

Joint response with recommendation 8, see below.

Accountability of UK regulators

8. **Recommendation: Any future regulatory regime will probably result in a significant increase in the powers of domestic regulators to determine rules and provide non-statutory, but binding, guidance. It is vital that Brexit, in transferring powers to domestic regulators, should not result in an unintended deficit in democratic scrutiny and accountability.**

Response: The Government agrees that the 'onshoring' of EU financial services regulation must deliver a UK regulatory framework that is fully functional and flexible enough to respond to changing conditions. It must also ensure accountability to Parliament for those key areas of law that establish the regulatory framework and set policy direction. The Government proposes to achieve this by onshoring EU legislation in a way consistent with the UK's existing regulatory framework. The cornerstone of that framework is the Financial Services and Markets Act (FSMA), which establishes the objectives, functions and responsibilities of UK financial regulators – namely the Prudential Regulation Authority and the Financial Conduct Authority. FSMA then delegates responsibility to the regulators for making the detailed technical rules that need to apply to firms in order to implement the policy direction which Parliament has set.

Following this approach would mean that 'Level 1' legislation and 'Level 2' Delegated Acts, which have been proposed by the Commission and negotiated through the European Council and European Parliament, would become the responsibility of UK ministers and the UK Parliament. This level of EU legislation sets the policy direction for financial services so it is right that responsibility for it should rest with ministers and Parliament.

For 'Level 2' technical rules, known as Binding Technical Standards (BTS), the Government proposes to transfer responsibility from EU regulators (the European Supervisory Authorities) to UK regulators – including the Bank or England, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). These standards do not set policy direction but fill out the technical detail of how firms need to meet the requirements set at 'Level 1'. This responsibility would be consistent with the rule-making responsibility already delegated to UK regulators by Parliament under FSMA. It would also provide the necessary flexibility to ensure these technical rules can be updated to respond to changing conditions.

Scrutiny of new UK regulation

9. **Recommendation: The EU's multi-layered approach to financial regulation is underpinned by detailed and resource-intensive scrutiny by the European Parliament. Assuming that domestic regulators will gain powers as a result of Brexit, the Westminster Parliament will need to increase commensurately the resources available to support a similar level of scrutiny. This is particularly the case with regard to the regulation of financial services, where powers transferred from the EU to UK regulators will require ongoing specialist scrutiny if the UK is to replicate the level of oversight that the European Parliament has to date provided.**

Response: The Government notes that Parliament may wish to consider its future approach to scrutiny of financial services regulation.

Parliamentary oversight of regulation

10. **Recommendation: We note that this issue concerns both Houses; we also note the forthcoming review of the Committee structure of the House of Lords, which is being**

conducted by the House of Lords Liaison Committee. In light of these factors, we do not seek to make specific recommendations on future parliamentary scrutiny. It is clear, however, that financial services will require increased scrutiny and resources in relation to domestic, EU and international level regulatory standards, and that the burden will necessarily fall upon Parliament. We look forward to the House of Lords Liaison Committee addressing this issue in the course of its review.

Response: The Government notes that Parliament may wish to consider its future approach to scrutiny of financial services regulation.

3. <u>Possibilities for a transition period</u>

Structure of implementation period

11. **Recommendation: Transition should in the first instance provide a standstill extension of the current conditions of market access: this appears to be envisaged by both the Commission and the Government. To be useful, however, any period of transition needs to form part of a three-stage process. First, a standstill period, allowing time for the two sides to agree the terms of their future relationship; then, once that relationship (the ultimate destination) is known, a period of adaptation; and, finally, the seamless commencement of trade under the terms of the new relationship. Absent all these elements of transition, financial services firms will be forced to activate their worst-case scenario contingency plans, with stark implications for the continued provision of services and for financial stability.**

Response: Our immediate goal is to agree an implementation period that will help us to build a bridge from where we are to where we want to be in the future. That is why the Government has proposed a time-limited arrangement based on the existing structure of EU rules and regulations. Article 50 makes clear that the Withdrawal Agreement needs to take account of the future relationship so we will know the terms of our new partnership with the EU by the time of our exit.

Urgency of implementation period

12. **Recommendation: We welcome the announcement by the European Council that the first priority for negotiations in 2018 will be agreement on transition. Such an agreement needs to be announced soon for it to prevent the enactment of the financial services industry's contingency plans, with the disruption and uncertainty that would cause for counterparties in both the UK and the EU-27.**

Response: The Government recognises the importance of reaching early agreement on the implementation period, in order to provide certainty to businesses about the arrangements that will apply post-exit. The guidelines and negotiating directives, agreed by the EU27, point to the shared desire of the EU and the UK to make rapid progress. The Withdrawal Agreement and Implementation Bill is expected to cover the contents of the Withdrawal Agreement, including the details of an implementation period agreed between both sides, and will apply from the day of exit.

Nature of the agreement on the implementation period

13. **Recommendation: We note the views of those in the financial services sector who seek a legally binding transition agreement in Q1 2018. Whether or not this is feasible, any such agreement will need to be at least politically binding if it is to provide reassurance to firms that there will be no cliff-edge in 2019. Due to the central position of the UK's financial services sector within the EU's financial services industry, and the number of EU-27 clients that rely on accessing this market, it is in the interests of both the UK and the EU that such an agreement is in place, in order to prevent large-scale risks to financial stability.**

Response: Joint response with recommendation 12. See above.

Contractual Continuity

14. **Recommendation: It will be essential, either alongside or as part of a transition agreement, to provide clarity on issues of contractual continuity. Insurance contracts will need to be 'grandfathered'—treated according to current terms—for their duration. It may be possible for other contractual issues, such as the servicing of derivatives contracts, to be provided for within the time-limited confines of a transition period, but such a period cannot be expected to solve all issues. It is imperative therefore that continuity of contracts is treated and resolved comprehensively.**

Response: There is a shared interest for both the UK and the EU in ensuring that we avoid outcomes that impose unnecessary costs and disruption on individuals and businesses as the UK leaves the EU. The Government and the European Commission both recognise that our exit has the potential to impact the continuity of service provision. This is why we are focussed on agreeing a deep and special future partnership with the EU and, crucially, an implementation period.

Furthermore, HM Treasury announced on 20 December 2017 that the Government will legislate, if necessary, to ensure that contractual obligations of EEA firms contracting with UK customers, such as those found in insurance contracts, can continue to be met. This would apply to in-bound firms only - it is in both our interests to ensure reciprocal arrangements are in place.

4. <u>Alignment and market access</u>

EU treatment of third countries

15. **Recommendation: The EU's equivalence regime is patchy in composition, and too politically insecure for firms to feel confident in making use of its provisions. It would not allow the highly-integrated web of financial services within the EU to persist in anything like its current form. Equivalence provisions are currently undergoing a review; depending on how equivalence is in future interpreted, there is a serious risk that it may leave the UK a rule-taker. And if the UK is no longer able to influence the composition of EU laws, these rules could increasingly become unsuited to the UK financial services sector, which is the largest provider of such services in the EU.**

Response: The sub-Committee's assessment concurs with other published analysis and the drawbacks of existing equivalence regimes are well understood. The Government is clear that the unique context of the UK-EU relationship requires a tailored solution and is committed to constructing a future relationship with the EU based on reciprocal market access and cooperation.

Achieving market access

16. **Recommendation: There are various legal means by which to facilitate mutual access. Equivalence, as currently framed under EU law, would not be sufficient, but could, with political will, potentially provide a basis for negotiating a more comprehensive agreement in the form of an 'enhanced equivalence' regime. A free trade agreement, or a separate bilateral agreement on mutual market access, would achieve a similar result.**

Response: The Government recognises that there are a number of ways to achieve EU market access for the financial services sector. As the Chancellor set out on 7 March, we are seeking a partnership with the EU in financial services as part of a wide-ranging economic partnership that enables the ongoing delivery of cross-border financial services in both directions, while protecting financial stability.

Phase 2 of negotiations

17. **Recommendation: An agreement granting secure, symmetric access would be to the mutual economic advantage of both the UK and the EU, but significant political hurdles remain. The Government, in approaching the next phase of negotiations with the EU, must work to foster the goodwill and understanding necessary to achieve this goal.**

Response: The Government is committed to approaching our negotiations with the European Union in a pragmatic, principled manner, recognising their principles and our shared interests. We have made good progress so far.

Current EU equivalence framework

18. **Recommendation: We conclude that the current equivalence regime would fail to provide the level of market access for financial services that both sides require, and that**

it would inhibit the UK from developing an appropriate regulatory framework. The Government should not settle for an agreement based on equivalence without securing substantial changes to that regime.

Response: The sub-Committee's conclusions concur with other published analyses on the drawbacks of the existing equivalence regimes. As the Chancellor stated in his speech on 7 March, the Government is clear that the unique context of the UK-EU relationship, including our regulatory alignment on exit, deep regulatory and supervisory cooperation, and market integration, means that our future partnership requires a tailored solution, which is more comprehensive and interactive approach than existing precedents.

Negotiating an FTA

19. **Recommendation: There are various possibilities for a future agreement covering financial services. These include a free trade agreement to include services, a standalone mutual recognition regime, and possibly some form of so-called 'enhanced equivalence'. We do not come to a view on which of these would be preferable, although all would be more satisfactory than equivalence. However, it has to be acknowledged that free trade agreements take time, sometimes years, to agree, and there is no precedent for an agreement on the scale that the Government seeks.**

Response: The EU and UK start from the point of complete regulatory convergence and have deeply integrated markets. We are, therefore, confident of our ability to negotiate an ambitious agreement within the time available.

Dispute resolution mechanism

20. **Recommendation: Whichever option is pursued, it will be vital to put in place a robust dispute resolution mechanism, which is as yet undetermined. This may require new institutions to arbitrate such matters, or involve existing courts. The Government should make clear which arrangements it favours, given its well-publicised red line on the jurisdiction of the Court of Justice of the European Union.**

Response: The Government published a Future Partnership Paper on enforcement and dispute resolution, setting out the UK's position on enforcement and reviewing examples of mechanisms for resolving disputes in international agreements. It is of mutual interest that the rights and obligations agreed between us can be relied upon and enforced and that disputes arising can be resolved efficiently and effectively. As set out in that paper, the four principles that will guide our negotiations on this area are to maximise certainty, ensure rights can be effectively enforced in a timely way, that the autonomy of EU law and UK legal systems is respected and that international obligations continue to be respected.

Mutual benefits of a deal

21. **Recommendation: We recognise that the EU, or individual Member States, may be politically motivated to reject a bespoke agreement regarding future access. However, such an agreement would be in the overriding economic interest of all sides. Without it,**

EU counterparties stand to lose the substantial benefits that come from being able to draw on the services offered by the UK. The EU has in the past shown ambition and imagination in seeking to include financial services in the TTIP free trade negotiations. We urge all sides to show similar imagination in negotiating the future UK-EU partnership.

Response: The Government is in complete agreement with this recommendation. A fragmentation of the EU's financial centre brought on by the exclusion of financial services from any economic partnership with the EU would lead to an increase in costs to businesses and consumers across the EU27. It would also have implications for financial stability. As the Chancellor made clear in his speech on 7 March, we agree that it is in all our mutual interests to reach an agreement.

5. Supervisory cooperation

Proposed EMIR revisions

22. **Recommendation: The Commission's proposed revisions to EMIR contain both good and bad elements. Giving ESMA additional powers of oversight will help reassure financial market participants, especially to the extent that this will involve cooperation with the NCAs. However, proposals to demand the relocation of systemic CCPs within the euro-zone will not achieve the Commission's objectives of bolstering financial stability. They will instead increase costs to market participants, particularly those inside the EU-27; cause fragmentation, by reversing G20 measures taken to contain risk within CCPs; and result in the loss of clearing business for both the UK and EU- 27, as clearing members move their positions to New York. The Government should resist these measures by whatever means possible.**

Response: We support the Commission's intention of ensuring the supervisory framework for CCPs is sufficiently robust. CCPs play a core role in safeguarding derivatives markets and are systemically important for the markets they clear. The regulatory and supervisory framework needs to reflect this. However, there is no size, nor complexity beyond which CCPs give rise to exposures so great that the resulting risks cannot be managed through strong regulatory standards and supervisory cooperation. EU27 activity in UK CCPs is small relative to non-EU activity – only accounting for 14% of global interest rate activity in LCH SwapClear (Source: London Stock Exchange Group). An EU location policy would therefore be very unlikely to result in the complete relocation of the UK clearing industry to the EU. Instead, it would effectively deny EU firms access to global derivatives markets, increase the cost of clearing and undermine efforts to strengthen financial stability. We agree that if clearing activity does move, it is most likely to go to the US leaving both the UK and EU27 worse off.

Third country supervisory cooperation

23. **Recommendation: The existence of supervisory colleges, and the relationships between third country NCAs and ESMA, could serve as a template for future supervision of financial market infrastructures. To the extent that such supervisory cooperation promotes financial stability, as would be the case with the proposals to revise EMIR, it may also obviate the need to relocate those infrastructures within the EU. Further measures to enhance such cooperation within the European legislative structure should therefore be encouraged, although proposals to centralise authority in ESMA will need to be carefully scrutinised.**

Response: The Government agrees with the recommendation to pursue close cooperation with the EU and also that proposals to centralise authority in ESMA will need to be carefully scrutinised. Supervisory cooperation is the most effective approach for ensuring that jurisdictions remain alert and resilient to cross-border risks – this will not change as a result of the UK leaving the EU. The UK has always been supportive of the supervisory college structure under EMIR which facilitates discussions and information exchange between EU supervisory authorities. Consistent with the importance that we attach to supervisory cooperation, the UK is also the only jurisdiction that has also established global colleges for UK CCPs, which aim to foster further international cooperation and information sharing.

Continued EU-UK supervisory co-operation

24. **Recommendation: The evidence we heard consistently highlighted the strength and depth of existing supervisory cooperation and the extent of the EU's reliance on the UK's contribution. While the UK's technical expertise is an asset for the EU, the Government should not treat this as a guarantee that the UK will be able to continue to contribute to the decision-making process. We therefore urge the Government to seek to secure continued participation for UK regulators at all levels of the supervisory architecture post-Brexit, to be imaginative in developing new forms of cooperation, and to continue to invest in international and bilateral relationships.**

Response: The Government agrees that there is currently a high degree of supervisory cooperation between the UK and EU, and that UK supervisors provide a significant technical contribution to the EU's regulatory knowledge and rulemaking process. As we leave the EU, the Government would like to see this cooperative and productive relationship being maintained.

Under the framework proposed by the Chancellor on 7 March, the EU and UK would establish comprehensive supervisory cooperation arrangements including extensive information exchange and potentially, supervisory colleges. Special arrangements would be considered for clearing houses. These supervisory arrangements would not involve either side transferring any responsibility for its rules or ceding any sovereignty. However, this remains dependent on the outcome of the negotiations.

In addition, the Government agrees that it is important for us to continue to invest in international and bilateral relationships.

6. Regulatory innovation: FinTech and the future

Solvency II

25. **Recommendation: While there might be reason to change some aspects of Solvency II, the benefits of flexibility will in all cases need to be balanced against the possible consequences of regulatory divergence. The key issue raised in evidence to this inquiry was the risk margin. The Government and regulators should consider whether Solvency II requirements need to be updated in order to reflect the specificities of the UK insurance market, within the bounds of whatever agreement is reached with the EU on future market access.**

Response: The Government supports Solvency II. However, we recognise that the UK insurance industry is concerned about the impact of some aspects, particularly the Risk Margin. The PRA is examining options for reform of the Risk Margin within the boundaries of Solvency II, and has promised to report its findings to the Treasury Select Committee by the end of March 2018.

Scope for regulatory amendment

26. **Recommendation: Basel rules were meant to apply to large cross-border institutions, and requiring smaller firms to comply with them may be unduly burdensome. Post-Brexit, it would be desirable for regulators to have the ability to apply any regulatory framework in a proportionate manner, where they judge this to be in the interests of consumers and the broader industry. The Government should consult on this once the terms of the UK's access to the EU are agreed.**

Response: The Government supports the implementation of international standards and the proportionate application of prudential rules. The Financial Services and Markets Act (2000) requires the regulators to take into account the eight principles of good regulation. One of these principles is proportionality: the principle that any burden or restriction that the regulators impose on a person, firm or activity is proportionate to the benefits they expect as a result. The Government welcomes the proportionate application of Basel rules by the Prudential Regulation Authority.

FinTech regulation

27. **Recommendation: The UK is a world-leader in the field of FinTech. One reason for this is its pioneering approach to regulation of the sector, and the regulators should be commended on initiatives such as the FCA's 'sandbox' and the Bank of England's 'accelerator', which capitalise upon their substantial expertise. Moves by the EU to legislate in this field should be resisted by the Government if they threaten the UK's flexible and adaptive approach.**

Response: The Government welcomes the recognition of the importance of regulation supporting innovation in financial services, including through fintech. The Government is keen to encourage proportionate regulation, ensuring we maintain a flexible and adaptive approach.

FinTech and access to capital

28. **Recommendation: We also urge the Government to support the sector's access to capital, given the potential loss of funds from the European Investment Bank. The Government should in particular strengthen the resources of the British Business Bank, not merely to replace the levels of funding offered by the EIB, but to increase UK firms' access to venture capital overall.**

Response: It may be mutually beneficial for the UK to maintain a relationship with the European Investment Bank and the European Investment Fund. As we move to the second phase of negotiations we will look to explore these options with the EU. Alongside our discussions, to ensure that investment finance continues to be available in the UK after EU exit, the British Business Bank has raised the limits on the amount it can invest in venture capital funds from 33% up to 50%. The British Business Bank has also brought forward some of the £400m additional investment that was announced at the Autumn Statement.

To strengthen UK firms' access to the long-term 'patient' finance that they need to scale up, the Chancellor announced at Budget a 10-year action plan to unlock over £20bn to finance growth in innovative firms. This will include establishing a new £2.5 billion Investment Fund incubated in the British Business Bank with the intention to float or sell once it has established a sufficient track record, and investing in a series of private sector fund of funds of scale. The British Business Bank will seed the first wave of investment in this series with up to £500m. Allocation of resources across programmes would be reconfigured if the UK does not retain a mutually beneficial relationship with the European Investment Fund.

Access to talent

29. **Recommendation: The FinTech industry is reliant on access to skilled labour, as is the wider financial services sector. We call on the Government to consult with the sector in developing its post-Brexit immigration and visa policies, to ensure that the UK's financial services sector, and FinTech in particular, can attract the best global talent.**

Response: The Government is aware of the importance of international talent, which currently plays an active role in supporting the UK's fintech sector. The Economic Secretary held a roundtable with fintech firms in July 2017, to discuss how to maximise opportunities for the sector - including access to talent. We are also working with industry to understand the sector's needs around talent, supported by hard data. We look forward to working with the findings of the Migration Advisory Committee's call for evidence on the economic and social impacts of the UK's exit from the European Union.

Competitiveness objective for UK regulators

30. **Recommendation: As the intensity of international competition facing the UK post-Brexit increases, it may become clear that regulators are unduly constrained by their current objectives. We recommend that the Government consider and consult on the**

desirability of adding a duty to promote international competitiveness to these objectives. Any change should be accompanied by strengthened Parliamentary scrutiny, given the potential trade-offs inherent in adding such an objective to the remits of the Bank of England and the FCA.

Response: The current objectives of the regulators reflect the Government's priorities for the financial services sector. Following the financial crisis, the Government introduced necessary changes – crucial to improve professional standards and culture across the sector – to restore public trust in financial services. The Financial Stability Board has commended the UK for its successful transition to a new regulatory structure and supervisory approach; and the International Monetary Fund has commented that the new financial regulatory architecture is helping the UK to build a more resilient financial system.

The Government is fully committed to securing the long-term competitiveness of our world leading financial services sector. The Financial Services and Markets Act (2000) requires the regulators to have regard to the regulatory principles of sustainable growth and proportionality. This requirement ensures that the regulators consider the impact of its rules on financial services firms. In addition, 'Competitiveness' was listed as an aspect of Government economic policy to which the regulators should have regard in Remit Letters issued by the Chancellor at Spring Budget 2017. The Government therefore does not believe that the regulators require a competitiveness objective.

Future trade opportunities for UK financial services sector

31. **Recommendation: Whether or not the Government decides to add to the UK regulators' remit, it is important that we engage with all of the pieces of the international regulatory jigsaw. Global competition and global regulatory standards-setting will become yet more crucial after the UK leaves the EU, and the Government should fight to ensure that the international regime for financial services continues to thrive. The Government must not squander the opportunity to enable UK financial services to become more outward-facing and access new markets, and should ensure that the regulators are appropriately equipped to oversee firms operating across borders**.

Response: The UK will remain a leader in the development of high regulatory standards, notably through our presence in international standard-setting bodies. The Government is furthermore committed to strengthening the UK's already world-leading positions in the markets of the future, whether in FinTech, green and sustainable finance, or rupee and renminbi products. The Financial Services Trade and Investment Board enables the Government to maintain an open and constructive dialogue with the financial services sector. Finally, the UK holds annual Economic and Financial Dialogues (EFDs) with key emerging markets, such as China, India, and Brazil.

UK regulators are well-equipped to maintain strong relationships with their overseas counterparts in order to oversee firms operating across borders. Our approach to the onshoring of EU legislation will facilitate cooperation arrangements with overseas regulators.