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Rt Hon Andrew Tyrie MP
Chairman of the Treasury Committee
House of Commons
London SW1H 9NB

13 January 2017

Dear Andrew

During my appearance at the Committee on 8 November 2016 you requested a written response on two issues. First, some information on what value of UK financial services could be lost if access to the European Union (EU) market were available only on the basis of global standards, and second, some further detail on transitional arrangements which might be established following the UK's withdrawal from the EU.

I am also aware that on 12 December 2016 the Treasury Committee issued a call for evidence on transitional arrangements. This letter answers the questions contained within the call for evidence where we believe it appropriate for the FCA to comment. We do not answer questions where others – such as firms – are better placed to respond, for example with regard to pre-emptive actions that may be taken by the private sector.

Current Global Financial Regulatory Standards

There are a number of global standard-setting bodies in the area of financial services. The EU often seeks to implement such standards via legislation that applies across the single market.

The scope and membership of standard setters varies, but they include regulatory authorities of G20 jurisdictions, and sometimes many others, who work together with the aim of both developing and implementing regulatory standards and principles. The standards themselves are not legally binding in the way that a treaty is legally binding under public international law. Rather they provide a broad, common framework across specific global markets. For example, the FCA is a member of the International Organization of Securities Commissions (IOSCO). This is the international body that develops, implements and promotes adherence to robust global standards in securities regulation, with the objectives of protecting investors, ensuring that markets are fair, efficient and transparent, and reducing systemic risk. IOSCO itself works closely with the Financial Stability Board (FSB) on regulatory reform. Here G20 commitments provide an additional impetus to member jurisdictions to implement agreements. The FCA is directly represented at the FSB, and other bodies including the International Association of Insurance Supervisors.

In terms of the relationship with EU legislation, certain initiatives following the financial crisis have been informed by global standards and follow the broad direction of travel set by global bodies. However, the legislation that provides the specific legal underpinning for integrated EU financial services markets has become much more granular, technical and detailed in its provisions. It would however be possible to take a different approach and to base market access on higher level standards which are transparent and subject to regular review. I will expand on this in the section that follows.

The table below shows – briefly – the main pieces of EU financial services legislation that are linked to a greater or lesser extent to principles set by global bodies, or in some cases influenced by those principles.

EU legislation	**Global standards or principles linked to or influencing legislation**
Markets in Financial Instruments Directive (MiFID II)	G20 commitment for trading of standardised over-the-counter (OTC) derivatives on exchanges or electronic trading platforms where appropriate; IOSCO Principles for regulation; IOSCO Principles for the regulation and supervision of commodity derivatives; IOSCO Principles for Direct Electronic Access to markets
Market Abuse Regulation (MAR)	IOSCO Principles for the regulation and supervision of commodity derivatives
European Market Infrastructure Regulation (EMIR)	G20 commitments for trade reporting of all OTC derivatives to trade repositories, central clearing of standardised OTC derivatives through central counterparties and margining of non-centrally cleared derivatives; Committee on Payments and Market Infrastructures (CPMI)/IOSCO Principles for Financial Market Infrastructures; Basel Committee on Banking Supervision (BCBS)/IOSCO margin requirements for non-centrally cleared derivatives
Central Securities Depositories Regulation (CSDR)	CPMI/IOSCO Principles for Financial Market Infrastructures
Proposed Securitisation Regulation	BCBS-IOSCO criteria for simple, transparent and comparable securitisations
Prospectus Directive	IOSCO International disclosure standards for cross-border and initial listings by foreign issuers
Regulation of Money Market Funds (MMF)	IOSCO Policy Recommendations for Money Market Funds
Credit Rating Agencies (CRA) Regulation and Directive	G20, FSB and IOSCO Strengthening CRA governance and reliance on ratings

Benchmarks Regulation	IOSCO Principles for financial benchmarks
Capital Requirements Regulation and Directive (CRD4)	The BCBS's Basel III accord. However the scope is for 'internationally active banks' at the global level. In the EU this is extended to capture all deposit takers and investment firms, including those investment firms prudentially regulated by the FCA.
Third and fourth anti-money laundering directives (3MLD and 4MLD) and the Wire Transfer Regulation (WTR).	Financial Action Task Force (FATF) Recommendations – International anti-money laundering and combatting financing of terrorism and proliferation
International Accounting Standards Regulation	International Accounting Standards Board (IASB).[1]

The Role of Global Standards

A primary aim of global standards is to promote regulatory outcomes that are consistent across jurisdictions, thereby avoiding so-called 'regulatory arbitrage' – the risk that firms might seek to locate their business in a jurisdiction where the regulatory regime is perceived to be less onerous. They also seek to ensure minimum standards to enhance financial stability and provide for a framework for cooperation among supervisors.[2]

By helping to promote international consistency and hence reducing the risks of regulatory arbitrage, global standards can support trade in financial services between jurisdictions. However, global standards, as currently conceived, are not designed *per se* to be a tool to facilitate market access, unlike trade agreements. Therefore they are not currently regarded as providing an alternative either to the financial services passport within the EU single market or to third country access provisions as provided in certain EU directives such as MiFID II. I described these mechanisms in my previous letter to you of 28 October 2016.

Standards developed by global bodies are the product of consensus-building across a range of diverse members. Such standards have to be designed to apply across a broad range of legal and regulatory regimes and therefore they have tended to be high level in nature. We believe that more work could be done to promote effective standards in areas of capital markets and conduct of business policy at the international level.

A more comprehensive body of global standards, which could provide a regulatory basis to facilitate market access, is conceivable could be beneficial in promoting open trade in financial services. This is an aspirational goal, the realisation of which would require a strong degree of international consensus and cooperation.

[1] Note that the United States adopts its own accounting standard.
[2] See for example paragraph 34 of the Basel III Capital Accords on the level playing field point, IOSCO objectives of "building sound global capital markets and a robust global regulatory framework", or the FSB Charter.

Absent a change of approach, it would not provide a solution to the shorter-term challenges around the UK's withdrawal from the EU. Global prudential standards established via the Basel Committee, for example, have enjoyed a strong degree of support and consistent implementation. Other examples are discussed in the table above. There is no reason *prima facie* to assume that a similarly comprehensive set of standards could not be established in other areas of financial regulation if there is a collective desire to do so.

In terms of how more effective global regulatory standards might be beneficial, it may be helpful to provide an example. Currently, where a firm seeks to enter an overseas market to undertake regulated financial services activity, it will likely be required to attain authorisation from the relevant regulatory authority in that market. The information that the firm is obliged to give to the regulator as part of its application varies from jurisdiction to jurisdiction. One important piece of evidence that the regulator may consider is whether, and to what extent, the firm's domestic authorities adhere rigorously to global financial regulatory standards. This may help facilitate the firm's authorisation application. Under the UK's authorisation regime, for example, where a third country firm is making an application the Financial Services and Markets Act (FSMA) allows the FCA and/or PRA to have regard to the supervision of that firm's overseas regulator in taking account of the regulator's opinion. Currently, while being subject to a jurisdiction which adheres to global standards may be a factor influencing authorisation, it is highly unlikely to be a sufficient condition.

If the body of global standards were to become more comprehensive, it might provide a broader basis on which authorisation decisions could be made. This would of course need to be supported by consideration of how such standards would be implemented and then supervised. This could help to make the authorisation process more efficient, potentially reducing barriers to entry and promoting a more competitive market. At the extreme, a system of mutual recognition could be established. Bilateral mutual recognition between securities regulators has some precedents but is far from commonplace. For example, the United States Securities and Exchange Commission (SEC) and the Australian Securities and Investments Commission (ASIC) signed a mutual recognition agreement in 2008 which provides a framework for US and eligible Australian stock exchanges and broker-dealers to operate in both jurisdictions, without – under certain circumstances – the need for separate regulation in each country.[3] To be clear, however, such a scenario could only be realised where regulators had sufficient assurance in the effectiveness of each other's regimes.

Finally, we do not have a measure of the value of financial services that may be impacted in the event that passporting arrangements were no longer applicable to UK financial firms after the UK's withdrawal from the EU. However, to draw on the content of my previous letter to the Committee of 28 October 2016, I reiterate that global standards and trade agreements do not, at least currently, provide for the recognition of authorisations in the way that the single market directives do.

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[3] For more information please see http://asic.gov.au/about-asic/media-centre/find-a-media-release/2008-releases/08-193-sec-australian-authorities-sign-mutual-recognition-agreement/

Transitional arrangements

This leads me on to your second question in relation to possible transitional (or more accurately "implementation") arrangements following the UK's withdrawal from the EU. As you are aware, any agreement on the framework for the future relationship between the UK and EU following withdrawal is a matter for the Government and Parliament, on the one hand, and the EU institutions, on the other, in accordance with Article 50 of the Treaty on European Union. The Committee asks in its call for evidence whether transitional arrangements are compatible with the Government's intention to leave the EU. I believe that they are indeed compatible with leaving the EU, and, furthermore, would likely help to support a smooth withdrawal process.

Our statutory objectives require us to seek to mitigate risks to consumer protection, market integrity and competition in the interests of consumers. We therefore view the risks around UK withdrawal from the EU in the context of those objectives. Hence, we believe a smooth transition will be important to avoid material risks to each of those objectives from arising by providing for an implementation period. My teams are working carefully to assess the likelihood and impact of such risks arising and possible measures to mitigate them. This work is continuing; however I can offer some preliminary thoughts. As you would expect, the FCA will continue to work closely with the Government throughout this period.

Transitional Arrangements in Financial Regulation or Free Trade Agreements

Given the variety of possible meanings that could be attached to the phrase transitional arrangements, it may be helpful to start by providing some context, considering their use in other international agreements.

The function and purpose of transitional arrangements varies depending on the particular situation in which they are used; generally within a financial services regulation context they provide a bridging period of time between agreement on any new rules and their required implementation by market participants. They are put in place in order to help mitigate execution and operational risks attached to a substantive change in the regulatory framework. They give market participants a clear view of their future rights and obligations and allow a set period of time to prepare for a smooth transition by, for example, making changes to internal processes, IT systems and staffing where necessary. Taking IT system changes as an example, we encourage firms to devote sufficient time and resources to building robust IT systems, and there can be significant risks associated with implementing changes too fast, including for consumers.

In general, in the context of EU financial services regulation, transitional provisions are often written into individual, specific pieces of legislation and serve to provide exactly this type of bridging period. The transitional arrangements are agreed at the end of the process of making the legislation, in order that the constituent elements of the new rules are understood and a judgement can be made about the length of time required to prepare for the implementation of the rules. The length of the period depends on the significance of the changes. During this time firms may not need to comply with all the new rules as set out in the legislation (though some may apply immediately), but they should prepare for their implementation. Sometimes transitional provisions provide a glide path of gradually increasing requirements, for example the increased capital requirements under CRDIV.

Within EU financial services legislation this time period ranges from six months to eight years. However, some time periods have been significantly longer, notably Solvency II which includes certain provisions allowing firms up to 10 years to adapt to the composition of capital requirements set out in the Directive, and up to 16 years to transition to a market consistent regime on the valuation of technical provisions.

There are other types of transitional arrangements beyond those in EU legislation. For example, in the domestic regulatory framework, the Financial Services (Banking Reform) Act 2013 set out requirements for structural reform of the UK's banking sector. Firms are required to implement the reforms by 1 January 2019. The six year period between the finalisation of the Act and the implementation deadline is to allow for the complex restructuring of legal entities required by the banks within the scope of the legislation. Looking more broadly than financial services, and indeed beyond the EU, global trade deals tend also to provide for transitional arrangements. For example, the recent Association of South East Asian Nations (ASEAN)-Australia-New Zealand Free Trade Agreement (FTA) was signed in 2009, and was implemented by all participating countries three years later.

So, whilst transitional arrangements can vary in their nature, they tend all to follow a similar principle of providing a bridging period to enable those impacted by new rules to implement the necessary changes, thereby reducing execution risks and, in turn, risks to consumers. The transitional arrangements themselves are typically established as part of the overall final policy agreement.

Transitional arrangements in the context of EU withdrawal

The UK's withdrawal from the EU is, of course, different from the implementation of new legislation or trade agreements. Article 50 foresees a period of two years (subject to possible changes as described in the text of the Article) for negotiations towards withdrawal arrangements. Article 50 notes that the negotiations on withdrawal should take account of the framework of the future relationship between the EU and the UK.

The Government's proposed EU Withdrawal Bill notwithstanding, to the extent that the future regulatory arrangement for trade in financial services between the EU and UK is not clear by the end of the two year Article 50 negotiation period, transitional arrangements may be required to provide a degree of regulatory continuity and certainty until the future framework is established.

The nature of the transitional arrangements will be determined in part by the degree to which the future framework is likely to differ from the status quo. Clearly, transitional arrangements should facilitate, rather than hinder, the eventual establishment of the future framework, if that is to be the ultimate aim of both parties in the negotiation.

The degree of preparation and change that firms may need to undertake will depend on the degree to which the regulatory framework following the UK's withdrawal from the EU differs from the existing arrangements. For example, if certain firms believe it will be necessary for them to provide products and/or services from a legal entity based within the single market, the firm is likely to require authorisations from the regulator in the chosen jurisdiction. It may also need to switch its contractual relationships with certain clients to that legal entity.

The extent to which such considerations apply will vary between different firms, within and across different sectors.

Risks arising from a 'cliff-edge' exit scenario

There are multiple issues or risks inherent in transitioning out of the UK's existing regime, which become particularly acute in a 'cliff-edge' scenario, whereby the regulatory framework for UK financial services changes immediately and substantially on the day of EU withdrawal and there are no transitional arrangements in place.

From an FCA perspective, the most critical risks relate to market integrity and consumer protection, but there are also competition risks, and wider legal, operational and general market stability risks to consider. I provide three examples below. It is worth noting, also, that to the extent that markets are cross-border, these risks may well affect regulators in other jurisdictions to a greater or lesser degree.

The first example to consider relates to passporting. The figures cited in my letter to you of 17 August 2016 show that as at July 2016, there are over 8,000 firms passporting into the UK from other EEA countries under various single market directives. These firms are authorised by their home state regulator, and, through the passport, are able to do business in or into the UK by virtue of that authorisation. The single market in financial services essentially relies on the mutual recognition of authorisations between regulators and mutual confidence in each other's supervisory oversight based on harmonised rules. Following the UK's withdrawal from the EU, and if such passporting rights and single market protocols no longer apply, there is a risk that those firms may continue to do business in the UK – perhaps inadvertently – without having the appropriate regulatory permissions in place. Similarly, funds domiciled in another jurisdiction may lose the ability to be marketed to UK investors. Where contracts provide for the performance of certain services over a period of time, it may not be easy or even possible to 'cease' business activities without incurring the risk of legal action for failure to deliver on such obligations. Indeed, if the loss of passporting is only confirmed late in the negotiations, then we could see a situation in which the FCA has insufficient time to process new applications for those firms who wish to continue doing regulated business or offering certain products here and require a UK authorisation to do so. This may carry with it market integrity, competition and consumer protection concerns.

In this scenario, transitional arrangements may be useful to ensure that existing EEA firms doing business in or into the UK have the appropriate permissions to continue operating in the UK. This might mean providing a suitable time period for firms and regulators to process new authorisation applications. Based on average statistics for the time taken to process new authorisation applications from July to September 2016, new retail authorisations took on average 23.1 weeks and new wholesale authorisations took on average 21 weeks.[4] The time taken generally depends upon the complexity and completeness of the application. Indeed, we would expect that, in the transition to a new set of arrangements, the necessary time period could be significantly longer.

[4] See https://www.fca.org.uk/publication/corporate/key-performance-indicators-september-2016.pdf

My letter of 17 August 2016 also contained figures on UK-authorised, outward passporting firms that may similarly be affected by a loss of passporting in such a scenario. Just as I have described above with regard to inward passporting firms, these outward passporting firms may need to seek an authorisation from an EEA Member State regulator in order to continue doing branch or services business on a cross-border basis. For example, with regard to payment services, around half of all payment services firms in the EU operate out of the UK, with approximately 25% of all non-bank payment service providers authorised in the UK holding passports to operate cross-border. These firms may need to seek an authorisation from an EEA Member State regulator prior to the UK's withdrawal from the EU in order to continuing doing business in EEA jurisdictions. Lead in times of 12-18 months have been quoted as necessary to achieve this.

Similarly, within the asset management sector, UK asset management firms bring in a significant portion of their revenue by providing portfolio management services to funds domiciled outside the UK or segregated mandates for EEA (excluding UK) clients. This business relies on a combination of passports and delegation arrangements under MiFID, UCITS and AIFMD. The nature of these arrangements and the ability for UK firms to continue this business would be impacted by a change in the relationship between the UK and the EU. A sample of UK asset managers the FCA recently polled showed that on average one third of their most recent year's revenue came from such business.

The second, linked example of a significant risk also relates to a sudden loss of passporting rights, and the implication for cross-border contracts. In the area of insurance products, for example, some providers currently use passporting provisions to service their contracts – that is to say, to process claims. After the UK's withdrawal from the EU, it could become more difficult for providers to service contracts entered into before withdrawal in the absence of the EU passport. This is an issue for EU providers to UK consumers and depending on whether and how those services are regulated in the particular EU State, this could also be an issue for UK providers to EU consumers. For some types of insurance product the length of the contracts can be significant, for example investment-based life insurance. Without suitable transitional provisions, there may be considerable uncertainty created for firms and consumers as to what the loss of passporting means in practice. We cannot rule out related risks at this stage so my teams are continuing work to map and consider potential mitigations to these risks.

The third example of such a scenario relates to the operational ability of the regulators to perform their duties. In my letter of 28 October 2016, I highlighted five principles which, we believe, should underpin an optimal outcome for financial services in terms of any future regulatory framework. The third of those principles is cooperation between regulatory authorities. The current single market directives and other EU measures as well as FSMA[5] provide legal obligations for EU national regulators to cooperate and exchange information for regulatory purposes. These provisions enable a broad range of supervisory cooperation activities and also help to underpin passporting, whereby EU Member States agree for firms authorised in other Member States to have access to their domestic markets on the basis that NCAs are obliged, amongst other things, to share important firm-specific regulatory information without the need for additional agreements on exchanging and handling confidential information.

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[5] E.g. section 354A FSMA requires that the FCA must take such steps as it considers appropriate to co-operate with other persons who have functions similar to those of the FCA.

In such scenarios the FCA may, then, face operational risks in terms of the availability of important supervisory information on firms doing business in the UK. The information could, for example, relate to instances of cross-border market abuse – a real threat to our objectives – where the timely exchange of information is critical to resolve issues. As this information exchange is mutual, other EU regulators may also face risks around an information gap.

More generally speaking, and linked to the above point on cooperation and information exchange, any lack of certainty with regard to the regulatory framework may affect the ability of the FCA, and perhaps other regulators, to take enforcement action as a means of both addressing and deterring misconduct. Cooperation between regulators relies upon a clear framework which sets expectations as to what is required of whom, when, and to what end. Without that clarity it may become difficult to properly discharge our regulatory functions.

Mitigation of 'cliff-edge' risks through transitional arrangements

None of the above risks are beyond mitigation, but the types of solutions required may be complex. Most of the options above cannot, generally, be achieved by the FCA acting alone but require action by the Government and, in some cases, reciprocal cooperation from other governments and European national regulators. Considering these risks in the round, however, and aiming to avoid – to the extent possible – a 'cliff-edge' scenario, what follow are some initial thoughts on broad objectives for any transitional arrangements. The primary motivation is to ensure continuity in the delivery of the FCA's statutory objectives of promoting competition in the interests of consumers, protecting and enhancing market integrity, and protecting consumers across all relevant financial markets.

- First, transitional arrangements should offer legal certainty to firms and consumers, and adequate time to prepare for implementation. Market participants need to understand their rights and obligations and have appropriate time to prepare for any changes from the current framework.

- Second, the FCA itself will need to retain an effective and clear rule book following EU withdrawal. As such, arrangements should be underpinned by a degree of regulatory continuity.

- Third, arrangements should be attuned to and based upon a clear understanding of potential risks to our objectives arising post-withdrawal, and offer mitigation against them. Some examples of the sorts of risks we currently foresee are set out above.

- Fourth, transitional arrangements should allow for continued and effective working relationships between UK authorities and European bodies, including the EU institutions, the European Supervisory Authorities (ESAs), and other European national regulators.

Clearly, sufficient time for adoption of any transitional arrangements will be important for both public authorities and firms. Indeed we recognise that risks related to EU withdrawal are not unique to the financial sector; in some cases, 'horizontal' solutions may be required, such as in relation to data protection. The FCA, of course, continues to work closely with other UK regulators and with the Government to consider risks arising around EU withdrawal and solutions or mitigating strategies.

I hope this will assist the Committee in its work, and we will of course be happy to follow up on any points where that would be useful. In view of the substantial content of the letter which is not contained in any other FCA publication, I am copying it to the Chancellor of the Exchequer, the Governor of the Bank of England, the Secretary of State for Exiting the European Union and the Cabinet Secretary.

Yours Sincerely

Andrew

Andrew Bailey
Chief Executive