



# The future shape of UK financial services regulation

**Rule-taker or rule-maker?**

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# Executive summary

What will UK financial services regulation look like after the post-Brexit transition period? Will the UK be a rule-taker or a rule-maker?

The answers may be influenced to some extent by the outcome of the EU-UK trade negotiations. This might leave considerable scope for the UK regulatory regime to diverge from EU financial services legislation; or an agreement might be reached that, in some areas, constrains the degree to which the UK regulatory regime can diverge from EU legislation for the foreseeable future.

Other factors will also be at play over the short, medium and long-term.

The UK's role in global capital markets has been built largely on its relationship with the US, the US dollar and other reserve currency markets. For 20 years or more there has been agreement with other international financial centres on joint regulation and oversight of market infrastructure, and the use of English law, which is likely to continue. This has led, in turn, to the UK being the second largest asset management centre, after the US. About £9 trillion of assets are papered and managed in the UK under English law contracts, about 40% of which are for non-UK clients.

The UK has often led the way within Europe on the regulatory response to conduct and financial stability issues, such as the fair treatment of retail consumers, individual accountability, payment for investment research, reform of interest rate benchmarks and, more recently, operational resilience.

The wider regulatory landscape continues to evolve. Brexit is influencing the EU legislative and supervisory dynamic. At the global level there is a combination of reviews of the post-crisis regulatory reforms that have already been implemented; unfinished business as other parts of the regulatory reform agenda near completion or implementation; and moves into new or more intensive areas of regulation such as sustainable finance, fintech, retail conduct, and interest and exchange rate benchmarks. Much of this is happening at different speeds and in different ways across sectors, as for example with the extension of financial stability concerns from the banking sector to the insurance and investment sectors.

This paper considers how the interplay of external and domestic drivers might shape UK financial services regulation. In particular:

- Despite early calls from some commentators for a 'bonfire of red tape', UK financial regulation is more likely to become tougher post-Brexit, as is evident from the observed tendency of the UK to impose super-equivalent requirements.
- Supervisory priorities around operational resilience have now been clarified and go substantially further than current European guidance.
- While the UK has lost its direct influence over EU legislation, it will remain an important player in setting international standards, even if its position within global standard-setting bodies has changed, given it no longer comes under the EU banner.
- There will be pressures for a divergence between the detail of UK and EU financial regulation, even where both regimes aim to deliver broadly similar outcomes, reflecting different regulatory and supervisory priorities and approaches.
- We identify six domestic drivers of UK regulation: financial stability and operational resilience, consumer protection and competition, fintech, UK competitiveness, review of the overall impact of the post-crisis regulatory reforms and social objectives.
- In responding to these drivers, there will be scope to strike different balances between principles and detailed rules, between resilience and resolution, and between the ways in which the principle of proportionality is applied.

**“..immediate questions about whether the UK will implement or mirror new or changed EU regulation over 2020 and 2021.”**

## Implications for firms

These developments will be of critical importance for financial institutions, which are likely to be faced with considerable uncertainty, complexity and cost as the UK regulatory regime adjusts in the new post-Brexit world and as further divergences in regulatory and supervisory approaches inevitably emerge between the UK and the EU.

These adjustments and divergences are likely to take various forms:

- The act of transposing existing EU regulation into UK legislation and the Financial Conduct Authority (FCA) and Prudential Regulatory Authority (PRA) rule books was a massive task. It will inevitably have led to a host of tweaks and changes, not least because even 'straight' copy-out was not possible for the UK as a third country. Further such issues may arise as new EU legislation is transposed during the transition period.
- Areas where the UK moves in conjunction with other international financial centres.
- Areas covered by international standards where the UK and the EU follow divergent paths in their detailed implementation, even where the UK and EU regimes remain broadly equivalent.
- Areas where the UK pursues its own path, moving ahead of international standards, other financial centres and EU legislation.

There are also more immediate questions about whether the UK will implement or mirror new or changed EU regulation over 2020 and 2021, such as the raft of sustainable finance regulations and the settlement discipline aspects of the Central Securities Depository Regulation. There may be political pressures not to do so, but not doing so could have significant impacts on markets, firms and customers.

# International influences on UK financial regulation

The views of global standard-setting bodies have for many years influenced UK financial regulation, directly or through their adoption into EU legislation and guidelines (which are in turn transposed into UK rules and guidance or, in the case of EU Regulations, apply directly).

The extent of this influence varies between sectors and by topic. For example, the standards agreed by the Basel Committee, although a voluntary framework, are usually followed closely in EU legislation and therefore set the baseline capital requirements for EU banks. Similarly, the standards set by the Financial Stability Board in areas such as recovery and resolution have been adopted in EU banking legislation.

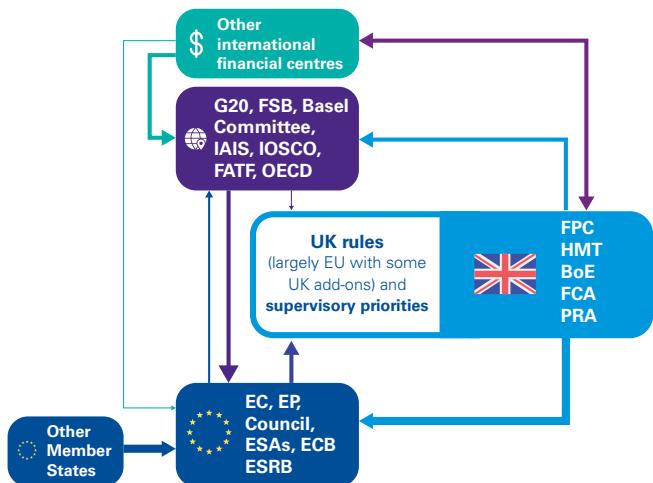
In other cases, EU or UK rules have significantly influenced or been a benchmark for the development of global positions. For example, the UK's risk-sensitive prudential regime for insurers, introduced in the early 2000s, became an important driver of the second EU Solvency Directive (Solvency II), which in turn was influential in the development of the Insurance Capital Standard by the International Association of Insurance Supervisors (IAIS).

Similarly a number of the International Organisation of Securities Commission's (IOSCO) principles and guidelines cite EU legislation as examples of existing good practice, such as in its report on open-ended fund liquidity and risk management.

Given the UK regulators' standing among their peers and the global importance of UK financial markets, the PRA and the FCA have played an important, sometimes central, role in the development of global regulatory thinking. They inform, shape and articulate debates. Examples of this include the UK's long-standing leadership in pushing forward the agenda for the regulation of retail and wholesale conduct, including the reform of interest rate benchmarks.

Sometimes this has taken the form of the UK working with the US and other international financial centres to develop regulation, for example on financial market infrastructures and on resolution regimes. There may also have been occasions when the UK joined a broader EU position, which added further weight to its influence on the global stage, although it is not clear how often this happened in practice.

## Pre-Brexit influences on UK FS regulation



**“...the UK was instrumental in shaping those rules. It has been as much (if not more) a rule-maker as a rule-taker.”**

Likewise, while much UK financial services regulation has been driven by EU legislation, the UK was a key player in influencing the shape and detail of that legislation. The UK was active in the development of legislative proposals by the European Commission, and in the consideration of these proposals by the European Council. UK Members of the previous European Parliament were major actors in amending European Commission legislative proposals, sometimes chairing important committees or holding the pen as rapporteur.

The FCA and the PRA played a significant role within the working groups of the European Supervisory Authorities (the European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA)), which provide advice to the European Commission on “Level 2” measures, draw up guidance for the industry and influence supervisory policies. The UK’s work on “value assessment” by investment funds, for example, prompted work by ESMA.

Some parts of MiFID II, such as payments for investment research, the payment of commission for investment advice, and the responsibilities of manufacturers and distributors of retail investment and insurance-based products, were heavily influenced by UK thinking.

It is clear, therefore, that while many UK rules emanate from EU legislation (and in some areas, from global standards copied into EU legislation), the UK was instrumental in shaping those rules. It has been as much (if not more) a rule-maker as a rule-taker.



# No wholesale deletion of rules

With greater scope for the UK regulatory regime to diverge from EU legislation, what form might this take? Despite early calls from some commentators for a 'bonfire of red tape' there seems very little prospect of a significant contraction of rules in the UK. Indeed, most indicators point in the opposite direction.

In general, and in particular since the global financial crisis, the UK has been at the forefront of arguing for and implementing higher regulatory standards. This has been across the regulatory spectrum from market infrastructure and prudential regulation, through retail and wholesale conduct regulation, to aspects of corporate governance and individual responsibility. Moreover, this approach is not confined to the PRA and the FCA. It extends more widely to UK primary legislation and to the Bank of England in its capacity as a resolution authority and as a macro-prudential authority (through the actions and recommendations of the Financial Policy Committee (FPC)).

As a result, the UK has introduced a large number of regulatory measures that have gone beyond EU legislation, in terms of two types of 'super-equivalence' – a tougher approach to regulatory reforms covered by EU legislation and the introduction of measures not (yet) covered by EU legislation.

## Examples of UK super-equivalence include:

- Agree the ring-fencing of large retail deposit-taking banks, which came fully into force on 1 January 2019.
- Resolution requirements for large UK banks, including the setting of Total Loss Absorbing Capacity requirements and of Minimum Requirements for Own Funds and Eligible Liabilities (MREL) under the Bank Recovery and Resolution Directive (BRRD), valuation preparedness requirements, and requirements for operational continuity in resolution – for more detail on these requirements see the KPMG International paper on "Resolution: pressures build on European banks".
- The general stance of the FPC in the setting of capital requirements for the large UK banks, and the setting of a positive counter-cyclical capital buffer, even in 'normal' periods.
- The annual stress testing of large banks and of the banking system by the FPC and the PRA, using a wider range of stress scenarios and usually more severe stress scenarios than the biennial stress tests run by the EBA, and the PRA's biennial general insurance stress tests.
- The setting of Pillar 2 capital and liquidity requirements.
- The application by the FCA of the Individual Capital Adequacy Assessment Process (ICAAP) and Supervisory Review and Evaluation Process (SREP) to a wide range of investment firms and to asset managers.
- The introduction of bans on commissions for financial advisers and platforms, and the concept of 'whole of market' advice.
- Other 'front-running' of EU retail consumer protection legislation, in particular MiFID II and IDD, in areas such as the responsibilities of product manufacturers and distributors, and transparency of costs and charges.
- The Senior Managers and Certification Regime (SMCR), which has now been rolled out to almost all regulated financial institutions in the UK – for more details see the KPMG International paper on "Individual Accountability".
- Some actual or prospective UK regulatory requirements have been driven by the FCA's objective to promote efficient competition, which underpinned its reviews of the mortgage market, the high cost credit market, the asset management market, personal investment platforms, wholesale financial markets and pension fund investment consultants; and is in part a driver of the FCA's focus on 'value for money' considerations across a range of financial products and services.
- The establishment and implementation of the Fair and Effective Markets Review, covering standards of behaviour in fixed income and commodities markets.
- The introduction of fintech-related regulatory requirements, such as the FCA's restrictions on various forms of peer-to-peer lending and the PRA's Supervisory Statement on algorithmic trading.

These measures are consistent with public pronouncements on the UK's approach to regulation:

*"We are absolutely committed to upholding open financial markets, underpinned by the highest standards of regulation and appropriate supervisory oversight."* John Glen, Economic Secretary to the Treasury and City Minister, 28 October 2019

*"So as far as the stringency of financial regulation goes, we at the Bank have a clear view of what would make sense for the UK in a post-Brexit environment: we should keep it calibrated roughly where it is now and have no desire whatsoever to weaken it."* Sam Woods, Deputy Governor for Prudential Regulation and CEO, PRA, May 2019

*"The FCA will continue to engage with the future EU agenda. This is because we share common regulatory and supervisory priorities, challenges and concerns. This includes such areas as next steps with EU Capital Markets Union, where building strong and open capital markets is in the interests of Europe as a whole. It includes investor protection standards, sustainable finance, the fight against money laundering, financial innovation and the future regulation of crypto assets."* Nausicaa Delfas, Executive Director of International, FCA, 23 January 2020

It should, however, also be recognised that there have been some cases where the UK has argued for a lighter EU regulatory regime or implemented a more accommodating approach.

### Examples of UK sub-equivalence include:

- Arguing against limits on the ratio between variable and fixed remuneration for individuals.
- Arguing against the need for many of the provisions of the Alternative Investment Fund Managers Directive (AIFMD).
- Under Solvency II, taking a less restrictive approach to the calibration of the risk margin for insurers, taking a more flexible approach to the matching adjustment, the volatility adjustment and the treatment of illiquid assets, simplifying the calculation of the transitional measure on technical provisions, and reducing the reporting burden on firms.
- Using the FCA's competition objective and the PRA's secondary competition consideration to drive a more accommodating approach to new bank entrants.
- The FCA's 'regulatory sandbox' for fintech start-ups to encourage and foster innovation, now extended globally.

#### KPMG papers:



Resolution: Pressures build on European banks



Individual Accountability



# The evolving international landscape

As the UK government and regulators consider the post-transition world, they will find that the context for those deliberations is not static. The wider regulatory landscape, within which the UK regulators and UK regulated firms operate, is evolving.

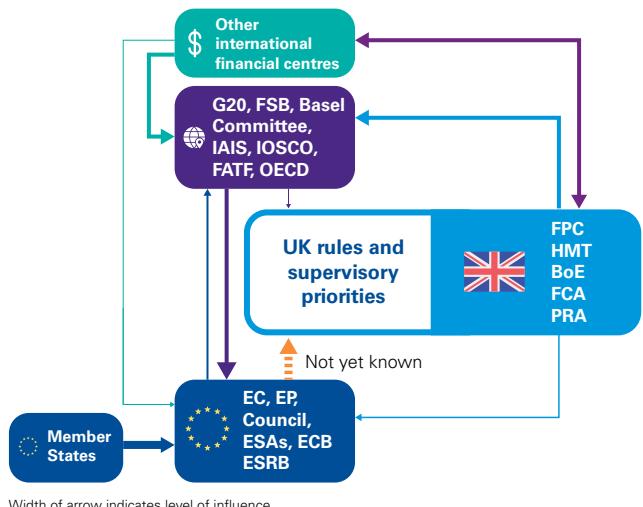
By their actions and words, UK regulators and other policy-makers are indicating that they intend the UK to remain a key player at global level and to adhere to internationally-agreed standards. But there are signs that the post-crisis commitment to co-operation and convergence of standards is breaking down in some areas.

The US reviewed the raft of post-crisis rules and reined back some of its earlier adherence or super-equivalence to international standards. The EU, on the other hand, continues to propose new rules – for example, on sustainable finance and “Capital Markets Union” – and its reviews of post-crisis regulation are piecemeal. Meanwhile, although Asian regulators are adopting the recommendations of the global bodies, they are also increasingly questioning the relevance of some of these standards for their local circumstances.

Will the degree of the UK’s influence within global debates change now it acts solo? In many areas, it always acts alone. Perhaps the more pertinent question, therefore, is how different the EU’s positioning will be without the direct influence of the UK. This will have an impact on global outcomes and it may also have a direct bearing on UK rules, depending on the extent to which the UK chooses in future to align with EU regulation.

The loss of the UK as a major actor in the shaping of EU legislation has changed the dynamic in EU legislative debates. Indeed, this had already begun to happen pre-Brexit, for example in the EU approaches to euro clearing outside the EU, booking models and centralised risk management, the delegation of portfolio management by investment funds to outside the EEA, and the centralisation of further regulatory and supervisory responsibilities in the ESAs.

## New world influences on UK FS regulation



Even if in the future the UK is not, or chooses not to be, constrained in any way by EU legislation, many UK-based firms have operations within the EU and will have to manage potentially divergent requirements, over and above divergence with other parts of the world. Divergence inevitably means additional costs for firms and potentially conflicting requirements.

**"Divergence inevitably means additional costs for firms and potentially conflicting requirements."**

The changing dynamic will also be felt in supervisory activity. The role of the European Central Bank (ECB) is evolving. It is issuing guidance and "supervisory expectations," which some regard as tantamount to rule-making. The ECB will not have a direct role in the supervision of UK banks, but large pan-European banking groups already come under its purview, which include some EU-owned UK banks and some EU subsidiaries of UK-headquartered banks. The extent of interactions and cooperation between the ECB and the Bank of England will therefore be an important driver of the prudential supervision of UK banks and UK supervisory priorities.

The EU's own regulatory agenda has changed, as evidenced by the priorities issued to each Commissioner by the new Commission President. Issues relating to climate change and the digital society are top of every list. For more details, see the KPMG International paper, "EU Financial Services regulation: a new agenda demands a new approach".

**KPMG papers:**

EU financial services regulation:  
a new agenda demands a new approach



Horizons: The  
outlook for  
financial services  
regulation



# Domestic drivers

While the UK can be expected to maintain its generally tough approach to financial services regulation, it may choose to take a distinctive and increasingly differentiated approach from the EU.

Six domestic drivers of UK regulation can be identified. In addition to these drivers, there are three broad questions about regulatory approach that could influence the design of UK regulation:

- the choice between the use of principles and the use of detailed rules (or the closely related debate between simplicity and complexity);
- the scope to introduce greater proportionality in the setting of regulatory requirements for smaller firms; and
- the balance between resilience and resolution (would the development of a credible resolution regime allow for a relaxation in prudential requirements?).

## Domestic drivers of UK financial regulation

### 1. Financial stability and operational resilience

Financial stability will remain a key driver, with UK regulators making it abundantly clear that operational resilience will now be considered a key component of stability, alongside the more established frameworks for capital, liquidity, recovery and resolution.

### 2. Consumer protection and competition

Consumer protection will remain a key driver, along with fair and effective markets. Largely in the absence of detailed international standards on retail consumer protection, UK consumer protection regulation will continue to be driven primarily by consumer behaviour and competition concerns, and by continuing the FCA focus on the role of purpose and culture, and the appropriate balance between consumer and firm responsibilities and between manufacturer and distributor responsibilities.

### 3. Fintech

The UK regulators have been providing an environment to encourage innovation to deliver better and more efficient products, with initiatives such as the FCA's regulatory sandbox and the call for input on 'Open Finance'. Technological innovation raises questions about whether

existing conduct rules, which originated in a paper-based and face-to-face world, are fit-for-purpose in the digital age. The FCA is focused on customer outcomes rather than simple adherence to detailed rules.

Given that the delivery of 'digital' financial products and services is not restricted by physical borders, effective regulation requires globally consistent standards. Global bodies are observing technological and market developments, and developing regulatory responses, including whether to extend the current scope of regulation and supervision to a wider range of firms and products. The UK has been in the leading pack in these debates, issuing guidance on which different types of crypto-assets fall within the UK regulatory perimeter, for example.

Linked with the second driver of consumer protection, the FCA is also focussed on mitigating the risks of new products and services with, for instance, a consultation on restrictions of the sale to retail clients of investment products that reference crypto-assets. Fintech developments provide an opportunity to redraw some lines around the extent to which consumers should be expected to take responsibility for their decisions and actions, for example by enabling consumer information and risk warnings to be delivered in new and imaginative ways. It is important that this discussion is properly pursued at an early stage in the development of fintech regulation.

### 4. UK competitiveness

The impact of regulation on the competitiveness of UK financial services is back on the policy agenda, driven by economic and technological priorities. As memories fade of the impact of the pre-financial crisis attempts to increase the size of the UK financial services sector, there may be political and industry pressures on UK regulators to take a more accommodating approach. The evaluation of future UK measures in the light of developments in other regulatory regimes might therefore, at least for a period, be more explicit. It seems unlikely, though, that UK competitiveness will over-ride the first two drivers.

### 5. Overall impact of the post-crisis regulatory reforms

Depending on the nature of the future EU-UK trade agreement, there may be more or less scope for the UK to undertake a wide-ranging review of the individual and collective impacts of the post-crisis regulatory reform agenda, and to adjust the UK regulatory regime accordingly.

### KPMG papers:



Regulation 2030 what lies ahead?



Brisbane G20 Summit – A new agenda for financial services



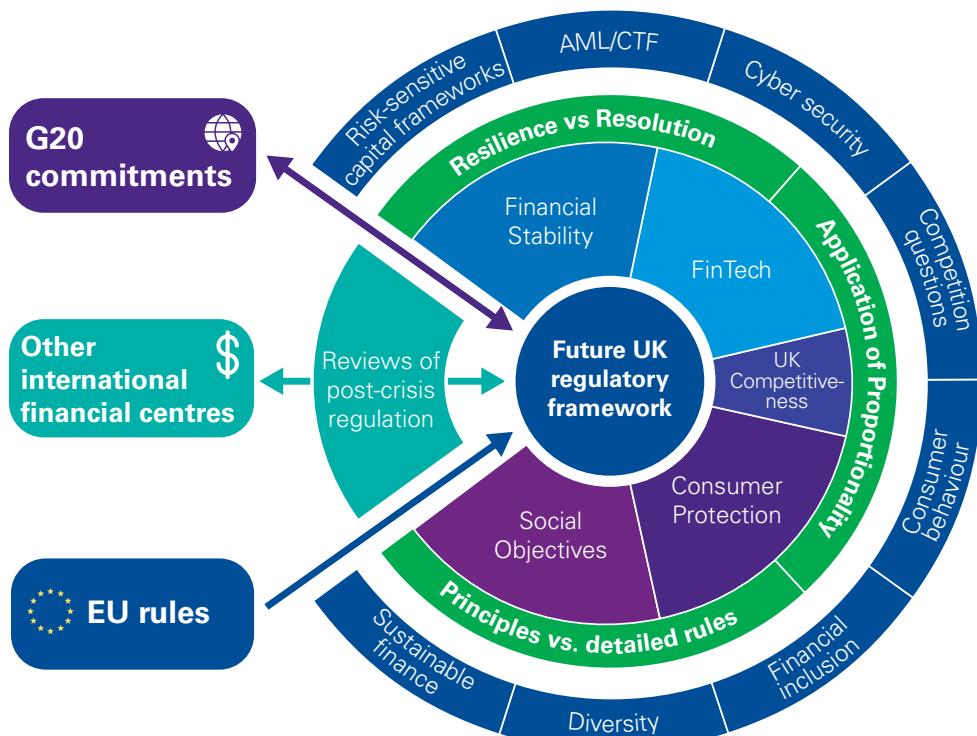
Impact of ESG disclosures – Embracing the future

As far back as 2014, KPMG International argued in its paper "Brisbane G20 Summit – A new agenda for financial services" that regulators should be brave and bold in:

- adjusting the capital and liquidity requirements on banks undertaking long-term financing and trade finance
- treating the issuers and holders of high quality securitisations more like the issuers and holders of covered bonds
- reducing capital charges, improving market liquidity and providing a more predictable tax regime for insurers and other long-term investors in infrastructure and the corporate sector
- developing capital markets, in particular in countries and regions where non-bank intervention plays a small role
- providing mechanisms for greater long-term investment through managed funds

Some of these recommendations have since been taken up.

### New world influences on UK FS regulation



### 6. Social objectives

Financial services regulation is increasingly faced with pressures to take into account a range of social objectives. This has already been a driver of the regulatory treatment of lending and investment in SMEs and in infrastructure investment, and has spread to considerations of how to support and facilitate sustainable (green) finance, financial inclusion and greater diversity in the senior management and boards of financial institutions.

There are tensions here concerning whether these aims might better be pursued using interventions other than financial services regulation, and more narrowly concerning the purity of a 'risk-sensitive' approach to regulation. But in both respects the separating walls have already been breached in a number of ways and these pressures on regulation are likely only to intensify.

# Conclusions

UK financial services regulation will be different in the post-Brexit transition world, scheduled to begin in January 2021.

This paper has identified three main influencers for this change:

1. pressures for a divergence between the detail of UK and EU financial regulation, even where both regimes aim to deliver broadly similar outcomes;
2. domestic drivers of UK regulation, such as financial stability, consumer protection and competition; and
3. the evolution of the wider regulatory landscape.

Despite early calls from some commentators for a 'bonfire of red tape', UK financial regulation is more likely to become tougher from 2021, given domestic drivers. Wholesale deletion of sections of the rules arising from EU legislation seems unlikely.

While the UK has lost its direct influence over EU legislation, it remains an important player in setting international standards, leading conduct debates and influencing supervisory priorities. And it can deepen further its relationship with other international financial centres.

Financial institutions are therefore likely to have to respond to considerable uncertainty, complexity and cost as the UK regulatory regime adjusts. This adjustment will include the divergent paths followed by the UK and the EU in the detailed implementation of international standards, and the UK following its own path, in some areas moving ahead of international standards and EU legislation.





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