PARLIAMENTARY DEBATES

HOUSE OF COMMONS
OFFICIAL REPORT

Tenth Delegated Legislation Committee

DRAFT OVER THE COUNTER DERIVATIVES, CENTRAL COUNTERPARTIES AND TRADE REPOSITORIES (AMENDMENT, ETC., AND TRANSITIONAL PROVISION) (EU EXIT) (NO. 2) REGULATIONS 2019

Wednesday 23 October 2019

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not later than

Sunday 27 October 2019

The Committee consisted of the following Members:

Chair: Mr Adrian Bailey

† Abrahams, Debbie *(Oldham East and Saddleworth)* (Lab)
† Brereton, Jack *(Stoke-on-Trent South)* (Con)
† Day, Martyn *(Linlithgow and East Falkirk)* (SNP)
† Djanogly, Mr Jonathan *(Huntingdon)* (Con)
Doughty, Stephen *(Cardiff South and Penarth)* (Lab/Co-op)
† Field, Mark *(Cities of London and Westminster)* (Con)
† Freer, Mike *(Lord Commissioner of Her Majesty's Treasury)*
† Glen, John *(Economic Secretary to the Treasury)*
† Heald, Sir Oliver *(North East Hertfordshire)* (Con)
† Jones, Andrew *(Harrogate and Knaresborough)* (Con)
† Powell, Lucy *(Manchester Central)* (Lab/Co-op)
† Reynolds, Jonathan *(Stalybridge and Hyde)* (Lab/Co-op)
† Rowley, Lee *(North East Derbyshire)* (Con)
† Smith, Jeff *(Manchester, Withington)* (Lab)
† Vickers, Martin *(Cleethorpes)* (Con)
† Walker, Thelma *(Colne Valley)* (Lab)
† Whitfield, Martin *(East Lothian)* (Lab)

Dominic Stockbridge, *Committee Clerk*

† attended the Committee

Tenth Delegated Legislation Committee

Wednesday 23 October 2019

[MR ADRIAN BAILEY *in the Chair*]

Draft Over the Counter Derivatives, Central Counterparties and Trade Repositories (Amendment, etc., and Transitional Provision) (EU Exit) (No. 2) Regulations 2019

8.55 am

The Economic Secretary to the Treasury (John Glen): I beg to move,

That the Committee has considered the draft Over the Counter Derivatives, Central Counterparties and Trade Repositories (Amendment, etc., and Transitional Provision) (EU Exit) (No. 2) Regulations 2019.

It is a pleasure to serve under your chairmanship once again, Mr Bailey. As the Committee will be aware—some Members will be too aware—the Government had previously made all necessary legislation to ensure that in the event of a no-deal exit on 29 March 2019 there was a functioning legal and regulatory regime for financial services from exit day. Following the extension to the article 50 process, new European Union legislation has come into force and, under the European Union (Withdrawal) Act 2018, will form part of UK law at exit. Further deficiency fixes are therefore necessary to ensure that the UK's regulatory regime remains prepared for exit.

This statutory instrument makes deficiency fixes to a new piece of EU legislation that has recently become applicable relating to the European market infrastructure regulation. EMIR implemented the G20 Pittsburgh commitments agreed in the aftermath of the financial crisis in 2009, regulating over the counter derivative markets, and in particular requiring some derivatives to be cleared in a central counterparty, known as a CCP. The European Commission reviewed EMIR in 2015-16, resulting in an update known as the EMIR regulatory fitness programme—EMIR REFIT—which came into force on 17 June 2019.

EMIR REFIT makes a series of changes so that the framework for over the counter derivatives applies in a more proportionate way. It focuses on users of OTC derivatives and does not make significant changes to the rules for CCPs. In particular, it expands exemptions from the requirement to clear trades in OTC derivatives through a CCP. As the Committee is aware, this is not the first time that EU exit legislation has been used to address deficiencies in EMIR as it will form part of UK law at exit, but this instrument is necessary to address new deficiencies that will arise as a result of the recent amendments made to EU legislation by EMIR REFIT. After exit, the UK would be outside the European economic area and outside the EU's legal and supervisory framework for financial services. The EMIR framework that will form part of UK law at exit therefore needs to be updated to ensure that the new provisions continue to work effectively.

This instrument will ensure continuation of the new provisions introduced in EMIR REFIT and will transfer new EU functions to the appropriate UK authorities. Many provisions in EMIR REFIT do not produce significant deficiencies in UK law, and will continue to work effectively at exit. For example, this is true of the new exemption for small financial counterparties from the requirement to clear trades through a CCP. However, there are two key deficiency fixes in this instrument that are necessary to ensure EMIR REFIT is workable in a UK context. First, the instrument ensures that UK pension schemes will continue to be exempt from the requirement to clear trades through a CCP. This is an important provision for industry and consumers; an exemption for pension schemes is needed because there is currently no approach to clearing that works without subjecting pension schemes to disproportionate cost, particularly the requirement to pay margin to the CCP. The additional costs would ultimately undermine the ability of pension funds to meet their obligations to pension holders.

EMIR REFIT includes a pension scheme clearing exemption that will last anywhere between two to four years. To ensure there is no ambiguity about the length of the extension, that extension will now last the full four years in the UK. The fix is appropriate given the size and nature of UK pension schemes, the vital role that they play in pension provision, and their crucial position as long-term investors in the UK economy. The instrument will provide the time to find a solution that balances the interests of pension schemes and CCPs, which will be particularly challenging in the UK context.

The instrument enables the Treasury to extend the pension scheme exemption further, for up to two years at a time if no appropriate solution for the UK market has been found. That will give certainty to UK pensioners and industry. The instrument also ensures that EEA pension schemes will continue to be exempted in the UK, enabling UK banks to continue trading derivatives with EEA pension schemes without using a CCP, just as they currently do. Her Majesty's Treasury committed to this action on 21 February 2019 to avoid disruption to UK businesses.

Secondly, the instrument transfers the function to suspend the clearing obligation from the European Securities and Markets Authority and the European Commission to the Bank of England. In EMIR REFIT, ESMA can recommend that the European Commission suspend the clearing obligation for three months at a time, up to a total of 12 months. We believe that the Bank of England is the most appropriate UK authority for that function, consistent with the responsibilities that Parliament has already conferred on the Bank for financial stability and the supervision of CCPs.

The Bank of England must secure the consent of Her Majesty's Treasury and inform the Financial Conduct Authority if it needs to suspend the clearing obligation in the UK. The Bank may decide to issue a suspension lasting any period up to 12 months. Such flexibility will enable the Bank to reduce uncertainty for globally significant clearing members and clients based in the UK in the unlikely event that a suspension is necessary. Finally, this instrument ensures that all references to EMIR are up to date on exit day so that references in UK legislation after that point will refer to the right version.

The Treasury has worked closely with the Bank of England and the Financial Conduct Authority to prepare this instrument, and we have engaged with the financial services industry. The draft legislation has been publicly available on legislation.gov.uk since 24 July, when the instrument was laid before Parliament.

In summary, this instrument is necessary to ensure that EMIR will continue to function effectively in the UK after exit, following the updates made in EMIR REFIT. In particular, it will ensure that UK pension funds continue to benefit from the pension scheme clearing exemption and enable the Bank of England to take necessary action to safeguard financial stability when necessary. I hope that colleagues from all parties will join me in supporting the regulations, and I commend them to the Committee.

The Chair: The question is that the Committee has considered the draft Over the Counter Derivatives, Central Counterparties and Trade Repositories (Amendment, etc., and Transitional Provision) (EU Exit) (No. 2) Regulations 2019.

9.1 am

Jonathan Reynolds (Stalybridge and Hyde) (Lab/Co-op): It is a pleasure to see you in the Chair, Mr Bailey. We have read out the title of this statutory instrument twice already, so I will exempt myself from that particular duty.

For the benefit of any new members of the Committee and for the record, my Opposition colleagues and I have strongly objected to the process of passing so-called no-deal SIs since it began a year ago. Secondary legislation is not an appropriate channel for the size and scope of the onshoring project that is being attempted, and does not allow time for the scrutiny that regulations of this magnitude demand. The fact that we are still, at this stage of the process, preparing for no deal is an indictment of the way the Government have handled these negotiations, which has left businesses and the City mired in uncertainty. However, we have had that debate in this room many times; the Minister knows my view, and I know his, so I will move on to the substance of the instrument.

As the Minister described, EMIR is a fundamental piece of pan-European financial markets regulation that emerged in the wake of the financial crisis and as part of a G20 commitment. It relates to building a more robust and transparent trading regime for the sale of over-the-counter derivatives, designed to protect against the type of systemic risk that worsened the freefall in markets after the collapse of Lehman Brothers by using an institution known as a central clearing counterparty.

Ongoing European co-operation is vital to the future stability and effectiveness of that regime, and the UK's role as a European clearing hub is vital. In the past, our competitors have argued that clearing of euro-denominated instruments should take place in the eurozone, and it is clear that Frankfurt and Paris will continue to try to win clearing volume from London. Therefore, it is of the utmost importance that we get the ongoing regulatory framework right, not just to maintain our competitiveness, but because CCPs are so fundamental to the stability of the financial system across Europe. It is vital that the Government work to secure a more permanent form of recognition from the EU for the UK's CCPs, for which the FCA has lobbied. Without that, we risk splitting liquidity and migration of contracts by EEA firms, which will be unable to use a UK CCP that is not formally recognised.

In preparing my comments on the instrument, some of the criticisms felt familiar. In particular, the Opposition have raised concerns in the past about the transition of powers from EU institutions to UK equivalents without properly considering the interaction between those institutions. A number of new powers to assess equivalence and recognition of third-country CCPs and trade repositories are being transferred to institutions including the Bank of England, Financial Conduct Authority and the Treasury. However, the relationship between the Bank of England and the FCA, for example, is not the same as that between the European Commission and the European Securities and Markets Authority.

The Opposition are concerned about this attempt to simply port across the Lamfalussy process of rule-making without considering whether it fits the framework that we have in this country. In addition, the secondary legislation process has been so piecemeal that it is challenging to scrutinise properly the allocation of powers to the different bodies. It is unclear how all these elements fit together and how extra responsibilities given to UK regulators will be accommodated in terms of resources.

By my count, this is the fifth statutory instrument that relates to central counterparty clearing, as the Minister mentioned. We were due to leave the EU in March 2019, so the fact that we are still porting across fundamental items of legislation tells us something.

The Minister said that the circumstances in Europe have materially changed, particularly the pension system. I would like him to clarify whether those changes form a new initiative on the European level. Perhaps the most interesting question I could ask is this: had we left in March 2019, would we still be making this change and essentially be choosing a form of voluntary alignment with single market regulations in the financial services sector?

Scrutiny of the instrument is challenging without a proper impact assessment. The explanatory memorandum states:

> "An Impact Assessment has not been prepared for this instrument because, in line with Better Regulation guidance, HM Treasury considers that the net impact on businesses will be less than £5 million a year."

That is a rather generous interpretation of the better regulation framework; it may well comply with the letter of the guidance, but it does not comply with the spirit. The political uncertainty we are in and the seriousness of these regulations mean that we need a proper impact assessment. Trillions of pounds-worth of trades are cleared through UK CCPs every year. We must be sure that we have assessed every possible outcome of change to the framework, particularly in a no-deal scenario in which markets will be volatile.

The FCA has been granted powers to suspend reporting obligations, with the agreement of the Treasury, for a period of up to one year in the event that no registered or recognised UK trade repository is available. Under that arrangement, the FCA will also be able to specify when, once the suspension ends, firms will be expected to report previous trades undertaken during the suspension

[Jonathan Reynolds]

period. That feels like a worrying step towards deregulation. Under what circumstances does the Treasury envisage that there will be such a cataclysmic failure that no trade repositories in the UK will be functioning? Is this requirement intended to apply solely to EEA firms operating here that are unable to use a UK trade repository because it has not been formally recognised by the EU?

If that is the case, surely the Government's priority should be to ensure that that recognition process is formalised and given a degree of permanence, as the unavailability of a trade repository suggests that there would be extreme disruption. Equally, allowing the FCA simply to suspend regulations risks creating uncertainty. The value is in a consistent and reliable regulatory regime.

More broadly, I would like to ask the Minister to provide reassurance that the measures will not result in any lighter regulation in market infrastructure. The regulations are a central part of our G20 commitments to prevent the derivatives market ever again inflicting damage to the global economy on the scale of 2008. We must not allow any repeat of those disastrous events.

9.8 am

Martyn Day (Linlithgow and East Falkirk) (SNP): It is a pleasure, Mr Bailey, to serve under your chairmanship. I have a couple of short points to make. Although I recognise the importance of addressing deficiencies, it is unacceptable that we are only just getting round to these regulations, potentially a week before we leave the EU. I fear that the SI will not protect Scotland's financial services industry, which benefits greatly from being in the EU, where I hope we will stay.

9.8 am

John Glen: Let me say at the outset that the instrument is needed to ensure that UK firms are able to make use of the new provisions included in EMIR REFIT and that EMIR will function appropriately after exit. Without the instrument, UK pension funds would be required to clear derivatives in a CCP, and that would come at a considerable cost to UK pension schemes and pensioners.

The instrument also ensures that the clearing suspension, a key financial stability tool, operates effectively in the UK. The hon. Member for Stalybridge and Hyde characteristically went through familiar arguments, stating his party's position on the unsuitability of this process, and I will not go over that again. As he said, we both know where we are on that. He did make some specific points, which I will respectfully try to accommodate.

On the appropriateness of the transition of powers, the Bank of England will be given responsibility for suspending the clearing obligation in exceptional circumstances, with the consent of the Treasury. Both the Bank of England and the FCA will take on the responsibility to set certain binding technical standards that currently sit with ESMA. That is a widely understood common responsibility between them.

The SI does not give any new supervisory responsibilities to UK authorities. No new firms will be subject to supervision by UK supervisors due to the SI. National supervisors across the EU already have responsibility for supervising the users of uncleared derivatives and CCPs, and we are confident that the regulators are appropriately resourced for those roles.

The hon. Gentleman made a point about the wider framework. As he knows, a review is ongoing with respect to what we term air traffic control of regulations. There will be subsequent reviews of the configuration of powers between the Treasury, the FCA and the Bank of England, so the wider point that he made was a fair one, but that will be resolved hopefully after a deal is secured.

The hon. Member for Stalybridge and Hyde mentioned impact assessments. The Treasury has considered the impact of all its financial services SIs. I did not mention it before, but I am happy to say now that the impact of today's SI was assessed to be below £5 million. When that is the case, Government policy is not to publish a full impact assessment. For previous exit SIs where the impact was assessed to above £5 million, impact assessments were published in advance and could be scrutinised.

The hon. Gentleman made some points about reassurance on the direction of travel of regulation. The context of the SI is that the UK's pension regime relies on a higher number of defined benefit schemes than the rest of the EU. The way that those schemes need to interact with CCPs is unusual and different, so we have had an enduring dispensation not to participate in the same way. That is not a deregulatory effect, but because the pension schemes would have to hold a large amount of cash, which would be costly and uneconomic for them.

In essence, there has been enduring uncertainty around the conclusion of the process of resolution, but we have actively participated in it, given our historically different pension scheme arrangement. There is no desire not to observe the G20 Pittsburgh obligations on derivatives, and this is not some sort of deregulatory effort.

Jonathan Reynolds: It is an entirely reasonable observation that the UK pensions industry is structured differently and requires a different set of regulations and approach, but we have always known that. Is the Minister saying that, if we had not spotted this back then and left the European Union without passing the instrument, our regime would be deficient, or has something changed so that we now need to address it?

John Glen: Clearly, had we left on 31 March, the EMIR REFIT regulation would not have come in in July. What happened would have depended on the conditions under which we had left at the end of March and on whether we observed the changes naturally as part of the EU through a transition period, or if, in a no-deal circumstance, we used a different mechanism to consider ongoing legislation into which we had had some input but that was not quite finished. That is a bit of a difficult question to answer fully, but that is my understanding.

Sir Oliver Heald (North East Hertfordshire) (Con): Hear, hear!

John Glen: I sense that there is a degree of frustration and impatience in the Committee, but I will respectfully address the point made by the hon. Member for Linlithgow and East Falkirk. We clearly have disagreements over the fundamental outcome that we need to secure, but all the interventions across the 58 SIs have been designed to give as much stability as possible in the event of no deal, which is in the interests of the whole of the United Kingdom's financial services sector.

I hope that the Committee has found this morning's sitting informative and will join me in supporting the draft regulations.

Question put and agreed to.

9.15 am

Committee rose.