EXECUTIVE BOARD MEETING

SM/18/249
Correction 2

November 9, 2018

To: Members of the Executive Board

From: The Acting Secretary

Subject: **United Kingdom—Staff Report for the 2018 Article IV Consultation**

Board Action:	The attached corrections to SM/18/249 (10/26/18) have been provided by the staff:
Evident Ambiguity	**Page 18 (para. 33, line 4)**
Typographical Errors	**Page 18 (para. 33, line 6)**
Questions:	Ms. Iakova, EUR (ext. 35365) Mr. Arregui, EUR (ext. 38456) Mr. Chen, EUR (ext. 34746) Mr. Espinoza, EUR (ext. 34831)

that have been eliminated due to UK's EU membership. Under this assumption, value added in the UK financial sector would fall by about 15 percent, with some increase in activity likely in the EU and US. In case of a no-deal Brexit, the output losses could be even greater.[13] Nonetheless, London would remain a large financial center as the majority of non-EU facing business is likely to stay in the UK.

32. The authorities are working with financial institutions to prepare for Brexit. There has been significant progress in converting relevant EU financial sector legislation into UK law, including the preparation of secondary legislation where needed and the replication of EU institutional capacity. The UK government has committed to bringing forward legislation to create temporary permission regimes to allow EEA financial services firms and funds to continue their activities in the UK for a time-limited period after the UK has left the EU, providing a backstop in case a Brexit agreement is not ratified. EU policymakers have also issued advice to financial institutions to step up preparations for a "cliff-edge" Brexit. Risks to financial stability include both direct effects from potential disruptions to the provision of financial services (see October 2018 GFSR) and indirect effects from macroeconomic shocks. The BoE's 2017 annual cyclical stress test suggests that the major UK banks are sufficiently well-capitalized to withstand a range of macroeconomic shocks that could be associated with Brexit (even if compounded by a global recession).[14]

33. Regulatory and supervisory cooperation between UK and EU authorities will be crucial to maintaining the integrity of cross-border transactions and business. A technical working group, chaired by the heads of the BoE and the ECB, has been established to discuss Brexit-related financial stability risks in the period around 30 March 2019. As suggested in the 2018 EU Financial Stability Assessment, the EU and UK authorities should work together to ensure legal continuity in insurance and derivative contracts and proper data sharing to avoid cliff-edge effects. The potential loss of euro-denominated derivatives clearing permissions for EU banks on UK-based CCPs could generate short-term financial stability risks related to the continuity of existing contracts, as well as netting efficiency losses related to the fragmentation of derivatives clearing. Changes in the regulation and oversight arrangements for euro-denominated derivatives clearing on UK-based central counterparties (CCPs) will require careful design to ensure smooth functioning of derivatives clearing.[15] Continued commitment to high regulatory standards will be important to preserve hard-won financial stability gains and prevent easing of prudential regulations.

[13] See chapter 1 of the Selected Issues paper, paragraphs 28–29. Staff estimates suggest that the loss of value added in the financial sector can be up to 25 percent in a low-access scenario. Oliver Wyman (2016) estimates that revenue in the sector could decline about 20 percent in a similar scenario.

[14] Stress test results should be interpreted with caution, as the exercise did not include all possible Brexit-related financial shocks (some of which are difficult to model, such as potential strains in derivatives markets or sudden liquidity shortages).

[15] The euro area FSAP recommended that ESMA be given direct supervisory powers over euro clearing in CCPs outside the EU; it also favored a stronger role for the Eurosystem in CCP oversight. The FSAP cautioned against mandatory relocation of euro clearing to the EU-27.