



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Rt Hon. Nicky Morgan MP
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Dear Ms Morgan —

Firms' contingency planning for the UK's withdrawal from the European Union

First, may I congratulate you on your appointment as chair of the Treasury Committee. I look forward to working with you.

Thank you for your letter of 24 July. Your questions touch on a number of key points related to the issue of how the transition to the new relationship with the EU could give rise to risks to our objectives, and how those risks might be mitigated.

Consistent with the Bank's objective to promote financial stability and the PRA's objectives to promote safety and soundness and policyholder protection, we need to consider the range of scenarios that could arise as the UK withdraws from the EU. As part of this, we are assessing the scenarios that could have the greatest impact on our objectives, such as one in which there is no agreement that provides for some form of ongoing cross-border market access between the UK and the EU at the point of exit and no period of transition to this new position. The Bank's Financial Policy Committee (FPC) is focusing on macro-prudential risks and will oversee the process of contingency planning across the financial system to mitigate these risks. The Prudential Regulation Committee (PRC) is focused on micro-prudential risks and issues arising from the preparations of individual firms.

The main purpose of my letter on 7 April to banks, insurers and designated investment firms undertaking cross-border business between the EU and the UK was to ensure that all firms are making sensible contingency plans concerning the UK's withdrawal from the EU, and getting ready to execute them in good time should the need arise. This includes contingency planning for a scenario in which there is no agreement at the point of exit and no implementation period. This is important to reduce the risk of unexpected breaks in the provision of financial services to end users, including consumers, and to mitigate risks to financial stability which could arise if firms are not sufficiently prepared. We also need to ensure the continuing safety and soundness of UK entities as the UK withdraws from the EU.

We have received 401 responses to my letter from UK and EEA firms that operate in both the UK and the rest of the EU. Of these responses, 147 were from banks and designated investment firms and 254 were from insurance companies. All UK firms and material branches of EEA firms who received the letter, with the exception of a handful of very small insurers, have responded. We also received some responses from firms that use freedom of services permissions under EU law to offer services into the UK.

We are in the process of analysing these responses in detail, and are examining both the detail of individual plans, to ensure that each firm undertakes sufficient preparations, and firms' plans collectively,

to identify whether there are broader financial stability risks which could arise from the collective execution of the contingency plans, and any thematic issues or concerns that could give rise to risk. This analysis will then be considered by the PRC and FPC, and we would expect the committees to reach a view on firms' submissions in the autumn. The Governor and I would be happy to provide you with further information on the outcome of this exercise once it has been completed. However, there are some further points we can make at this stage in relation to the issues you raise in your letter.

First, the FPC has considered the potential risks to financial stability arising from the UK's withdrawal from the EU, and has identified two main channels of risk as set out in the June Financial Stability Report. The first concern is direct effects on the provision of financial services, if services are dislocated and fragmentation increases costs and risks. Fragmentation of market-based finance could result in higher costs resulting in less activity, particularly in relation to the hedging of risk, which could result in risks for both the EU and the UK. The second channel of risk is the possibility, in some scenarios, of a broader disruption to the UK real economy that could test the resilience of the financial system. The UK's withdrawal from the EU has the potential to affect the economy through supply, demand and exchange rate channels. This could require banks to be able to withstand, and continue lending in, an environment of higher loan impairments, increased risk of default and lower asset prices and collateral values. The Bank's stress-testing regime aims to strengthen banks to withstand scenarios of this kind. Going forward, the FPC will continue to develop and refine its assessment of the potential financial stability risks associated with the withdrawal of the EU.

Second, firms' submissions to us provide further evidence of cross-sectoral risks we have previously identified, specifically issues relating to the continued servicing and performance of existing contracts and restrictions on data transfers. It is clear that these are significant issues for many firms, and that planning assumptions (in particular, whether these issues are expected to be resolved by the authorities or by individual firms) vary considerably. In this context, for insurance firms there is a possibility of a significant increase in the volume of Part VII transfers to move contracts between entities. We are engaging further with firms and trade bodies to examine the possible mitigants to these risks and determine which are likely to be most effective.

Third, re-structuring by firms to mitigate risks to their business will in general increase complexity. In particular in relation to 'outbound' firms (those firms based in the UK but selling services to clients in the EU) for both banks and insurers, re-structurings will in many cases result in strongly inter-connected entities between the UK and the EU. We will need to ensure that these structures do not impede supervisability or resolvability.

Fourth, the authorisation, and then the ongoing supervision, of a significant number of additional firms is likely to place a material extra burden on the PRA's resources. The issues set out above pose a material risk to our objectives, and this work is therefore a top priority. It is incumbent on us to manage this burden but we may have to make some difficult prioritisation decisions in order to accommodate it.

With these risks in mind, as we and colleagues have noted consistently when giving evidence to the Treasury Committee previously, some form of implementation period is desirable, in order to give UK and EU firms more time to make the necessary changes to adjust to the UK's new relationship with the EU in an orderly way.

Yours sincerely •—

Sam Woods
Deputy Governor and CEO, Prudential Regulation Authority