SUMMARY SESSIONS - HELSINKI SEPTEMBER 2019

Brexit developments and future of EU-UK relations

1. Level of preparedness of the financial services industry regarding Brexit

1.1. High level of preparedness of the financial industry

An official stated that following a process initiated by the industry after the Brexit referendum and supported by supervisors, there is a high level of preparedness in the UK financial sector for the possibility of a no deal exit after current transitory arrangements are over. The aim was to answer the expectations of clients, shareholders and regulators. Preparedness includes not just being resilient to possible shocks within the financial system caused by a no-deal Brexit, but also being able to continue to serve the economy. This has been a remarkable achievement by firms and regulators in a difficult political climate. The industry will nevertheless have to keep engaging on those issues if a no deal situation is confirmed.

An industry representative felt that the financial industry is probably the best prepared sector in the UK economy, and also among most member states. Unfortunately, being the best prepared is not a guarantee of being able to ensure a smooth functioning and continuity of service in all areas. Another industry representative agreed that although there is a high level of preparation, care is needed because the devil is in the detail.

Another official subscribed to the overall assessment that preparatory work has been intense, both from the private sector and public authorities at the European and national levels. Everyone is prepared to keep risk in check, and monitoring is ongoing.

1.2. Remaining risks in the case of a no-deal Brexit

An industry representative believed that remaining risks are potentially manageable. Speakers on the panel identified different areas where potential risks remain to be tackled in the short term in the case of a no-deal Brexit.

A first area is liquidity. The liquidity gaps that a no deal Brexit may lead to could disrupt the provision of certain services for some market segments, an industry representative warned. It is hard to know to what extent this will be the case and which services will be affected, but there will be cost issues. The issues that cause the most worry are the unexpected and the unidentified ones. Firms are dependent on thousands of people in the market understanding how to operate in a different regime on the day and also on regulators and policymakers continuing to talk to each other, which one can hope will happen despite possible political hostilities.

An official agreed that thin liquidity in the weeks immediately after a no deal exit is a risk, which could be exacerbated by the consequences of the share trading obligation (STO) of MiFID II. Many people are expecting the UK to say what it is going to do about the STO, but there is also the question of the operation of the STO, which originally was intended to facilitate and stabilise cross border trade, and how that could play into what may happen immediately after a no deal exit. The challenge is in particular for the 6,229 shares that are not included in the STO, an industry representative noted.

For another industry representative the biggest concern in terms of market liquidity is US dollar liquidities, because the majority of transactions for certain instruments are in US dollars e.g. 87% of the FX market in US dollars. If a liquidity crisis happens, funding costs will go up and investors will sell the papers they hold.

Clearing is a second area of concern, an official stated. The European Commission's temporary equivalence decision on clearing was very welcome but it is due to expire at the end of 2019, which means that this question will resurface in December if the direction is unknown. If the arrangements are not renewed or replaced that would be a serious issue. It is to be hoped that there will be some pragmatism about this.

Regarding uncleared derivatives, the UK's concerns are well known, the official added. It is a 'slow burn risk' that is very hard to identify, and potentially long running and difficult to manage. A number of member states are taking action to address that. An industry representative felt that the Commission had taken a relaxed view on this question and on the related risks; as a result member states have implemented somewhat different regimes, which is quite hard to manoeuvre for the industry. Some of these regimes also are not clear and explicit enough about how they may work, which means that they are difficult to put into practice in the market.

Data transfers are a further area to be considered, the industry speaker believed. The private sector is mostly using the standard contract clause solution. That has legal uncertainty, and it is hoped that the market will not respond badly to a lack of a standardised, transparent solution and that barriers will not come up as a result.

1.3. Progress made with customer repapering and customer transition

An official stated that the dry run to a no deal exit in the spring highlighted that in many ways the client is the constraining factor regarding preparedness, which continues to be the case. Client behaviour is changing, but the authorities and the financial sector are generally more aware of the various Brexit scenarios than corporates. An industry representative emphasized that the least well prepared companies are SMEs. Larger companies are well prepared and have started to be more cooperative in the repapering exercise, but the reality is that they do not particularly want to move. Another official confirmed that repapering is not fully done; the question is whether the situation is manageable. Supervisors put pressure on banks to move along and onboard as many clients as possible and have also taken steps to facilitate the repapering process for some aspects, but there will always be remaining risks, although these should not be systemic.

An industry representative stated that a key issue for their bank has been to assist customers to transition where appropriate from their UK entities to their new German entities. Good progress has been made but after Brexit was delayed after 31 March customers considered transition to be less urgent. Larger customers are well prepared, especially the automobile sector, who are already changing their factories from the UK to continental Europe.

Other challenges for the speaker's bank are the need to build up the revenues of the new entities in Germany, which is impacted by the slower than planned customer transitions and the difficulty to implement staff changes in the current period of uncertainty. In the short term the bank will use its significant middle and back offices in the UK to support the operations of the new entities in Germany. Repapering is being completed and no issues have been raised so far. Their bank has focused on the large corporates and, as it is not present in the SME portion of the market, it is unlikely that there will be major issues.

2. Future of EU-UK relations in the financial sector

2.1. Possible post-Brexit scenarios

The Chair suggested that there are various options for the UK if it leaves the EU. It can have a regulatory regime for financial services which is very close to the European one, in which case one would expect the equivalence mechanisms to be the way of organising trade relations. A more radical option is to 'cut and run' and try and gain competitive advantage from lowering standards, but there have been no signs from London that that is a course of policy which is favoured. The third option is a model where the UK would try to build parallel agreements with different large markets like Switzerland, Australia, and Canada. The model that the UK eventually decides on will determine whether there is going to be regulatory divergence and whether that is manageable or not.

An official did not see the UK stepping away from the international standards that currently structure the functioning of the financial market. As long as financial services are a very large part of the UK's economy and the UK plays a leading role in this sector it is essential that the UK should participate fully in global financial institutions. Divergence with global standards would indeed go against the competitive, political and economic interests of the UK.

The risk of divergence over time with the EU is a critical point however, the official stated. The UK will leave on 31 October with exactly the same rules as the EU in all key areas of the financial sector. So far there has been no call from the UK based financial industry to review or change these rules. On the contrary they ask the authorities to avoid any haste in changing the regulatory approach because they would prefer the present regulatory dialogue between the UK and EU to continue. There are concerns about some regulations, and in due course financial firms will ask how they can be addressed, but there is no immediate pressure. It is hard though to see there being exactly the same rules in 20 years' time. One of the reasons is that the EU will be making rules for its 27 member states and not with the UK's specificities in mind. This will inevitably lead to some differences in the way regulation operates over time.

An industry representative agreed that changes will not happen quickly. UK regulators until now have shown a very high tendency to gold-plate EU regulations rather than to undermine them. If the UK continues to import risk and export risk management with a strong financial intermediation sector, risk management will remain essential and the UK will not become 'some kind of Singapore' contrary to what some have suggested. In terms of fragmentation, whether the Capital Markets Union (CMU) develops as an alternative source of capital markets for European issuers and the European real economy and how it develops is important. Fundamentally one cannot develop an international capital market without being open to global capital. The UK serves the European issuers by being open to global capital, and the development of the CMU is going to be a very fundamental part of what happens in the future.

An industry representative noted that the role of the US should not be underestimated in this debate. The share of the capital market business in 2010 was 53% US and 47% Europe, and is currently 70% US and 30% Europe. A key objective for Europe should be to increase the scale of its capital markets and diversify its financial system building on technology and capital pools available in the EU, otherwise the biggest beneficiary of Brexit may be Wall Street.

2.2. Potential issues raised by regulatory divergence between the EU and the UK and possible safeguards

An official highlighted the materiality and the implications of gaps that might appear between the EU and the UK. Gaps that may allow regulatory arbitrage are a concern for everyone, as they may damage the stability of the system. Moreover divergence may create barriers and fragmentation within the European market. That would be a commercial concern for firms and an economic concern for European economies including the UK, leading to a less competitive European financial services sector and a reduced contribution of the sector to the economy, with firms suffering from an uneven level playing field.

This having been said, the extent to which that gap emerges is not just a consequence of the UK's approach; it has also to do with the EU's strategy concerning its financial services system and how the dialogue between the EU and UK is working, which is partly a regulatory and partly a political question. In addition, rules should not be the only focus, because it is the supervision of the rules that often determines the outcome. But eventually, what happens in the financial sector and whether the policies defined in the EU or UK are a success or not are going to be determined by the clients and where they want to do business i.e. which entity they will use and in which jurisdiction.

An industry representative felt that the main issue is the risk management of how divergence is controlled, and whether there is some framework of common supervision that can encourage a shared view. Another key question is how equivalence regimes are used i.e. as an industrial policy or as a political strategy possibly with a certain degree of protectionism aiming to leave UK firms out.

Another official stated that the time dimension is important when discussing the risk of divergence. What is important are the safeguards that can be built into the system to limit that risk. One has been referred to - the global standards – to which EU jurisdictions adhere as much as the UK. The continuity of this engagement at the international level is essential. The equivalence regime can also be seen as a safeguard against tendencies to diverge and compete on regulation. Europe is facing a situation where it needs to further develop and integrate a diversified financial system for the Euro. This does not mean that it should reduce its openness to the global market, which needs to be maintained. That has never been part of the intentions or the mandate given to the EU authorities, including from a financial stability perspective. However the EU also needs to ensure that the appropriate mechanisms are in place vis a vis third-country entities for ensuring financial stability. ●