SESSION SUMMARY - BERLIN SEPTEMBER 2020

Can the EU manage without the City and how will financial services regulations with third countries evolve post-Brexit?

1. State of progress of EU-UK equivalence arrangements in the financial sector

An official stated that the UK's aim for financial services relations with the EU is to establish complete equivalence findings under existing laws before the transition period ends in areas where equivalence arrangements are available. This should be supported by clear processes for regulatory cooperation allowing industry to understand how the situation will evolve as regulation continues to change. Unfortunately equivalence is not yet in place and will not be considered by the Commission this year. Negotiations will continue on the services component of the Free Trade Agreement (FTA), but the UK is not where it aimed to be. This includes MiFID and the substantial cross-border trade flow between the EU and UK. Another aim was to have CCP equivalence in place before the transition period ends, following the definition of the relevant supervisory processes. ESMA and the Bank of England are discussing the necessary Memorandum of Understanding (MoU), which will be challenging to define but is achievable, as both sides want to manage stability risk. The UK is also considering its own equivalence decisions regarding the EU and other third-countries. A temporary permission regime that will operate after the transition period should however alleviate any cliff edge concerns.

A regulator confirmed that the relevant MoUs between EU and UK regulators will be in place. Clearing remains a stability concern, so there will be time-limited equivalence after the transition period and ESMA and the Commission will ensure that clarity is provided on UK CCPs' recognition sufficiently in advance. The situation is different concerning MiFID trading obligations, which will not have stability implications and therefore can be managed without equivalence arrangements.

An industry representative regretted the persistent uncertainty about Brexit that impacts many policy discussions and hoped that next year will bring some certainty relative to the future relationship. This also requires having a discussion about whether there exists a similar strategic view on how to regulate financial markets and the effects of regulations on the firms operating in the market.

A market observer noted that three main issues come into play in discussions about cross-border operations. One is financial stability, the second is consumer protection which can also be part of stability and the third is competition issues.

Regarding the preparedness of financial firms and possible cliff edge risks, an official explained that firms reacted to the news about the delay on MiFID equivalence by assuming that there will be no deal, so they have been preparing for this scenario. Client readiness challenges seen during dry runs are still being tackled, but there are no financial stability risks related to a possible immediate cliff edge, since there is now a better understanding of risks and more transparency about how they can be managed than in the earlier stages of the Brexit negotiations. The wider economic situation was not anticipated however, and authorities are monitoring this as well. A regulator confirmed that public and private sector stakeholders had had ample time to prepare for a no-deal scenario and thus ought to be ready now.

2. The risk of regulatory divergence between the EU and the UK

2.1. Short term situation

Regarding the possibility of regulatory divergence, an official stated that the UK has set out its post-Brexit approach to existing and planned EU regulations and their implementation. There has been much debate about the UK's intentions, hence the need for clarity. The main area where the UK intends to review the acquis is Solvency II, as this includes areas of challenge for the UK such as risk margin and matching adjustment. This will be done progressively starting with a call for evidence that will be launched later this year.

In addition, the UK will not implement the MREL[1] component of the new Bank recovery and resolution directive (BRRD) as it has its own framework, the Central Securities Depositary Regulation (CSDR), some Securities Financing Transaction Regulation (SFTR) reporting requirements and the requirement of the Investment Firm Regulation (IFR) for firms to re-authorise under the new regulation. These changes are quite measured in the UK's view and constitute in no way a 'bonfire of regulation'. The UK moreover intends to be as transparent as possible about the decisions made that will be based on cost impacts as well as the broader strategic context of the market.

2.2 Longer term evolutions

An official noted that in the longer run, the UK will not be mapping detailed changes to the EU acquis as it evolves, since these changes will be negotiated between member states without consideration of UK needs. The EU and UK will however continue to share similar challenges and operate in similar risk environments. It is likely that the policy thinking of the UK in areas like sustainable finance, crypto assets and technology for example will stay close to the EU's and that both will be aligned with the international debate in these areas. It will also be interesting to see if the absence of the UK

[1] Minimum requirement for own funds and eligible liabilities (MREL).

changes anything to EU policy decisions in the capital markets area in the future.

A regulator considered that although political decisions will be made on regulatory alignment and possible divergences, because the EU and UK are sovereign, regulators will need to continue cooperating within that framework, because the UK will continue to be important for EU financial markets, and cooperation is vital for effective supervision and regulation.

An industry representative stated that there has to be a step back from the political FTA negotiation. Financial policy issues should be considered from a global standpoint, without opposing EU and UK perspectives, because the financial market is global and many financial firms and their clients operate globally. The proposed EU pandemic emergency measures in particular, which include changes to MiFID II, raise some questions in this regard. For example, issues like commodity derivatives position limits that took months to negotiate may apparently be scrapped by the EU with the intention of creating an energy commodities derivative market. If the EU rulebook is changed significantly as a result it will be difficult for the EU to argue that global rules must conform with their rules.

3. Expected evolutions of the financial sector in Europe post-Brexit

3.1 Impacts of Brexit on the structure of the European financial sector

A market observer emphasized that although the final outcome of the Brexit negotiations is unknown (at the time of the panel), passports will disappear and it is expected that 40 to 60% of UK-based bank balance sheet assets could be affected. €300 billion of banking assets have already flowed from London to Frankfurt, with another €100 billion likely to be transferred by the end of 2020 and a further €400 billion are ready to move. In addition the clearing of close to 20% of euro-denominated interest rate swaps has been transferred from London to Frankfurt, with costs on par for market participants.

An industry representative agreed that Brexit will cause further business restructuring towards Europe and additional transfers of people and activities. The challenge is to manage these transfers without creating frictions. This can be addressed thanks to technology to a certain extent, but it is a complex process requiring changes to a huge amount of legal relationships between banks and their clients.

An official, referring to the title of the session, believed that the EU will not have to manage without the City, since it is not going anywhere, although frictions in the relationship will increase. The UK financial sector is competitive, open and safe and will continue to be so. In addition, the official believed that moving a significant part of business to the euro area, beyond the transfers underway, would be complex and may not be justified in terms of efficiency. Fragmentation is inevitable but has many angles that will require to be closely monitored in the future. The main shift of clearing activity to the euro area concerns at present euro-denominated government securities, which makes sense. Most of the rest will remain in the UK due to efficiency considerations. Capital fragmentation occurred as banks set up entities in the EU to mitigate the impacts of a no-deal exit, but the impacts on non-bank assets are more difficult to establish, as the sector is more complex and global norms favour managing portfolios cross-border. As for jobs, impacts are limited due to the use of technology and effective cost-cutting in the UK. Job moves out of the UK into Europe due to Brexit should be under 10,000 out of a total of about 300,000 people employed in financial services in London. Impacts on liquidity also need to be considered because of the consequences for the funding of economies, for investors and also in terms of competitiveness. Finally the official stressed that the main question raised by market participants is not about fragmentation within Europe, but globally. It will be vital to assess the possible movements of activity, assets and liquidity from Europe to the US or Asia in the future rather than trying to 're divide the pie' regionally.

Another market observer was convinced that there would be further changes in the financial activities conducted in the EU and the UK. A great deal of change has already happened with legal entities built in the EU in areas where equivalence arrangements are not available, such as banking, insurance or some parts of asset management. The ECB SSM has clearly indicated that banks would have to progressively move operations to the EU and the corresponding bulk of responsibilities and operations, in order to avoid disruptions. Equivalence arrangements will be negotiated, but careful evaluation is needed to ensure that financial stability and control of the liquidity of the euro can be preserved. Other aspects that need to be considered in this perspective include the delegation of asset management responsibilities. ESMA has advised the Commission about the conditions for the delegation of core functions and the need to ensure that a critical mass of effective management is performed in the EU. Back-to-back operations are another issue. The ECB allows back-to-back operations, but this should not result in the main part of the euro market being outside the EU, which would not be acceptable from a financial stability perspective.

3.2 Potential impacts of Brexit on the competitiveness of European financial markets

An industry representative stated that the main issue for third-country financial institutions concerning European financial markets is their competitiveness. It is at risk with Brexit and this may lead capital to be reallocated from Europe to the US or Asia. EU and UK legislators and regulators must cooperate in order to reduce disruption to the financial industry at the end of the transition period. London is one of the biggest financial markets globally and will remain prominent, acting as an investors' gateway for Europe, the Middle East, Africa and Russia. It is not clear at this stage whether a financial centre in the EU is able to challenge this position in the future. In addition, which EU or UK financial centre 'wins' is secondary from a global perspective. London's attractiveness ranking has deteriorated to number two since the Brexit referendum and is now close to Tokyo, Singapore, Shanghai and Hong Kong. Regional economic growth is another factor for third-country financial institutions. Recent GDP growth in Asia-Pacific (APAC) is around 5%, compared to 2% in the US. That is before COVID-19, but Asia will be better positioned than Europe. A second element is each market's scalable opportunity. The US is the biggest capital market with $39 billion in 2019, Europe is second with $15 billion and APAC third with just $13 billion. Third is capital efficiency, which is lower in Europe Middle East Africa (EMEA) than in the US and Asia, due to an average cost-to-income ratio of European banks 10-20% higher than the US. Varying regulatory regimes and market uncertainty in the EU make this worse.

Another industry representative emphasized that activities such as share and derivative trading should be approached differently from interest rate swaps clearing in the equivalence discussions. While ensuring financial stability in the clearing area and sovereignty over instruments such as euro-denominated swaps is important for the EU, there is a risk of valuing a market structure objective over the competitiveness of European financial providers in other discussions about equivalence (e.g. concerning share and derivative trading obligations). European financial institutions could be placed at a disadvantage in this case without achieving any useful objective in terms of price discovery or liquidity. Ultimately, liquidity cannot be mandated in one direction or another. Markets evolve and seek the place where there is the least friction.

A third industry representative agreed that capital is global, and people can choose where to access it. Competition is good, but liquidity cannot be trapped or forced. It comes through genuine, superior systems, so it is good if standards rise globally. This is what clients need, so market participants must 'cut the politics and get on with it'.

An industry representative stressed that cost implications should not be forgotten in the discussions about Brexit and equivalence, because the complexity of doing business in the current environment is increasing for financial institutions, with geopolitical challenges and the economic consequences of the pandemic. Market volatility is also expected to increase given the current divergence between market valuations and the real economy, potentially leading to significant price correction in the near future. Prolonged negative interest rates are impacting bank profitability, at a time when banks also need to invest in new digital business models. The increasing substitution of fiscal policy through monetary policy is also leading central banks to lend directly to the real economy, in competition with banks. Caution is advised that these temporary measures designed to relaunch growth do not become permanent. The more structural and long term these actions become, the higher the challenge will be to exit them and private investment must continue to be encouraged. This difficult environment however also offers many opportunities, provided policies are appropriately focused on what is needed to support the funding of the economy in the long term.

A market observer suggested that efficiency impacts should be approached more holistically. Costs not only occur on banks' accounts, but also on state budgets. A 'scaremongering' figure of €100 billion additional costs for moving European bank activities to the EU was put forward. Today there are no significant costs, with further stability and competition benefits, so well-chosen fragmentation can add to stability and competitiveness in the market. Moreover concerning clearing, given the importance of financial stability, standing on two feet (the EU and the UK) is eventually better than on one that is difficult to control.

3.3 Implications of Brexit and the Covid crisis for the Capital Markets and Banking Unions

An industry representative emphasized the importance of the Capital Markets and Banking Union initiatives for strengthening the European financial ecosystem and commented on their factors of success in the present context. Banking Union may foster further, much-needed, banking consolidation, with important benefits for consumers of financial services. CMU also offers many opportunities, such as the possibility of providing consumers with easier access to capital markets, increasing market liquidity and depth across the EU and also reducing the complexity of cross-border investment. At present EU households only hold about 20% of financial assets in equities compared to around double that percentage in the US, showing that there is a strong potential for private investment in the real economy besides that provided by central banks. Realising the benefits of these initiatives in terms of economic growth and competitiveness of the European financial sector vis-à-vis the US or Asia however requires a focus on the role of financial services in the funding of the economy rather than on protecting EU markets. In addition, it is necessary to understand that the benefits of these initiatives will take years to realise, so time is of the essence. There needs to be a win-win situation for member states participating in these initiatives, who should not feel that their national interest is diminished by a European level project. The same goes for third-country participants who can play an important part in the CMU by facilitating global capital flows to the EU if they benefit from an appropriate equivalence regime.

Another industry representative considered that in a context of mounting conflicts among countries, Europe should return to the basic strengths of its financial market, which are to be international and competitive.

A market observer noted that the Covid crisis created a push towards digitalisation and solidarity in Europe that even surprised optimists. This may be the early days of a safe asset class that could accelerate the creation of a new common capital market and the completion of the CMU. Europe has grown under stress in the past and there is room for optimism.

4. Improvement of the EU equivalence system: initiatives underway and possible additional needs

A regulator stated that equivalence is a tested regime that has been widely applied, particularly for capital market activities, and has recently been reviewed also in the context of Brexit. The process takes time to implement but once it is granted it is generous, providing third-country entities with the possibility to fully participate in the single market. There has also been recognition that this process has helped to reduce fragmentation.

A certain number of limitations of the current EU equivalence system were discussed by the panellists, as well as the initiatives underway for addressing them.

4.1 Reliance on third-country supervisors

A regulator stressed that a key limitation of EU equivalence arrangements is the reliance on third-country supervisors, who might overlook certain financial stability risks for the EU. The EMIR 2.2 reform addresses this issue for CCPs with a more elaborate regime for the supervision of systemic third-country CCPs, which is currently being implemented. The possibility of supervising third-country market participants in certain cases is also reflected in the IFR regulation where ESMA is endowed with certain quasi-supervisory tasks regarding third-country investment firms, provided there is equivalence regarding UK investment firms offering services in the EU. As a result of changes to their founding regulations, the responsibilities of the European Supervisory Authorities (ESAs) regarding the monitoring of third-country supervisory frameworks have also been increased. This will help the ESAs to monitor changes to the regulatory and supervisory system in third countries and any implications for equivalence, which is crucial with the UK continuing to be an important market for the EU.

4.2 Outcomes-based equivalence determination

Several industry representatives on the panel emphasized that equivalence determination must evaluate the outcomes of legislations, rather than compare regulations line-by-line. One representative suggested that equivalence means that the 'direction of travel' is the same, although the details of legislation may differ. This idea is reinforced by the fact that EU legislation is evolutionary and is periodically reviewed. Another representative was in favour of 'reasonable equivalence' comparing outcomes, which is less costly than the US-type line-by-line compliance arrangements. A third representative suggested that equivalence determinations should consider the outcomes of third-country regulations against internationally agreed standards, rather than comparing local regulations line-by-line. If requirements stem from global standards, equivalence should be presumed. This will facilitate equivalence determinations, lead to more harmonisation and help to level the playing field. Several speakers were also in favour of international cooperation and stronger international institutions in order to facilitate the implementation of global standards and reduce fragmentation.

Other speakers on the panel stressed that the present EU equivalence process is already outcomes-driven and is not a line-by-line comparison. The process, which does not cover all financial sectors, has recently been reviewed by the Commission in order to provide more transparency.

A market observer pointed out that the EU's approach is to assess whether rules broadly match up, and is not a line-by-line comparison, as in US, where equivalence means exactness. Although it would seem logical to use global rules as a reference, this is not possible at present, because there are no binding requirements to use international standards. One issue that needs to be avoided is the politicisation of this process, which should be a technical exercise. Another market observer agreed that strong international institutions are needed. Much work is being done by IOSCO and the Basel Committee among others but fragmentation cannot be avoided, because the US in particular is not in favour of multilateral cooperation at present. When the 'political heat' about Brexit is down, informal cooperation between the EU and the UK will be possible.

A regulator noted that although outcome-based equivalence determination seems desirable as a principle, it is not always compatible with the maintenance of a level playing field and risk mitigation. EU regulatory and supervisory requirements have become more granular over time, moving from directives to regulations, because this matters from a risk perspective and also reduces regulatory arbitrage and costs within the EU, which is necessary for a well-functioning single market. This is not relevant for all financial market activity, but in some areas details are very important. For example it is difficult to conduct outcome-based assessments of margining models, which determine clearing costs. There would be an unlevel playing field when a member state leaving the single market could re-access the single market as a third-country via equivalence evaluated on a high level, while the EU member states would need to continue to respect granular requirements. Fragmentation is an inevitable result of the UK leaving the EU. Detailed assessments of third-country standards and supervision should be limited as much as possible in everyone's interest, but they will be necessary in certain cases.

4.3 Unilateral decisions

An industry representative was concerned by the possibility of withdrawing equivalence arrangements unilaterally, as this poses a material risk to business continuity and may threaten the funding of the European economy.

A market observer believed that there is no room for discussing the key concepts of equivalence, such as its unilateral nature. Equivalence must remain unilateral so that regulatory and supervisory convergence can be judged at all points in time and discontinued if this is no longer the case. This contributes to preserving the interests of the EU, so it is outside the FTA framework. Informal discussions will nevertheless take place with third-country partners about the process and also possibly about some legislations. For example, if the UK reviews the Solvency II framework in an appropriate way (i.e. with an approach that is not unfairly competitive and does not create new financial stability risks), this could push the EU to make some improvements as well and help to find a convergence point. ■