European Shadow Financial Regulatory Committee
(www.esfrc.eu)

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How to Mitigate the Shock of Brexit to Financial Services in the EU

Most ways to resolve the current stalemate in the UK parliament with respect to Brexit imply that the UK will no longer be part of the internal market for financial services. There is a risk that capital market services in the EU-27 will decline in scope and quality without the UK in the internal market but this risk can be mitigated. We propose that the EU and the UK form a joint high-level committee to develop proposals for simplified and better regulation that strengthens market discipline. Even without such a committee the EU-27 should take the opportunity to reduce the regulatory burden for suppliers of capital market services. Finally, we suggest that the EU and the UK jointly work to enhance and improve equivalence requirements for suppliers of financial services to markets in both the UK and the EU.

The members of the European Shadow Financial Regulatory Committee (ESFRC) unanimously share the view that the decision of a slight majority of voters from almost three years ago to leave the EU is regrettable. The inability of the UK Parliament to decide on conditions for Brexit is likely to cause serious damage to the British economy and hurt the rest of the EU as well. Much depends, of course, on the decisions that need to be made in the coming days. From a purely economic and financial perspective the best course of events would be if the British government revokes Article 50. Alternatively, the UK leaves without a deal or the agreement signed by the UK Government and the EU will be accepted. Some combination of the current agreement and the prospect of a customs union could also be acceptable for the EU. These versions of Brexit have in common that the UK will stand outside the internal market for financial services.

In this statement we address the future relationship between the EU and the UK in the area of financial services with an emphasis on capital markets. We will not discuss the possibly severe consequences of Brexit for British banks, London as a financial center and the British economy as a whole. Our focus is on the implications of Brexit for the financial system and the supply of financial services to firms and households in the remaining EU-27.

The severity of the consequences of Brexit depends strongly on how the involved parties respond to the new situation. Both British banks and foreign banks operating in London have already made plans to relocate some of their activities and their staff to other cities. In this situation it is up to the EU to prepare for a Brexit in the form of an end to the joint financial market. What are the challenges and options for the EU? How can the damage best be kept within limits and is it possible that Brexit will offer opportunities for capital market developments in the remaining EU-27?

We address three specific topics to suggest ways forward for the EU-27: the historical contribution of the UK to the effectiveness of capital markets in the EU, benefits of capital market integration and the costs of substituting equivalence requirements for mutual recognition.

Contributions of the UK to markets for financial services

Substantial steps have been taken towards common rules and supervisory practices in the EU; mainly in banking and to a lesser extent in capital markets. Regardless of which Brexit scenario prevails, the position of the ESFRC is that the future EU-UK relationship should preserve and promote the integrity and stability of the European financial system in the global economy. Unfortunately the Brexit process has slowed down progress towards a Capital Markets Union and cooperation between national supervisors has stalled.

Europe needs a new narrative for the financial sector to promote growth and prosperity. Going forward this means relying relatively more on market-based financing rather than bank financing, which has been the pattern in the past in most EU countries.

The UK and the EU-27 have a good record in developing a market-based approach toward capital market integration as embedded in the Capital Markets Union project. The UK had a major input in this agenda ever since the Lamfalussy initiative on streamlining securities markets regulation almost 20 years ago. The influence of the UK in the EU regulatory process has been beneficial in terms of promoting market discipline, greater accountability and transparency.

The Capital Markets Union would bring the Continental approach to financing individuals and corporations in line with the more diversified Anglo Saxon approach. Capital markets cannot be regulated in the same detail as banks: the prime task of the regulator is to facilitate the developments of new market structures and infrastructure based on principles and supervisory cooperation rather than to develop a detailed common rule-book. Inadequate development of venture capital and excessive reliance on public provision of pensions are two areas where changes remain desirable in Europe to create vibrant financial markets. Indeed, smoothing the intermediation process from savings into long-term investments via pension funds and insurance companies, removing restrictions and facilitating business rather than strictly regulating them, can help advance this positive narrative.

Benefits of capital market integration

From an economic perspective, capital market integration is the preferred alternative to segmented or fragmented capital as more efficient in offering depth and liquidity, increased efficiency in trading, arbitrage and hedging strategies. With Brexit there is a high likelihood that securities markets in the EU and the UK will become more fragmented as a result of lack of mutual recognition. An example is the proposed requirement that EU registered investors will have to trade the 14 largest UK shares as well as 6,200 other share on the exchanges of one of the 27 member states, thereby splitting up liquidity between these two markets.

To improve the quality of capital markets within Europe the EU has made some advances to create a capital market union (along with a Banking Union). Even with the UK in the EU, Europe remains far from having integrated capital markets and substantial market fragmentation remains. Since one objective of the EU has been to shift some of the investing and financing activities from banks to capital markets, substantial efforts are still required to support integration of the capital markets by lowering regulation, access to capital etc. After Brexit the need to develop, strengthen and unify capital markets within the EU becomes even greater since much of the capital market activity to date has been concentrated to London.

Ways forward

One way forward is to maintain bilateral recognition of EU and UK exchanges as well as clearing and settlement, as before Brexit. Since this may not be politically viable, and a common regulator might be unacceptable, some other measures, such as a jointly appointed oversight board could be useful to ensure the proper functioning of the markets. Given the complexity and uncertainty underlying the Brexit process, there is a need to foster further cooperation between the EU and the UK supervisory bodies.

A dedicated high-level committee including the major financial authorities of both the EU and the UK (ECB-SSM, BoE, ESAs) could be established. This Committee would propose recommendations to deal with the current weaknesses of the EU framework towards more a simplified, better regulation and enhanced market discipline. The committee would make proposals to modernize financial intermediation and move towards a less bank-based system as a response to global competition and a need to improve interactions with the US and other emerging players in the financial markets. This Committee could also serve in a monitoring role for the benefit of the common interest.

With or without such a committee the EU should consider streamlining regulation by reducing the regulatory burden when costs exceed the benefits. Otherwise fewer companies will go public and more companies will be taken private all over Europe. This will force companies in need of equity funding to go for more expensive outside capital market funding sources such as private equity, which could weaken public equity markets.

Regulatory equivalence

The outline of the political declaration setting out the framework for the future relationship between the EU and the UK has only three paragraphs on financial services. The principle of regulatory equivalence is recognized in Part II: Economic Partnership-Financial Services.

- Commitments to preserving financial stability, market integrity, investor protection and fair competition, while respecting the Parties' regulatory and decision-making autonomy, and their ability to take equivalence decisions in their own interest. This is without prejudice to the Parties' ability to adopt or maintain any measure where necessary for prudential reasons.

- Commencement of equivalence assessments by both Parties as soon as possible after the United Kingdom's withdrawal from the Union, endeavouring to conclude these assessments before the end of June 2020.
- Close and structured cooperation on regulatory and supervisory matters, grounded in the economic partnership and based on the principles of regulatory autonomy, transparency and stability, recognizing this is in the Parties' mutual interest.

The UK will become a third country upon exiting the EU and, thus, it will be governed by the third-country regime, which currently relies on regulatory equivalence as opposed to mutual recognition. The EU equivalence regime has serious disadvantages relative to mutual recognition as a way to govern the regulatory relationships between the EU and third countries. Mutual recognition can be viewed as an instrument to promote regulatory convergence based on reciprocity of treatment; generally on the basis of prior minimum harmonization, which is still a cornerstone of the Single Market in financial services. EU regulatory equivalence, on the other hand, depends on unilateral decisions by the European Commission applied on a case-by-case or sector-by-sector basis. It is limited to a specific subject and country for a renewable period and, thus, temporary. Decisions may be politically motivated and subject to unilateral withdrawal. A UK equivalence regime will similarly be unilateral.

A serious problem with equivalence is that if it is refused, there is no appeal mechanism and the grounds for refusal will remain unknown to the wider public. Thus, equivalence is likely to be used as a technique to protect the European interests against the interests of third countries, which would include the UK post-Brexit. Naturally, in the case of a UK equivalence regime, the UK can use it similarly. Equivalence is, therefore, not as reliable and predictable as the principle of mutual recognition.

We endorse a regime of enhanced equivalence, 'super-equivalence' or 'equivalence plus' with a broad cross-sectoral scope (since banking is currently not included when it comes to the traditional banking functions: lending, deposit-taking and payments). Enhanced equivalence should contribute to greater reliability, transparency, flexibility, independence, technical expertise and consistency in both the initial determination and the withdrawal so as to protect consumers and confidence.

Given that the Withdrawal Act 2018 states that all EU law will become UK law on Brexit Day, divergences in implementation and interpretation by the Courts of Justice will only happen after Brexit Day. The starting point of identical regimes on Brexit day should facilitate comparable approaches to compliance in the UK and the EU-27.