Can the EU manage without the City?

Katharine Braddick

Director General, HM Treasury

How are EU-UK financial relations expected to evolve post-Brexit?

The United Kingdom and the European Union have a long, shared history in financial services regulation. We can, and should, build on that history as we tackle the challenges of the present and of the future. Whatever the outcome of the current negotiations on the future relationship, I am confident that we will remain close partners on the issues that will face, and indeed are facing, the financial services sector, legislators and regulators – and most importantly consumers.

I do not think it is hyperbole to say that we are living through a period of unprecedented technological change, and the challenges and opportunities posed by rapid technological innovation are a good example of a space in which we will continue to work together.

The growth of cryptoassests, including stablecoins, is a case in point. This new technology transcends national borders and demands cooperation by the international community if we are to understand the risks it presents and the future role it may play in the financial system.

Research from the Financial Conduct Authority shows that only 5% of British consumers of cryptoassets, including stablecoins, use UK-based exchanges for buying and selling. Of the top five exchanges used in this country, only Binance has a European Union or United Kingdom domicile – the others are based in the United States or Hong Kong. The picture is similar in the rest of Europe.

In the United Kingdom we are working through the G7, G20 and the Financial Stability Board to build consensus on regulatory approaches to global stablecoin and I know that the European Union will be too.In 2018 the United Kingdom's Cryptoasset Taskforce – HM Treasury, the Bank of England and the Financial Conduct Authority – published a paper discussing the opportunities and risks presented by blockchain technology and to consumers.

One of the principal risks is the familiar conduct challenge of consumer detriment arising from inadequate information and we have moved to address this by bringing cryptoassets into scope of anti-money laundering legislation and consulting on the inclusion of certain cryptoasset promotions in financial promotions rules.

The UK will work with partners to ensure that the world's financial system remains safe.

These rules are enforced by the Financial Conduct Authority and backed by criminal sanctions. Looking further ahead, the UK Government has committed to consult on a broader regulatory approach to cryptoassets later this year.

The European Union faces the same risks and questions as the United Kingdom and a Commission proposal for an EU crypto asset regime is widely anticipated. As we move forward we can continue to learn much from each other's approaches, which will be geared towards the same goals: protecting financial stability, protecting consumers, and ensuring that the financial services sector continues to drive growth.

The United Kingdom and the European Union will continue to be members of the same international regulatory organisations, working together with other partners such as the United States and Japan to ensure that the world's financial system remains safe, stable and effective. We look forward to working together with our European partners in the future. ●

Christian Noyer

Honorary Governor, Banque de France

EU-UK Financial relations post-Brexit: where are we heading for?

To understand where we might be heading for after Brexit in the domain of Financial services, one needs to remember what the Single market is all about.

When it was created, the key consideration, strongly supported by the United Kingdom, was the following: if you have a single regulation, with a single jurisdiction providing for a single case law, then you can have a single market, wherever actors providing services are located.

Within the single market, the UK succeeded in developing the City of London as the major EU financial center, which progressively attracted most of the international institutions that were until then operating in several places on the continent.

Later, we realized that having a single market without a single currency was creating significant problems of all kinds. We then decided to include in the EU institutional setup a single currency and a single central bank, although the UK decided to stay out.

Nevertheless, because of the single market rules, there was no obstacle to the concentration of market operations of the single currency in London : most trading rooms that were active in major financial places (Frankfurt for the DEM, Paris for the FRF, Milan for the LIT…) concentrated in London (in fact, only a few remained in Paris, but nowhere else). We then came to an extraordinary situation, where the market liquidity of the Euro was dominantly outside the reach of the issuing central bank, the ECB-Eurosystem.

After the Global Financial crisis, we realized that we had missed another important aspect, which was the risks for Financial stability stemming from a diversity of regulators and supervisors, who in extreme circumstances, might give preference to national interests rather than the interest of the EU – or, as it might be, of the Eurozone - as a whole.

It was then decided to add two major institutional setups: the creation of four supranational regulators and the creation of a single “federal supervisor”, the single supervisory mechanism.

The problem we are facing today is not only that the UK is formally leaving the EU. It is that it has decided to diverge from EU regulations in the future, to refuse the case law of the European Court of Justice. and not to be submitted to the supranational regulators just mentioned.

Therefore, it is just impossible to accept that London would remain the financial center of the European Union. That would create unbearable systemic risks that we can simply not stand. No country in the world, no central bank of systemic importance, would tolerate not to be in control of the liquidity of its currency, and of the major financial players of its own market. In effect, there is no choice than to organize the migration of the bulk of financial services from London to the EU.

The EU has no other choice than to force the relocation of most of its financial sector.

Part of it has already happened, and the movement will continue, according to the decisions that will be taken by the European Commission, the Supranational agencies, and the various regulators, including in particular the ECB/SSM. For instance, trading activities will have to move during the coming years, as well as asset management activities, and the extend of back-to-back operations and delegation will need to be progressively limited.

Is there a risk, as is often advocated, for the funding of the EU economy? I do not believe so. The players will remain the same, they have started to migrate their operations, with the key objective of continuing servicing their clients at the same level of quality. Is there a risk of fragmentation across several financial centers? There will be most likely less concentration, although the bulk of activities will tend to concentrate in a limited number of financial places, in particular for market activities.

But most importantly, with modern technology, a certain diversity of locations does not mean that the market cannot function in an integrated fashion and provide the best level of liquidity. ●

James von Moltke

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Building an open and competitive financial market for Europe

Brexit comes at a time of dramatic change. In COVID-19, the world is confronting one of the great peacetime challenges of the modern age. Digitalization is transforming our personal and professional lives, and the pandemic will accelerate the pace of technology adoption. Relationships between the world's superpowers, the US and China, are increasingly strained.

As Europe strives to assert its place in a more competitive and uncertain world, well-functioning financial markets are vital for the strength and competitiveness of Europe's economy. Designing Europe's financial markets to thrive in the post-Brexit environment represents a challenge, but also an opportunity.

In the near term, continuity is key. For over 40 years, the City of London has been Europe's financial center. Financial services firms and their clients will need to adjust their activities and manage the complexities inherent in providing services across borders previously covered by single market passports. Supervisors will need to establish new modes of cooperation and regulators will have to deploy equivalence to avoid unnecessary disruption.

This transition will not be without cost or effort. Financial firms and businesses have already spent tens of millions of euros preparing for Brexit, and goodwill is necessary on both sides of the channel. Our goal must be to ensure that, as Europe's economy recovers from the impact of the pandemic, businesses across the EU continue to have access to financing and risk mitigation opportunities through deep, liquid and well-diversified financial markets.

In the short term, many of these markets will remain in the UK. Closing the door to EU firms accessing these markets – ie through the operation of trading obligations in the absence of equivalence - will do nothing to promote the attractiveness of EU capital markets. It may, however, make financial market access narrower and more expensive. Avoiding permanent frictional costs and loss of EU market efficiency is key. Equivalence needs to be understood with this goal in mind.

Brexit, however, needs to be more than a near-term challenge. In the longer term, it can serve as a catalyst for the development of an ambitious, strategic vision for an open and competitive European financial market. One which is integrated with other capital markets across the globe: an essential enabler of economic recovery post-COVID, the shift to a low carbon economy, and Europe's efforts to remain competitive in a fast digitalizing world.

The path to achieving that goal will require delivery of an ambitious Capital Markets Union (CMU). Furthermore, given the unique role that banks play in the financing of Europe, it demands further progress on Banking Union. The removal of intra-EU regulatory barriers and further harmonization of rules relating to trade and post-trade activity is an essential pre-requisite to further development of Europe's sub-scale capital markets.

That is the prize that CMU can deliver - for Europe's businesses, investors, governments and supranational institutions. Also, in this context, discussion of a Financial Transaction Tax must take account of the added cost for businesses accessing much-needed capital, and the risk of eroding the competitiveness of Europe's financial markets.

Managed correctly, Brexit can be an opportunity for Europe.

For EU financial markets to flourish, however, we will need European market makers – banks with the scale and capital to support trading activity – and a prudential regime that is calibrated to support that role. This is what the completion of the Banking Union can offer. By clearing the path to a true single market for banks, and removing barriers to free movement of capital and liquidity within EU banking groups, it will support overdue consolidation in the banking sector and greater resilience and profitability.

Managed correctly and combined with a clear vision for EU financial markets, Brexit could be an historic opportunity for Europe. To grasp that opportunity will, however, require co-operation across international borders and decisions that supersede national interests. It will require political courage, ambition and a pragmatic approach to regulatory cooperation. Defining our vision for Europe's financial markets, and moving swiftly and decisively to turn vision into reality, is all-important, given the uncertainties and competitive pressures facing Europe in the 21st century world.

Markus Ronner

Group Chief Compliance and Governance Officer, UBS

A healthy financial ecosystem to strengthen the European recovery

As the world emerges from the initial phase of the COVID-19 pandemic, it is clear that the consequences will be far reaching. The IMF now predicts that global GDP in 2021 will be 6.1% lower than projected prior to the pandemic, while global government debt is predicted to reach a record high of 101% of GDP. In these circumstances, Europe needs to pursue a strong and coherent strategy to recover from the recent – and indeed previous – crises and address long-standing structural issues. An efficient banking and capital market system will be a prerequisite for this strategy to succeed.

> *A clear strategy to boost integration of the banking sector and deepen EU capital markets will help to finance the recovery.*

Overall, banks performed well in responding to the crisis, with high levels of capital and liquidity as well as operational resilience. However, in order to fulfil their role of supporting the economic recovery, banks must contend with several key challenges. The first is a further prolonged period of negative interest rates as the ECB continues to pursue a very expansive monetary policy. This further aggravates a situation in which most European banks were already struggling pre COVID-19: Eurozone banks' Net Interest Income was 45% lower at the beginning of 2020 compared to 2007. Thus, revenues from traditional banking activities have been significantly squeezed. The second key challenge is the extension of credit by the unregulated non-bank financial system: According to the Financial Stability Board (FSB), non-bank financial, or shadow banking, activities in a narrow sense have grown by almost one-third over the last decade to 59% of GDP. The FSB also finds that almost three-quarters of these investments are held in instruments "with features that make them susceptible to runs". Despite the risks it poses to the financial system the non-bank sector is not subject to the same standards of regulation as the traditional banking sector which also leads to less transparency and an increasingly unlevel playing field.

The pandemic will also lead to substantially higher Non-Performing Loans, an increase in bank funding costs and, over time, additional costs for liquidity buffers. As a consequence, European banks will struggle to return to sustainable profitability and generate attractive returns for investors. The market is already pricing this in: In the first six months of 2020, Eurozone bank valuations had on average deteriorated by one third whereas most broad market indices were only down by single-digit percentage points.

In response to these challenges, policymakers and banks need to take joint action to strengthen the European financial ecosystem. This should involve the following:

- Further integration of the European banking sector by completing the Banking Union, demonstrating that this is a win-win for all EU countries. Removing barriers to cross-border consolidation should therefore be a priority, in particular eliminating regulatory fragmentation across the EU, including different national regimes for many prudential, accounting, insolvency and AML rules, as well as excessive limits on the fungibility of capital and liquidity within a banking group.
- A clear strategy to deepen Europe's capital markets and diversify sources of finance. It is well known that capital markets in the EU are only around one-third as deep as in the US, but even more importantly, while US capital markets have grown relative to GDP over the past decade, they have shrunk in 80% of EU member states. Deepening European capital markets in a transparent manner, with appropriate regulation for non-bank financial services, will provide greater resilience to the economic cycle and to idiosyncratic shocks such as COVID-19.
- A pragmatic and open approach to market access for third country participants. Third country banks can play an important role in deepening the CMU by facilitating global capital flows to the EU. This will allow Europe to benefit from investment from jurisdictions with deeper and more liquid markets, boosting innovation and competition. Equivalence is an important part of this, which should be outcome-focused and take into account relevant international standards.

This strategic approach, alongside an enabling regulatory framework, will support the European banking industry in adopting the new business models that the digital revolution demands. Together with deeper and more vibrant European capital markets this will help to create a healthy financial ecosystem to strengthen the European recovery.

Shinsuke Toda

Managing Executive Officer, Head of EMEA, Mizuho Financial Group, Inc. / Mizuho Bank, Ltd.

Regulatory fragmentation may affect allure of City for international banks

Our view is that the City will not lose its position as an international financial centre, at least in the immediate aftermath of the Brexit transition period, due to the significant financial market infrastructure and depth of talent that exists and will remain in the City. London has historically been the gateway for third country investors to access the whole of the EU market, but, in the mid to long term, with that access potentially being severely restricted, such investors may need to consider entering through an EU hub as well, or instead.

Third country banks primarily consider the economic growth of a region, the size of its capital markets and its overall attractiveness when deciding whether to continue to invest there. Real GDP growth on an annual basis for the APAC region is around 5% in recent years, being a key driver of the world economy, whilst the US and Europe's figure is around 2%.

However, in terms of the scale of the opportunities in capital markets (by reference to the annualised fee pool), the US is the biggest (USD 39 billion in 2019) due to developed capital markets through a large single market with no territorial boundaries, followed by Europe (USD 15 billion), and then the APAC region (USD 13 billion).

According to the Global Financial Centres Index (GFCI), which measures five broad areas of the competitiveness of a city for business (business environment, human capital, infrastructure, financial sector development, and reputation) London lost its top position in March 2019, which seems likely due to Brexit considerations. Financial cities in the US and APAC region have consistently occupied the top 10 places in the GFCI.

When considering our global operations, it is clear that capital efficiency in EMEA business is inferior to that in the US and Asia. For example, the average cost to income ratio of European banks is around 10-20% higher than that of US banks, which itself is around the same factor higher than for APAC banks.

The increased costs associated with regulatory and market fragmentation, for example operational overlap and higher transaction and compliance costs due to varying regulatory regimes, will further impact the strength and efficiency of European banks – and thus make the overall region less attractive for third country firms to invest in. Third country entities may look to allocate capital elsewhere if their EMEA business is not sufficient to maintain sustainable growth as part of their global operations.

Therefore, it is expected that EU and UK legislators and regulators will work closely to ensure there is as little disruption as possible to the financial services industry at the end of the transition period, as they have been doing thus far. Market participants would want a harmonised regime to avoid fragmentation and the increased regulatory and operational burden that comes with it.

> *We urge policymakers to adopt outcomes-based equivalence.*

The increased scrutiny and consequent increased risk of withdrawal of any unilateral declaration of equivalence as a result of the proposed enhancements to the EU equivalence mechanisms poses material risks to business continuity for market participants and the wider health of the European economy. There is an inherent paradox whereby compliance with internationally agreed standards does not necessarily result in the maintenance of equivalence.

Therefore, we urge policymakers to adopt outcomes-based equivalence, depending on whether third country regulations meet internationally agreed standards, rather than line-by-line comparisons to local regulations which may be gold-plated to global standards, for example KYC requirements. Where requirements stem from globally agreed standards, it is arguable that equivalence should be presumed until the contrary is proven.

This would be a step towards re-establishing the primacy of international standards, enhancing the global level playing field and reducing the cost and burden of regulatory fragmentation – all of which would also make European financial markets more attractive internationally.

Kay Swinburne

Chair of KPMG's EMA Risk and Regulatory Insight Centre (RRIC) and Partner, KPMG in the UK

Capital markets: open or closed?

Whether capital markets work best – most efficiently, effectively and safely – if they are open or closed is a long-standing policy debate. The high volatility seen in the early stages of the spread of COVID-19 has re-opened that debate yet again. The full economic impacts of the pandemic are not yet fully understood, but it is certain that businesses of all sorts will need to tackle debt burdens not seen on such a scale before.

The crisis has also highlighted that all business sectors are deeply interconnected across borders and that economies of all types and sizes are vulnerable. Financing channels – in particular, the capital markets – need to reflect this reality in order to help support recovery. Achieving sustainability goals, both environmental and social, will require additional and large levels of private funding.

In the face of such extraordinary circumstances, it is understandable that some temporary measures were introduced to protect capital markets and sovereign debt. They should be temporary. The building of more permanent protective walls around economies, including limiting access to national financial markets, must be avoided.

History has shown us time and time again that closed capital markets damage the very economies that officials are trying to protect. I sincerely hope that the debate within the EU will not be as stark as open or closed, but about whether access should be limited in anyway and the optimal degree of regulation.

In the retail markets, a greater degree of regulatory protection is understandable and necessary. In the wholesale capital markets, while customer protection should not be forgotten, the focus should be on financial stability, market integrity, fair competition and the prevention of regulatory arbitrage. To achieve this, there needs to be a commitment to developing deep constructive relationships with third-country regulators, including dialogue on enhancing supervision and coordination.

Clearing, for example, is a global business and is key to financial stability in the capital markets. Both globally and in the EU, the regulation around the recovery and resolution of clearing houses is consistently developing. The intention is that all market participants can plan for and will know how to act if a clearing house becomes distressed or starts to fail. Regulators are encouraged to work closely together in their supervision of clearing houses through regulatory colleges and crisis management groups, sharing information and helping ensure a smooth system. Strong regulatory cooperation is essential. To be truly effective it requires trust on both sides.

Access to EU markets largely falls under equivalence provisions. The equivalence process is meant to be outcome-based: assessments should be determined not only by reference to the content of law and regulation, but also considering the approaches of the respective parties to supervision and enforcement.

> *I would urge the EU to make a strong commitment to open and well-regulated global capital markets, in words and in action.*

Line-by-line analyses of a third country's rules can miss the point and, potentially, limit market access, adversely impacting EU economies, businesses and citizens. Barriers to capital markets will result in European corporates having less access to liquidity and choice, and potentially higher cost of financing, which will be a cost to the overall finance system.

This underlines the importance of regulatory dialogue and coordination. It requires a framework for strengthening the processes for granting and withdrawing access to and rights within the EU markets.

It should ensure greater legal and regulatory certainty, while protecting regulatory autonomy. It is also paramount that central banks and banking regulators co-ordinate actions to ensure they do not inadvertently jeopardise systemically important, global FMIs.

Regardless of the outcome of the negotiations between the EU and the UK, and ongoing discussions with other key third countries, I would urge the EU to make a strong commitment to open and well-regulated global capital markets, in words and in action. ●

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

Brexit and the changing landscape of EU financial markets

2020 has so far been a year that has been dominated by the impact of the global coronavirus pandemic, which has unprecedented repercussions for financial markets, the broader financial system and economies. One would be forgiven for overlooking the fact that back in January, Brexit was viewed by many as being the biggest challenge for the year ahead. In reality, the scale of the Brexit challenge has not changed, but the difference is that it is now taking place in the midst of a global pandemic crisis with far-reaching consequences, including for our financial markets.

On 31 December 2020, the UK's transition period after Brexit will come to an end. At the moment, we do not know how an agreement on the future partnership of the UK and EU will look, or even if one will be in place by the end of the year. However, we know that the landscape of the financial services sector will inevitably change significantly with the largest financial market leaving the EU single market.

With Europe's largest financial centre leaving the Union, the question of how this affects EU financial market policies needs to be answered. While the EU's equivalence framework is a very useful tool that can provide benefits and access to the EU for some third-country firms, it obviously does not replicate the advantages of the single market. It only covers some specific areas where third-country firms can directly access EU markets, for example, in the area of central clearing counterparties (CCPs).

Moreover, the extent to which equivalence will be granted to the UK is not determined yet, as these decisions are subject to a positive assessment of the UK's legal, regulatory and supervisory framework. This uncertainty only underlines the need for the EU to re-enforce its efforts to build and develop its own capital markets, which is why support for the ambitions of the Report of the High Level Forum on the Capital Markets Union (CMU) is key. A successful CMU will help mobilise investments throughout the EU, lower the costs of funding, offer new opportunities for savers and investors, and make the financial system more resilient.

At the same time, the EU will need to remain an open and globally integrated financial market, meaning that the EU and third countries, including the UK, will together need to continue to contribute to the smooth functioning of global financial markets, and so avoid fragmentation and ensure financial stability.

One area identified by the EU as presenting potential financial stability risks as a result of the UK's withdrawal is in relation to the central clearing of derivatives. To address these risks, the European Commission has announced that it will adopt a time-limited equivalence decision for UK CCPs, and that they may continue providing clearing services in the EU after the end of the transition period.

> *It is vital that constructive UK-EU supervisory relationships are maintained between regulatory bodies to achieve common objectives.*

With the third-country landscape evolving, it is imperative that appropriate supervisory oversight is in place. EMIR 2.2, and the changes introduced by the Investment Firms Regulation for third-country investment firms, are examples of how supervisory models can be adapted to face new challenges presented by non-EU firms that play a significant role in EU financial markets. Within the EU, the current supervisory model combines both EU and national level responsibilities, with most day-to-day supervision of capital markets conducted at national level. Within this mixed model it is essential that supervisory activities regarding third-country firms is conducted or coordinated at EU level.

Third-country firms have typically quite some discretion regarding their choice of location, which increases the risks of regulatory arbitrage. In addition, differences in supervision of third-country firms results in barriers and undermines the single market.

Finally, above all else it is vital that constructive UK-EU supervisory relationships are maintained between regulatory bodies to achieve common objectives like stability, investor protection and orderly markets. ESMA has already established cooperation agreements with its UK counterparts to achieve this and will seek to maintain close supervisory relationships with these authorities in the years to come. ●

Hubertus Väth

Managing Director, Frankfurt Main Finance e.V.

Never waste a good crisis

EU and UK are still in negotiation mode. In absence of an extension of the transition period, a no-deal Brexit has once again become a plausible scenario. The advice "hope for the best and prepare for the worst" is as valid as ever in this saga.

We advise financial institution to not plan based on equivalence. Even in the best of cases, equivalence doesn`t cover all relevant areas. What's more, neither the very rational of the Brexit - taking back control - nor the way negotiations are going, point to equivalence as a solution.

Market participants acted accordingly. The loss of passporting rights will lead to a shift of roughly 50 percent of EU business on UK based bank balance sheets to the continent. We have seen bookings move into Frankfurt of about €300 billion so far. We expect another €100 billion before the end of the year and we know of another €400 billion ready to move.

Will all that lead to more inefficiencies? Not necessarily. Fragmentation may, but does not necessarily, lead to higher costs. Notto forget that costs occur not only on banks profit and loss accounts, but eventually also in state-budgets. Given the impact on financial stability, standing on your own two feet is better than standing on one, especially if that one is beyond your control.

It was a key project of the G20 under the stewardship of Japan fighting global fragmentation of financial markets and rightly so. At the very same time Japan continued on its endeavour in bringing the Yen clearing back to Tokyo, at least to a sufficient degree.

Take Eurex as an example: We are nearing 20 percent of Euro denominated interest rates swaps, were clearing moved from London to Frankfurt, and growing. This was achieved with costs and spreads on par for market participants. Social risks could be reduced and at the same time costs for market participants been avoided. If it sounds like the holy grail, it probably is. Let's remember the scaremongering numbers of up to €100 billion additional costs European banks would have to bear once clearing would have to move. So clearly there can be a good fragmentation, leading to a healthy competition and more financial stability – at no additional costs for the industry. Fragmentation can, but doesn't have to be bad and may even be good.

The train of shifting business is in motion. In a world ever more polarized and global powers increasingly self serving, Europe can ill afford to loose control of it's financial ecosystem, given the geopolitically relevance of the industry. Naturally the UK will always be invited to be the EU's preferred partner.

> *We need to ask ourselves: Do we witness the early days of a new European safe asset class?*

The corona virus created a push towards digitalization and solidarity in Europe, at a spead, that was surprising even for optimists. As a result, we need to ask ourselves: Do we witness the early days of a new European safe asset class? And if so, could it accelerate the creation of the common EU capital market. Europe's ability to move under stress has repeatedly been underestimated. I'm bullish on Europe living up to its challenges, not wasting this crisis. ●