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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.

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. ●