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GLOBAL FINANCIAL FRAGMENTATION: CAN PROGRESS BE MADE?

The Covid crisis has not led to a financial fragmentation at the global level so far, but challenges and concerns for international cooperation remain. Multilateralism is the most efficient way to solve common issues.

1. The global financial system has not fragmented in the Covid crisis

1.1 Rapid and coordinated policy responses to the Covid crisis prevented fragmentation

An official is cautiously optimistic, as the financial system was not at the centre of the crisis. After a shaky start in March 2020, it stabilised due to international coordination and swift public policy action to support the economy. Since then, supervisors and regulators have monitored the evolution of the crisis and provided flexibility where needed, while markets have generally responded positively to the strong public support given to the real economy. This resulted in unexpectedly high asset prices in such a severe crisis.

1.2 A great deal of progress has been made

A regulator noted that this is still an all-male panel, which shows that one area of fragmentation still exists within the financial services system. However, compared to the 2008 financial crisis, much distance has been travelled. Common rules were set up to strengthen the capital, liquidity or shock absorption capacity of the financial systems and global fragmentation decreased. Cooperation amongst regulators is as good as ever. Issues are discussed with standard setters and taken seriously. Progress has been achieved. However, there is still fragmentation, and the potential for additional fragmentation.

An industry representative stated the 2008 crisis did not go to waste as infrastructure was built, and so it would be great if this became a catalyst to get people around the table to work towards the next point. One problem is that the 2008 crisis was specific and clear, whereas this one had different vectors.

1.3 International regulatory reforms introduced after the Global Financial Crisis (GFC) have built up resilience

An industry representative said the intersection between Brexit and Covid is interesting. If Covid had happened in 2008 the impact would have been much worse and that is in large part due to support from the public side and the lessons learnt during the post-financial crisis, which have helped the financial system and the global economy. Congratulations are due to the public side on global coordination. The amount of work in coordination has been a positive.

1.4 Deference between regulators has increased

A regulator stated that IOSCO has 125 members globally, regulating more than 95% of the world's capital markets. A 2020 report on deference and fragmentation found an increased use of deference[1]. It might be counterintuitive, but deference between regulators significantly increased with enhanced cross-border capital flows. It is not that there are increasing signs of fragmentation, but there is the context of the pandemic. IOSCO ramped up its internal board meetings and made a public commitment to keep markets open, as the functioning of equity, credit and funding markets was vital for the real economy. That announcement ensured that markets did not close down and tried to address potential fragmentation.

1.5 International standard setters (IOSCO, FSB, Basel Committee) help with market fragmentation

A regulator noted that on pandemic and non-pandemic-related issues, the work done by international bodies helps with market fragmentation. It may not be perfect, but it has been shown to help. Important work with other standard-setting bodies like the Basel Committee helped to put the final implementation phases of the margin requirements for non-cleared derivatives in place and ensured that fragmentation did not happen. Guidance was made available on the application of IFRS 9, as that would have resulted in more fragmentation. Less glamorously, the setup was announced. Depository fund members float in real time, so encounter measures in their jurisdictions, and the measures taken meant that a depository could be populated for other members to see, which helped in not fragmenting markets and aligning standards, even without producing standards. That gave flexibility in areas like annual general meetings (AGM), disclosure options and on-site inspections, but also for voluntary control mechanisms.

1.6 Reasons for optimism

A Central Bank official thought there is good news, but also development areas. Structures established 10 years ago for global cooperation and coordination in the financial sector came through Covid well. Information on experience sharing was key when the situation was unprecedented and trying to reach a common view was vital, as was collective risk assessment and action and the substantive coordination of regulatory flexibility and forbearance. Standard setters and the FSB agreed on principles for regulatory action, either delaying regulatory changes such as IFRS 9 or allowing temporary forbearance where it did not weaken the system. Putting back those measures should be coordinated and collectively discussed.

1. At the St. Petersburg Summit in September 2013, the G20 Leaders agreed that "jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulatory regimes."

These structures work because they recognise the inevitable heterogeneity of different structures, and that different legal systems make the rules, while bodies like the FSB and the Basel Committee cannot. Maybe one day the United Nations will be the global financial regulator. However, until then the system has to accommodate different structures and stresses, but that those actions were coordinated made a huge difference in contrast to 10 years ago. The test of that will come as the recovery phase is entered, public support schemes are withdrawn and the long-term damage to the economy and financial sector losses emerge. A collectively coordinated approach will be essential.

On the importance of the joint risk assessment and actions to address it, there has been market turmoil and stress, with disruptive call markets in March, as the financial markets adjusted to the pandemic and the likely economic impact. International structures were quick to assess risks, producing assessments and formulating a programme of work to address fragilities. That is now moving forward. It will be a test of the system whether a risk assessment can be agreed upon, with the necessary policy items to deal with vulnerabilities in non-bank finance and implement them consistently across jurisdictions. However, the situation is so far so good.

The other good is how the technology side is dealing with payments issues. The G20 and FSB have a great deal of work to do on the roadmap for improving cross-border payments, and on standards for systemic stablecoins, which raise fundamental questions, and those which deal with the role of money in jurisdictions. It is vital to avoid 'Uber-isation', where something takes hold quickly and is used at scale before regulators catch up.

An industry representative raised the issue of non-performing loans (NPLs), which are considered benign and under control; there will be some, but less than expected. They are not as worrysome now as in 2008. Meetings were held in Brussels and the UK about progressing the securitisation market so that banks can move back books into the market and free up balance sheets to lend to the real economy. The opportunity is known, and there is room for optimism.

1.7 Basel and LIBOR reforms are good examples of international coordination

An industry representative stated that global coordination on LIBOR, a major financial services project for firms, has been significant. The UK will meet Andrew Bailey's deadline at the end of 2021 and is in execution mode. The UK's leadership o LIBOR globally, has been top class.

Basel is a good example of coordination. The Basel Committee jointly decided to postpone implementation by one year. There has been no decision to postpone it further, and so it should be done according to the timelines indicated. The EU will put forward a proposal in the middle of 2021. Covid has caused a timetable blockage in the College of Commissioners, but that is the proposed schedule, and it will be followed. The average time to pass such a proposal through the Union machine is two years minimum, which shows the timing for adoption. Then there will be a period for implementation. These timelines have been made known to the Basel Committee and will not be changed.

A regulator indicated that the key sense for recovery is optimism, but not complacency. Existing international infrastructures must be appropriate, such as IOSCO, CPMI and the FSB, as it matters for producing standards, information sharing, agreeing to disagree or addressing issues. Action may be required globally in non-finance areas like data localisation technology, and others in policymakers' broader remit. Examples from the financial space allow for learning.

2. Future challenges for international cooperation

2.1 The Covid crisis shows potential for ongoing fragmentation

A regulator noted that the position of the economic cycle can add to fragmentation. With the market turmoil in March, regulators were quick to speak of forbearance and a great deal of it happened. There have been many different measures, small and large, and some could have been better coordinated. Everyone mentioned that buffers are there to be used, but people understood different issues by that. Some thought that banks needed to support the real economy and ensure credit flows no matter what. Others said that buffers are cushions to be used for banks in trouble. These are two different issues. If the economic cycle is at the moment when things turn sour, national jurisdictions, regulators and economies tend to look after themselves. The Covid crisis showed the potential for continued and ongoing fragmentation.

2.2 Brexit is fragmentation

An industry representative stated that whether it is the cost of doing business or more permanent fragmentation is often discussed internally. Many are dealing with Covid issues, but Brexit is troubling others. People are adapting. Some of it is the cost of business, but some is real fragmentation in financial services and the real economy. National tensions may harden attitudes in dealing with cross-border equivalence and finding compromises, as there have been some disagreements in dealing with Covid and that is a worry.

An industry representative observed that competitiveness in European financial markets is deteriorating compared to other major financial centres, due to Brexit and the lack of harmonising regulations. The cost/income ratio of European banks is higher than in the US and for Asian banks. EU/Japan economic partnership agreements have been successful at bringing consultation before implementing new regulations. This coordination should be expanded globally, with policymakers moving towards global regulatory harmonisation, to achieve economic recovery, a carbon-neutral society and financial stability.

2.3 Financial fragmentation could arise if exit strategies are not coordinated

A regulator considered that problems with regulatory coordination could arise if the post-Covid recovery is characterised by wide divergences across the world economy. Pressure can build on regulators to keep support measures too long, in a way that is

not prudent, or to postpone the necessary structural reforms to support the underlying resilience of the system. There may be differently perceived trade-offs between short-term supply measures and longer-term reforms in different regions that could result in pressure for regulatory deference and fragmentation, so it is vital to ensure that the right choices are made.

As to whether a tapering of public measures could result in tensions between states, coordination was deemed good going into the crisis especially in the financial sector. Exiting the crisis will entail asymmetrical impacts and so there will be different pressures and pacing from the withdrawal of support measures. An industry representative considered that efforts should be made to ensure that does not happen, as if it is not focused on, it will.

2.4 Different sources of concerns

2.4.1 A tricky political environment

A policymaker stated that the political context is not great. Trust between countries across the world took a hit following the global financial crisis and has not yet fully recovered. The reaction to Covid has shown that trust has reduced significantly. It is not an ideal environment, but it has been like this for a while. The financial sector will have to work to identify the benefits of common responses and convince politicians that common responses are best. There are limits to that and it is important not to be naïve, but to be realistic with the private sector and not overpromise on delivery or under-promise either. It is a tricky environment, but the EU has tight coordination methods in place, even at local level, which can work to mitigate risks.

2.4.2 Increasing protection needs and different mindsets of national populations

A Central Bank official noted that the pandemic has focused governments on risks imported across borders and the protection of national populations, and on the balance between localisation and overseas procurement in supply chains. This is obviously most notably in health but not exclusive to it. Some of the political sentiment which has been generated around that, which is as powerful as government's first priority is to protect citizens' lives, may spill over into other areas, and that is something to watch.

An industry representative stated that these comments are striking. The mood in the UK is different to that in Ireland. People's mindsets coming out of Covid will be different in terms of how they tackle the future. There are worries about whether it is the end of the beginning or the beginning of the end, and false optimism where people feel Covid is behind us. Ultimately, there will be the recovery and the bill to pay, which is not being talked about yet. Paying for the financing of the crisis will strain politicians and smaller economies.

Three countries are doing well in vaccine rollout: the US, the UK and Israel. Everyone else is playing catch up and there will be spikes. There are questions of the next variant or what winter brings, so there is still a way to go, and it is important not to be complacent about financial preparedness, given that institutions still struggle with growth and low interest rates. There are good things in place, but there are many worries about the future in terms of shocks to the system, geopolitical considerations and more.

2.4.3 The international banking crisis management evolution highlights a trend of ring-fencing issues

Additional requirements on loss-absorbing capacity were agreed on to make systemically global banks resolvable. The international framework also focused on stronger standards with territorial approaches to prudential supervision and crisis management, resulting in a duplication of supervisory and reporting requirements.

An industry representative stressed that it is not a contradiction if the public side thinks global coordination is improving and the private side thinks it is deteriorating, as much has been achieved, especially with prudential regulation in Basel III and capital liquidity. But following a decade of perceived global financial integration, there is a trend of localisation in a number of areas, be it as a consequence of Brexit or in the area of crisis management framework due to frictions between home /host countries. Loss-absorbing capacity has to be localised to a significant extent at each subsidiary. Considering the last mile and prepositioning of resources, an internationally consistent approach to lenders of last resort functions would help enhance the banks' resolution planning. The public side must agree that plans are credible and can be executed, maybe going beyond recovery and resolution planning into operational resilience, which is new and broad and important to have a common understanding of. The scope of what supranational bodies focus on should expand, because supranational regulators, together with national bodies, have responded to the crisis excellently, as with the overall response to the financial crisis, and these practices should be carried forward.

2.4.4 The size of Central Banks balance sheets

An industry representative considered that another question is the expansion of central bank balance sheets, which many economists see as taking central banks close to governments, in terms of governmental funding and what that means. The issues are in different vectors. Taking advantage of this crisis will be difficult to do or will require an additional amount of imagination.

The Chair asked if the build-up of debt in many European countries is a worry. An industry representative stated that the size of central bank balance sheets is, as is the misallocation of capital. If there is credibility and the ability to print money, that may go away. Having access to domestic savings, as in Japan, may make it possible to have a debt to GDP ratio of over 200%. Over the last 15/20 years, 60/70% of global GDP growth has been in emerging market countries. Many of the Basel and other rules have made it more difficult for emerging markets to access capital, and developed markets need economies like Brazil, China and India to grow rapidly. When they do not, global growth is anaemic. The question is if the price mechanism functions when there are negative yields of minus-30, high-growth emerging market countries borrowing at 9% and excess savings going into different parts. Smart economists can figure that out.

2.5 New areas and pending issues where more global coordination is required

2.5.1 The future will be driven by new topics

An industry representative stated that emerging issues and technologies need to be appropriately considered to avoid further fragmentation. Next to operational and cyber resiliency and digital assets, there is a need to focus on sustainable finance and to help investors to understand the relevant context and details. A further focus has to be on the growing importance of Non-Bank Financial Institutions, on market conduct and financial crime. These themes must be identified, and work agreed to respect national interests within a global system.

2.5.2 Sustainable finance: global convergence on ESG standards is challenging

A Central Bank official noted that climate is an issue where, probably for political reasons, the structures are behind where they should be. The Task Force on Climate-Related Financial Disclosures (TCFD) is there for disclosure, but the standards need more to enable the cross-border financial sector to price risk and assess reward as governments tackle climate change. The International Financial Reporting Standards (IFRS) proposal for an international body to coordinate sustainability standards is a step forward.

An industry representative expressed his concern for the future on Environmental, Social and Corporate Governance (ESG). Addressing climate change and directing capital towards facilitating the transition to net zero carbon emissions calls for ambitious international solutions. ESG and fragmentation are related to each other as governments encourage ESG-related investments in response to the pandemic and fiscal stimulus packages are implemented on a national discretion basis. There is a huge challenge globally in reducing greenhouse gases and transforming to carbon neutral. There are uncertainties, such as how and in what time horizon this can be achieved. Short-sighted aggressive campaigns like greenwashing in finance could harm the transition, for which most corporates are thinking of initiatives and investment in renewable energy, together with public investment.

Economic recovery from COVID-19, which is the original purpose of the fiscal package, could be an opportunity. Banks and policymakers must support sustainable transition pathways with appropriate liquidity provision. Europe is a world leader in ESG, with the EU's sustainable finance strategy. Regulations for promoting this should be harmonised globally. Regulatory harmonisation is critical for a common understanding of the rules and for categorising activities from an ESG perspective. Different global economic substances and features may cause understandable confrontations or disagreement in coordination amongst countries. Reaching realistic agreement requires focus on high-level global standards, rather than detailed prescriptive rules. The EU's international platform for sustainable finance will have a key coordination role.

2.5.3 Data and technology: For a G7 digital and technology forum?

A Central Bank official noted that there are areas of data and technology which are not the responsibility of financial sector regulators, but where what is decided will go to fragmentation and localisation. A cross-sector group of international corporates have suggested to the G7 that something like the FSB be established as a technology and data forum to coordinate emerging convergence. On cloud and AI, data will create financial sector fragmentation if authorities cannot be brought in or do not work together.

An industry representative stated that an issue in the US is the democratisation of data allowing retail players to play in the markets, blurring the lines between trading, investing and video gaming.

The Chair asked about support for a type of technology G7. A Central Bank official stated that a proposal had been made to the G7, but it could be the G20. FSB experience suggests a forum in which standard setters and regulators work under a broad political umbrella to try and line up and discuss areas where they cannot. There may be places where trade-offs cannot be made but trying to line up on standards where future fragmentation is likely and the financial sector will be affected by what is useful.

2.5.4 Deference and CCPs

A Central Bank official stated that it is not clear that much progress has been made on deference and CCPs. All possible progress may have been made due to political blockages as well as technical ones, but it is a balance and a trade-off, and jurisdictions will put the trade-off in a different place.

2.5.5 Recovery and resolution of failing banks at the global level

A regulator noted the reference to prepositioning. Even if Total loss-absorbing capacity (TLAC) standards try to tackle the issue, there is an inherent conflict. It must ensure where capital is held, so there is thus a fair share for all the jurisdictions for global international banks and also ensure the free fungibility of the capital and liquidity in case it is needed in an area of these banks. This issue has not been solved and there is still fragmentation.

An industry representative thought that a reliable, internationally consistent approach to central banks' lender of last resort role will be crucial as a key enabler of an effective and credible bail-in tool. This should encourage host authorities to limit excessive pre-positioning requirements, as intended by the FSB in designing the TLAC framework. Consequently, the increase in costs for banks, which would over time feed through to the economy, would be limited. Clearly this is important for supporting the recovery.

3. Multilaterism remains the most efficient way to find solutions for common issues

3.1 Fragmentation will always exist for structural reasons

There will always be fragmentation, for various reasons, according to a regulator. With a global supervisor, a global tax base and global government, it might be possible to dream of fully integrated global financial systems, but that is not there. The importance of integrated global financial markets should not be underestimated, but they are not the

most important consideration in the governance of the global system. The system is characterised by different national boundaries, reflecting different legal and tax frameworks, different governments, and different accountability frameworks, so there will always be a trade-off between efficiency gains achieved by integrating markets across borders, and possible strategic or financial risks created by the provision of services by entities supervised in other jurisdictions. In that trade-off fragmentation is to be found.

The IOSCO report which fed into the FSB work concluded that such fragmentation is almost inevitable in the system and is not down to protectionism in the narrowest sense but to the fact that as long as there are different jurisdictions frictions will exist. Regulators must optimise the benefits of integration, subject to the natural constraints on process. The public side has seen more coordination not less. If the private sector sees it, it is due to market behaviour and not because of a failure of regulators to work together.

3.2 Fragmentation can have detrimental effects

Financial market fragmentation is seen as a significant challenge for regulatory authorities and policymakers because it might entail less competition, higher costs of capital and reduced availability of services.

An industry representative stated that the private sector would love to see consistent global implementation for international regulatory reforms. For global institutions with entities in different jurisdictions, running different processes and implementing different rules at different times brings fragmentation to the institution and a real cost. It seems like a small point in terms of rollout consistency and implementation timetables, but when not adhered to it is a huge cost.

An industry representative stressed the importance of further developing the financial system, banking and non-banking, to the benefit of customers, and agreeing on global topics to support open markets. Implementation must be completed where not yet fully done, including on internal TLAC/MREL prepositioning, and clarity has to be established on open issues such as lender of last resort capabilities, to ensure that the work done is credible. The hope is that this resolution planning is never used but working towards a common goal will develop the financial system going forward.

An industry representative hoped that language can be found to remind people of the benefits of financial services. There tends to be a defensive tone but articulating how it can be a driver for global growth will help. That has been difficult to do since the financial crisis.

An industry representative appreciated how financial regulators' global coordination has helped with the unprecedented problems of COVID-19. Society is now tackling ESG issues, which require new global coordination. Further regulatory divergence may affect the competitiveness of the European financial market, with European banks' average higher cost/income ratio crucially affecting third country banks operating in Europe, who may look to allocate capital elsewhere if their EMEA business is not sufficient to maintain sustainable growth. That will have a consequent impact on clients through direct cost increases, poorer service quality and more limited choice.

The Chair noted that making European capital markets deeper, bigger and more liquid would have an effect on growth. If the EU can deliver its projects, it will create a dynamic which will be beneficial to everybody.

3.3 Switching from looking back to looking forward and fostering international cooperation

An industry representative considered this an opportunity to switch from looking back, as a great deal has proven to be effective, to looking forward and enabling the financial system on digitalisation, cyber, digital assets, the increasing use of AI and consumer protection. National self-sufficiency can be balanced in a globally consistent regulatory framework so there is a level playing field and common standards. With different legal regimes, it can be impossible to have one standard, so the equivalence regime should be outcome-based to avoid a struggle over line-by-line equivalence; instead, it should focus on the outcome in achieving an overarching goal.

It is important to be pragmatic and forward-looking. This is owed to the next generation. The last decade was mainly about recovery from the financial crisis. The financial system must be made robust and stable enough to help the recovery from this crisis and to accommodate changes from the technological revolution, the new needs of investors and borrowers, and the overall economy. There is too much focus on looking back while being overwhelmed by the future. Prioritising how to create the new environment is vital.

A regulator agreed that it is vital to be forward looking, while finishing what was started. Basel III's too big to fail regulations still lack full efficiency and effectiveness. Areas such as non-bank financial intermediation, hedge fund leverage and money market funds are still on the table. The industry should take on new things but finish tackling the proven inefficiencies and vulnerabilities that were identified.

An industry representative agreed that there are actions which could foster further international integration to the benefit of each country, given the global financial system remains highly interconnected, reflecting both supply and demand needs across jurisdictions.

Authorities must follow through consistently on the reforms already begun, such as the completion of the Banking Union, the TBTF reforms and a consistent implementation of Basel III. Stepping up efforts to remove existing impediments to cross-border consolidation is the best route to attain financial integration.

An industry representative urged policymakers to move towards global regulatory harmonisation and enhance mechanisms for continuous and systematic cross-border cooperation, with appropriate deference for national and industry idiosyncrasies, so that all enterprises can thrive without being burdened unnecessarily with the cost of incremental compliance.

NEARLY 4 MONTHS AFTER BREXIT: WHERE DO WE STAND AND FUTURE PROSPECTS

1. Current situation in the financial sector 4 months after Brexit

1.1 A smooth transition thanks to adequate preparation

An official explained that there have already been some visible changes in the financial sector since the end of the transition period (end of 2020). There was a relatively smooth exit thanks to the preparation of market participants over the last few years and to extensive work from the regulatory and supervisory authorities on both sides. It was important that the Trade and Co-operation Agreement was agreed beforehand, and it is equally important for it to be fully implemented.

A second official agreed that the transition has been relatively smooth, stressing that the industry has now adopted a way of working that bifurcates business between the EU and UK, given that equivalence is not in place in most financial areas. That is not where the UK had hoped to end up; nonetheless, the industry has successfully adapted to that reality, and there is a need to move on.

A regulator noted that there have been some shifts in business, but overall no major disruption or significant volatility has been observed. This means that the correct judgments were made on where there could be potential financial stability risks and how they could be tackled. For example the temporary equivalence granted to UK-based CCPs was an appropriate decision and the EMIR 2.2 regime helped to assess the risks posed by systemically important entities for the EU in a far better way than previously.

An industry representative confirmed that the main structural changes had taken place for global banks with a significant presence in the UK in advance of January 1st 2021. Global banks have opened EU entities to continue servicing EU clients and have transferred account opening to the EU for new European clients. Since Brexit, many banks have also enhanced their staff resourcing and regulatory permissions in their EU entities.

Another industry representative commended the authorities for appropriately flagging their requirements and demands, which allowed industry players to make the necessary changes to ensure that they could continue to serve customers. Putting customers at the centre of decisions is a good place to start both for the industry and the authorities, especially with the need to fund the growth and recovery of the EU economy in the Covid-19 context. The industry speaker agreed with previous comments that Brexit events and the volatility triggered by Covid-19 had been adequately handled by the industry and the authorities. The fact that most asset management products and services held up very well during March-April 2020 also shows the effectiveness of asset management regulation such as the UCITS directive, which provided the private sector with a high degree of visibility. UCITS has now become a gold standard and has also been adopted by many non-European investors such as pension funds. There must therefore be caution about any changes to this regulation, in particular in the context of potential divergence between the EU and UK.

1.2 Ongoing changes in the European financial landscape

A regulator stressed that a significant shift of share trading from UK trading venues to EU trading venues, representing around €6 billion of trades has been observed since January 1st 2021, while on the derivatives side some trading has shifted to the US. No major issues have disrupted trading activity or market operations. Further adjustments of business practices are expected and will continue to be monitored by the European Supervisory Authorities (ESAs) and the National Competent Authorities (NCAs). One key focus of this monitoring are the activities of relocating entities in order to ensure that they adhere to the agreed establishment plans. The risk of unauthorised business being provided by UK-based firms in the EU is also being assessed, with so far mostly minor indications of such activity.

A market observer stated that with Brexit the European financial sector has evolved towards a more fragmented landscape around a certain number of specialised hubs, which is closer to the situation that existed before the single market and the euro. Amsterdam attracted equity trading flows from the UK; Dublin attracted some commercial banking and asset management; Luxembourg mostly gained back office for asset management; Frankfurt has a number of commercial banks; Paris has a variety of areas and is probably the only place where parts of the full financial ecosystem can be found, including a concentration of broker-dealer activities. A greater transfer of activities to the EU has not yet been seen, simply because it takes time and was delayed by the pandemic. The Single Supervisory Mechanism (SSM) has given banks more time to adapt. There will probably be a more definitive outcome in the movement of activities to the EU by the end of 2021.

The trading of derivatives however poses a problem both for the EU and UK, the market observer emphasized. There has been a significant relocation of activity to the US, mainly resulting from the duplication of differing EU and UK derivatives trading obligations (DTO), both derived from MiFIR: the UK applies its DTO on a territorial basis and the EU applies it on a legal entity basis, which creates conflicting requirements. At present, about 70% of international exchanges between brokers and clients have moved to the US and 30% have stayed in London. European banks operate via branches and the share of business remaining in Europe cannot be accessed by European actors. It is urgent therefore that the EU should apply its DTO also on a territorial basis.

1.3. Policy work underway in the UK

An official explained that the UK is currently establishing its direction and approach to financial services legislation in order to create the proper environment for financial services, as it moves out of the EU. In the summer of 2020, a statement was made in Parliament about the UK's approach to what it described as "in-flight" European legislation and how the UK would complete the delivery of the acquis and possibly amend it. In importing the acquis into UK legislation, the UK has been confronted in particular with a challenge about defining where responsibility and accountability lie between UK policy-makers and regulators and the Parliament for setting and implementing policy. Through the Future Regulatory Framework Review, the UK is considering those constitutional arrangements.

The major area of reform identified by the UK authorities is Solvency II, which has been a longstanding concern for the UK, for example regarding the matching adjustment, the official added. The UK has also conducted a review of the listings regime, to which some changes will be made and will now embark on a process of consultation with the industry regarding possible adjustments to the regime for wholesale and capital markets. This review will be conducted in parallel with the Commission's review of the MiFID II directive. Different conclusions may be reached in the UK and the EU that may be discussed in the context of the upcoming EU-UK regulatory dialogue. This is however expected to be a process of adjustment rather than a radical reform.

2. Challenges associated with Brexit in the financial sector

2.1 The risk of legislative divergence between the EU and UK

An industry representative noted that beyond the area of derivatives clearing, which requires some form of cooperation, the 'new reality' is that either the UK becomes a regulation-taker, in order to continue accessing the single market of financial services, or it diverges to build a competing 'Global Britain', and in this case no one would have a political mandate in the EU to give the UK access to the single market of financial services. There may be shared views or ambitions between the EU and UK in certain areas e.g. concerning the green economy or technology, but converging on rules is needed to create a single market.

An official emphasised that there being divergence or not from EU policy thinking is not an end in itself for the UK. It is a possible consequence of the UK's thinking about what it needs to do to make its financial services safe, transparent and competitive. The UK was very closely engaged in the development of the European acquis for financial services, so there is no intention to 'throw it all out'. The UK is not expecting either to be able to continue operating in the single market post-Brexit. The question is rather to evaluate and manage the risk of divergence between the EU and UK as two autonomous third-party jurisdictions. The Memorandum of Understanding (MOU) recently agreed between the EU and UK sets in place a framework through which those conversations can take place.

Another official emphasized that while the UK does not want to be a rule-taker nor does the EU. A way of working together has to be found that allows autonomy to be retained on both sides.

An industry representative mentioned that although the UK government has made some statements to indicate that UK rules would diverge in certain areas, the extent of this divergence has so far been quite limited. In addition there may be some constraining factors on divergence in the longer term. For example, a significant number of financial services rules in the EU and the UK are derived from globally agreed standards e.g. at G20 level, which generally ensure some degree of alignment between jurisdictions regarding core rules. There are also global supervisory coordination frameworks in place, such as supervisory colleges and crisis management arrangements that may ensure a certain degree of convergence as well as a level playing field for market participants.

The market also has a role to play in ensuring that broadly common rules and standards can be maintained, the industry speaker believed. Global financial institutions normally have global matrix-organisational structures in place, with local reporting lines and governance structures as well as a global or regional coordination framework. Under such a matrix structure, some businesses are managed regionally or globally and internal insourcing and outsourcing arrangements are put in place, which makes sense from an efficiency and risk management perspective and is critical for managing business effectively. This is possible to the extent that financial services rules are broadly consistent at the international level, being derived from globally agreed standards.

2.2 Issues related to delegation arrangements in the Brexit context

A regulator stated that delegation arrangements could raise potential issues in the Brexit context. The delegation or outsourcing of services to other firms based outside the EU requires a continued monitoring to ensure that there is sufficient substance, control and risk management in place in the EU to achieve an adequate level of investor protection and stability. This is one of the focus points of the investment fund regime in particular, given the importance of delegation in the global business model of asset management, in order to ensure that the management companies of EU UCITS or AIF funds are taking the key decisions and properly managing risks in a context of delegation. The Single Supervisory Mechanism (SSM) is also monitoring the delegation and outsourcing arrangements of banks and the way their activities are organised, for example their trading book.

An industry representative stressed that delegation is a global supply chain model in the investment fund sector that improves the quality of services for customers, increases choice and helps to drive prices down. Having a framework that allows EU savers to invest in companies, technology and infrastructure around the world is something that requires continued support as it will benefit EU citizens. A clear and consistent regulation concerning delegation is needed in that perspective.

Responding to a question of the Chair about whether the responsibilities between e.g. the management company based in the EU and the trading arm possibly based in the UK are clearly defined at present, the industry

representative confirmed that the rules are very clear. European fund management companies that have a delegated model have very strong safeguards and investor protections in place, and sufficient substance in the management companies onshore to ensure this. The continued focus of supervisory authorities on this issue is welcome. Delegation is indeed a key component of the UCITS model and essential for its reputation and sustainability.

A market observer agreed that delegation is part of the global business model of financial institutions, but there is a clear intention of the European authorities to have a critical mass of activities in the EU so that they can assess how the overall financial system is functioning and whether control and risk activities are appropriately conducted.

3. Possible post-Brexit evolution scenarios for the EU and UK financial sectors

3.1 The challenges posed by Brexit for the EU and UK financial sectors

An official stated that for the financial sector Brexit is a fragmenting event, since a jurisdiction is being broken into two. When a member leaves the EU it leaves the single market and the previous level of integration cannot be replicated, even with equivalence. Indeed, the financial sector arrangements cannot be insulated from the overall political context. However it is important now to strive for the best possible cooperation arrangements. Before Brexit, the City of London was not only a global financial centre but also an EU financial centre. London will remain a very important financial centre on the EU's doorstep. This is not a problem for the EU, since there is already a very significant level of interconnectedness between the EU and the UK and many areas of common interest in regulation. On the other hand, the fact that a significant part of the EU's domestic financial system may remain located in London and so outside of the jurisdiction, puts the EU at risk of being a rule-taker. The EU is indeed rather unusual in the extent to which its domestic financial system is relatively underdeveloped compared to the size of its economy. Longer-term risks of financial stability or loss of autonomy will need to be addressed by the EU, even if this raises costs and reduces efficiencies in the short term. Integration with the UK has tended to be an organic process built over several decades thanks to EU membership, so the process for reverting it will require time.

An industry representative added that EU clients will be increasingly serviced by EU entities, but the UK still has capabilities to continue to be a major hub for European clients, which can be aided by regulatory alignment between the EU and the UK.

Another industry representative agreed that there has to be acceptance that Brexit is a meta-fragmentation decision that will significantly impact the financial sector and that there is no way to insulate financial services from that fundamental force. Trying to replicate the pre-Brexit integration with equivalence does not seem possible, therefore the best way forward for the EU is to organise and build its own integrated and interconnected financial centres.

An official observed that the financial services sector is already adapting to a 'no-equivalence world' with a bifurcation of business between the EU and the UK that has now taken place. The official suggested that Brexit may be generating even more strategic policy questions for the EU than for the UK, because the UK continues to have its own financial centre, whereas the EU now has to determine how its own financial system is going to evolve. The UK moreover has means other than equivalence to manage access to its financial sector and a number of routes or options that it can use to manage its relationship with third countries and that it is currently exploring e.g. mutual recognition agreements or exclusions for overseas persons.

Answering a question from the Chair about whether the UK's approach includes ramping up its policy efforts at the international level, the official confirmed that the UK has always engaged very closely with international standard-setters, because it is in the UK's interest to do so. The UK moreover thinks that the transition to net zero (i.e. eliminating CO2 emissions) and the increasing use of technology in particular are going to require cross-border and convergent approaches at the international level. Common discussions will also be needed in the near-term about how to exit some of the measures used in the regulatory sphere to address the challenges of the pandemic. These are areas of shared interest between the EU and UK, where there are significant challenges in terms of efficient allocation of capital, the official emphasized. Europe as a geography needs to think about how it can operate together to establish a market that enables the allocation of the capital needed for addressing these challenges in a cost effective and safe way, which is a process that will be worked on by the authorities and market participants for several decades. There are serious challenges and imperatives in this area that require cooperation and collaboration and that go beyond the notion of equivalence.

3.2 Likely evolutions of the EU financial sector post-Brexit

A market observer suggested that the most likely long term scenario for the EU financial services sector is a concentration around one or two main financial centres where talent can be most easily attracted, together with a few other more specialised hubs.

An industry representative considered that the EU has the potential to build and operate the financial infrastructure that is needed for funding its economy and that is currently mainly based in London. With 450 million potential customers, one of the highest saving powers on the planet, hundreds of blue-chip companies and tens of thousands of small and medium-sized enterprises (SMEs) in the EU this is quite possible. This requires the development of interconnected financial centres across the EU, building on more integrated trading venues and market infrastructures. Accelerating and deepening the Capital Markets Union (CMU) is also essential, which may necessitate a big bang approach notably in terms of convergence of corporate and insolvency laws. Europe indeed must not be a territory of 'finance-takers', but a continent of 'finance-makers' in order to transform the high saving levels of EU citizens into high investment in successful companies. The focus of all EU institutions, regulators and supervisors should be on achieving that objective in a competitive and innovative manner, open to the rest of the world.

Another industry representative considered that there is reason for optimism about the future of investment and savings in the EU particularly when considering the area of sustainable investment and climate change, where Europe is in a leading position. The Sustainable Finance Disclosure Regulation (SFDR) is very pragmatic and allows the directing of savings to industries that will align with these values.

An official stressed that the EU is approaching the future as an open financial jurisdiction that wants to remain engaged with the rest of the world, including the UK, while at the same time developing a resilient domestic financial system and solid market infrastructures. Work around Banking Union and CMU will need to be accelerated in that perspective. Dependency on other jurisdictions may translate into insufficient autonomy or financial stability risks that also need reducing. This is a strategic approach that the EU needs to have for ensuring its economic future and should not be considered as protectionism.

The Chair stressed that trust between the EU and UK is crucial in this approach. The hope is that common ground can be found more broadly, because there is a big dividend on both sides to getting the relationship right and tackling the challenges that are at stake in the post-Covid environment.

4. Possible regulatory and supervisory framework for managing future EU-UK financial relations

4.1 Framework needed for EU-UK regulatory and supervisory cooperation

An official explained that the Joint Declaration on Financial Services Regulatory Cooperation between the EU and UK committed to establishing a framework for regulatory cooperation by March 2021. A Memorandum of Understanding (MOU) has been agreed with the UK at a technical level and its formal approval by the EU is expected soon. The MOU is not a framework for making decisions and is an important element of the EU-UK relationship on financial services going forward. It is based on the model used for the EU-US regulatory dialogue and should also work for the UK, although this dialogue could be more intensive, due to the higher degree of inter-connection. Both sides will retain their regulatory autonomy and independence, thus the dialogue going forward will be about cooperation and not a co-management of processes.

Another official added that the MOU is not a policy tool but closer to an 'administrative vehicle', establishing the norms of the new relationship and helping stakeholders to understand the nature of the engagement between the EU and the UK in the future. Eventually, it should become a way to progress policy with no reference to Brexit, allowing the EU and UK to cooperate in areas such as the transition of economies to net zero or enhancing the digitalisation of the financial sector.

A regulator agreed that there needs to be discussions between the EU and the UK to ensure a shared understanding about the direction of travel and that the MOU is an appropriate framework in that respect. The European Supervisory Authorities (ESAs) and ESMA in particular will fully participate in that regulatory and supervisory dialogue with the UK, which is already occurring on the ground. ESMA, which is directly supervising certain entities in Europe will indeed need effective and close cooperation with the UK authorities. The ESAs have other challenges at the European level in this new context. One is the ability to be sufficiently fast and adaptive in rule-making. The other is addressing the far more fragmented financial-services sector that is now developing within the EU around different financial centres, which will require more consistency and convergence in the supervisory and regulatory approach within the EU. The Chair added that if the objective is to achieve a truly integrated capital market in Europe, then the necessary supervisory powers have to be devolved to ESMA including stronger enforcement powers in the cross-border and systemic areas.

4.2 Possible EU-UK equivalence arrangements

An official stated that there will be no blanket decisions regarding equivalence and that equivalence decisions will be assessed on a case-by-case basis. The equivalence assessment phase may begin when the MOU has been formally adopted and the regulatory cooperation is in place. A 100% alignment is not required for equivalence, but divergence cannot be too strong either. There are tolerable levels of divergence and there are levels of divergence that are less tolerable for equivalence arrangements to be possible. The regulatory cooperation framework that the MOU creates will be very important for having additional clarity on this aspect.

A market observer stated that equivalence decisions also have different implications depending on the activities and currencies concerned e.g. for securities and derivatives trading, clearing and settlement. When equivalence concerns contracts in a given jurisdiction's own currency, which are highly systemic for this jurisdiction, there may be a risk to financial stability if an excessive amount of this activity is allowed to happen outside that jurisdiction. This may apply to the UK as well as to other third countries.

The Chair noted that the UK's own policy reviews are just commencing with a large consultation exercise and that demand for equivalence seems to be decreasing in the UK. An official confirmed that there is now a less broad-based pressure in the UK for reaching equivalence with the EU, although interests may vary across firms. Many financial firms have indeed adjusted to a world without equivalence and have invested in new legal entities in order to be able to sustain services to clients on the continent. To a certain extent the industry has moved on from the question of equivalence with the EU to broader questions about future UK policymaking and the harmonisation of standards. Multinational firms however remain interested in maintaining convergent regulatory standards with the EU.