

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.