

EU-UK RELATIONS: WHAT FUTURE PERSPECTIVES AND IMPACTS ON THEIR FINANCIAL SECTORS?

1. Current status of the EU-UK cooperation in the financial sector and risks of regulatory divergence

1.1 Current status of EU-UK cooperation

A regulator considered that the Brexit transition went smoothly thanks to the important preparation done by the UK, the European authorities and financial market participants. Despite several minor issues of concern, the post Brexit landscape seems relatively stable in the area of capital markets in particular. In terms of day-to-day cooperation, there is effective supervisory cooperation between the EU and UK. There are regular exchanges and ongoing dialogue between ESMA and the UK authorities, which are important to maintain, given the high degree of interconnectedness between EU and UK markets. Ultimately, the two public authorities still have the same goals: to ensure investor protection and to maintain stable financial markets. There are memoranda of understanding (MOUs) which form a framework for cooperation between the EU and UK capital market supervisors: one MOU which enables dialogue between ESMA and the UK Financial Conduct Authority (FCA) and a multilateral MOU that facilitates dialogue between national competent authorities (NCAs) and the UK FCA.

An official agreed that the stable exit from the transition period reflected the good work done by officials on both sides and by the financial sector and that there is strong on-going cooperation between the EU and UK authorities. The transition of supervisory responsibility from the EU to the FCA for credit rating agencies (CRAs) and trade repositories, for example, was managed very effectively. The exchanges during the pandemic were also effective in terms of managing both the particular issues around money market funds for example and the general turbulence which occurred throughout the crisis. A regulator added that even during the COVID crisis the EU and UK regulators had had effective dialogue and discussion on new trends such as gamification.

1.2 Risk of regulatory divergence between the EU and UK

Answering a question from the Chair about the risk of regulatory divergence between the EU and UK, a policy-maker stated that divergence is inevitable because the EU and UK are two different markets and jurisdictions. Legislation will evolve on the EU side as well. This will be based on reviews and analyses conducted by the Commission and public consultations will be organized to inform all stakeholders of potential changes.

A regulator described how regulatory divergence between the EU and UK was announced and expected, stressing that it is a natural process. Divergence is becoming clearer following a number of announcements, publications and consultations by the UK authorities concerning financial regulations. The European authorities did not expect the UK authorities simply to copy EU rules, so these changes will need to

be carefully monitored and assessed to understand the potential impacts. This review process is only starting but it covers a wide range of topics, which means there are many potential areas of divergence. These include listing rules, prospectuses, packaged retail investment and insurance products (PRIIPs), open access and a Wholesale Markets Review. Equally, the Commission and the European authorities have an ambitious regulatory agenda and their own priorities, which may lead to further divergence. The question therefore is not whether there will be divergence but how it will be managed. ESMA will support the Commission in monitoring those developments, understanding their origins, assessing the impact on the industry, and offering advice on potential changes. There is also the need for an institutional framework to enable dialogue between the EU and UK and allow the EU authorities to understand the changes that are happening and their potential scope and consequences.

The regulator added that there are different views on how the European industry should adjust. There is no proper answer to this question. Some people view Brexit as a huge opportunity for the European industry to make the most of both regions and possibly benefit from arbitrage, meaning that ESMA will need to monitor such possibilities. Others feel there is a need for alignment because the industry's business models were created when the UK was part of the EU.

An official agreed that divergence is neither side's fault. The UK authorities have published a set of proposals for reforming certain financial frameworks, which are more incremental than fundamental. These proposals aim at making these frameworks inherited from the EU better adapted to UK markets. In the UK, the review process is managed in a stable, orderly and predictable way. The UK will conduct consultations, reflect on the results and then engage with industry and with international counterparts, including the Commission.

A policy-maker emphasized that while the review process may be incremental at the technical level, the rhetoric put forward at the top level of the discussion is quite different, with regular statements about 'big bangs'. Since it is this top level that matters in the end, the 'big bang' rhetoric tends to cloud the discussion and make things more complicated.

2. Progress made on the setting up of a new EU UK cooperation framework

2.1 Progress made on the proposed EU UK MOU

A policy-maker described the technical agreement achieved on the MOU. The language has been agreed between the Commission and the UK and the MOU is 'ready to go'. Once the MOU is endorsed by the member states, adopted by the Commission and eventually signed this will establish the framework for regulatory dialogue between the EU and the UK,

which will enable both sides to understand where divergence will inevitably arise and the extent to which it can be tolerated. As Commissioner McGuinness said on several occasions, the financial sector cannot be isolated from the broader political context. Ultimately, there is only one relationship between the EU and the UK. Noting the geographical proximity of the EU and UK and the inevitable degree of future interconnectedness between them, the policy maker explained how there is a desire to create an EU-UK forum in order to establish a regular, ongoing and structured dialogue. Cooperation should be based on trust, and the way to build trust is through dialogues such as this one. The intention is to build on the model that is used for discussions between the EU and the United States. There is a framework to this dialogue, and trust can be built up within that framework. Eventually, it should be possible to have fairly frank exchanges and 'get the job done'.

An official considered the establishment of a technical agreement on the future MOU to be very positive. It will be essential to make this forum operational and facilitate these kinds of conversations.

2.2 The prospects for future EU UK equivalence of financial rules

A policy-maker stated that equivalence assessments could be addressed once the MOU is formally concluded. These assessments would be conducted on a case by case basis. Equivalence does not require complete consistency, but there are limits to the amount of divergence that is tolerable and trust is essential.

Answering a question from the Chair about the possibility of minimizing any differences in rules via legislative or regulatory and supervisory means in order to ensure the freest flow of capital and financial services from the UK to the EU and vice versa, a regulator suggested that ESMA will certainly seek to maintain and strengthen cooperation here. The deep interconnection between the EU and UK creates a need for the public authorities to monitor the situation closely. The Derivatives Trading Obligation (DTO) and the Share Trading Obligation (STO) for example demonstrated how activities can sometimes move very quickly. As a supervisor, ESMA's objective is to strengthen its cooperation with the UK authorities and to create a stable situation in which dialogue can occur. The two sides will not agree on everything, but it is important to ensure there is a forum in which views can be exchanged. Many regulatory priorities are global in nature, which will require EU regulators to have a different engagement with their UK colleagues within international fora. In addition there are several areas such as sustainable and digital finance where the goals are shared between the EU and UK and significant progress should be possible within this forum.

The regulator also stated that ESMA will seek to provide objective evidence to support conversations about equivalence. Taking CCPs as an example, ESMA will provide evidence to the Commission and to wider stakeholders around key indicators, appropriate risks, and the consequences of changes in normal and stressed times from a market perspective, an orderly functioning perspective and a supervisory perspective.

Answering a question of the Chair about the future role of ESMA in equivalence determinations, the regulator suggested that the EU authorities would 'learn by doing'. ESMA's teams will focus on providing input to the Commission on the basis of their technical expertise and analyses of the impacts of specific measures from a consumer protection and access perspective in line with ESMA's new mandate to support the Commission on equivalence assessments. As part of ESMA's new equivalence monitoring responsibility, ESMA's focus will be on scrutinising regulatory, supervisory and enforcement developments in relation to equivalence decisions that currently exist, for example, STO and DTO decisions with the US – meaning that the UK does not generally fall within the scope of this exercise for the time being. It is important for ESMA to ensure that it has a good understanding of any potential implications for the European markets for areas and jurisdictions where equivalence is currently in place.

3. Future EU and UK strategies for the financial sector and implications for EU-UK relations

3.1 The EU open strategic autonomy agenda

Answering a question from the Chair about whether strategic autonomy is fundamentally about financial stability, a policy-maker agreed, highlighting the fact that, while the context of Brexit is inescapable, the strategic autonomy discussion was 'bubbling under the surface' before the UK's exit from the EU. It was simply made more acute by this democratic decision and its political consequences. The concept of 'strategic autonomy' is tricky, because the term is borrowed from foreign affairs and does not translate perfectly into economics. Secondly, the word 'autonomy' has often been misunderstood. Ultimately, 'autonomy' is about choice. It is not about doing anything per se; it is about the choice to do something rather than being forced to do it. The mention of 'autonomy' does not presuppose any particular outcome.

The policy-maker explained how the EU is an outlier in terms of developed economic and financial blocs, because it has a relatively small financial sector due to its historical evolution. The European Union quite sensibly put its domestic financial system next to the global financial centre that was available to it, namely London. London could grow further as a financial hub thanks to its membership of the single market. Due to the jurisdictional changes of Brexit, a large part of the EU financial system is still outside its jurisdiction and therefore outside its accountability framework.

Although the question of strategic autonomy goes beyond finance, it is particularly acute for finance and is a vital question for the EU public authorities. While this type of arrangement functions relatively well when the situation is normal, history proves that it is not optimum in periods of stress, even within the EU. A jurisdiction will not necessarily take decisions to the disadvantage of the other, but each jurisdiction may well have a different definition of what is best for financial stability and it is impossible to presume how third-country relations will work. What the EU does to maintain financial stability may be different for legitimate reasons to what action is taken in the UK or elsewhere.

The policy-maker suggested that this position is sometimes seen as the EU 'responding' to Brexit or seeking to 'take back' markets, but this is not the case. It is simply stating the fact that there are supply chain issues in finance and considering whether or not this situation makes sense over the long term. The EU recognised even before Brexit that there are vulnerabilities here, and these vulnerabilities have become more acute because of Brexit. It is often said that the US has a greater amount of risk in the UK than the EU does, because there is a larger absolute amount of dollar exposure than euro exposure. Proportionately, however, the amount of euro exposure is much higher. In addition, the US can use Chicago as an alternative. As the discussion about the DTO makes clear, transactions can migrate from London to the US relatively easily, but this is currently impossible for Europe. Autonomy, however, is not about changing things per se; it is about having the option to change things and therefore being more comfortable with a decision in the first place. The Commission remains fully committed to integration and multilateralism and will continue to have a close relationship with the UK going forward. If that relationship is more balanced, however, it will be more sustainable and more robust.

Responding to a question from the Chair's about the possible relocation of euro denominated clearing to the EU, the policy-maker noted that the present situation is not comfortable for the EU in the long term. From the Commission's perspective, the EU UK relationship is unbalanced. This does not mean that clearing should happen entirely in Europe, but there should be more balance. The Commission established a working group to discuss these issues with market participants from the buy and sell sides. The public authorities, including ESMA, participated in a discussion of the risks. The question is whether the EU can live with this risk. The Commission is currently assessing the pros and cons of making any changes.

3.2 The UK vision for financial services

An official described the UK's general vision on financial services, which is grounded in the desire to build on the success of the UK as a financial centre. This success is founded on adherence to robust standards. International standards are important, but in many cases the UK is looking to go far beyond them. The UK will succeed in the future by playing a leading role internationally and having the highest standards possible, because this will mean the UK is a place where people want to do business.

Mentioning several important examples of areas of international collaboration, such as digital regulation and sustainable finance, the Chair queried the UK's ambitions in terms of bilateral and international agreements, highlighting the mutual recognition agreement currently being negotiated with Switzerland. The official explained that the UK considers that global markets are good for the UK and good for those who participate in them. Complicated and technical rules can obstruct the provision of services in any highly regulated sector. The UK is focused on talking to partner jurisdictions about ways to support the cross border flow of capital and tackle global issues such as green finance and technology. The UK's philosophy on participating in these markets

is to acknowledge that there will be inter reliance and interdependence. The UK relies on the provision of services and infrastructures in the EU and in the US for the proper functioning of its markets. The question for the UK is around finding an arrangement that will make all parties comfortable that this arrangement will work in good times and times of stress.

The official noted that these were the kinds of conversations that the UK is having with the Swiss, for example. The UK and Switzerland are two sophisticated and well-regulated developed markets. The discussion is about what is possible in terms of any mutual recognition agreement. The work with Switzerland is focused on activity in the wholesale markets. It will genuinely set a standard for what is possible in sophisticated and advanced jurisdictions; it is up for other jurisdictions to determine whether that model is also interesting for them.

In terms of the possibility for financial services to be part of future trade agreements, while the GATT (General Agreement on Tariffs and Trade) does not substantially affect financial services, prudential and conduct supervisors must be involved in anything that affects the cross border provision of financial services due to the impact this can have on the economy, which makes it complicated to include any substantive changes in a trade deal. The UK approach has therefore been to establish the kind of dialogue that is taking place, for example, with Japan or Australia based on the GATT framework. This will allow finance ministries and regulators to explore improvements to the cross border functioning of markets for the benefit of both sides.

4. Possible improvement to the EU equivalence determination process

4.1 Specific issues raised by the UK

A policy-maker described the issues around equivalence in relation to the UK. Typically, equivalence decisions happen between jurisdictions that are already relatively close and expect to move closer to each other based on multilateral discussions. There are international standards with which all jurisdictions conform, but the idea is that the jurisdictions will stay where they are or converge rather than diverging. The problem is that the EU and the UK started from almost total alignment and the discussion is now about moving apart. This makes it more necessary to consider how far the two sides will go. Nobody wants an unstable equivalence process in which equivalence is granted, revoked and then granted again. When equivalence is granted, it should be stable and there should be an expectation that the degree of convergence will not deteriorate substantially, if at all. However, currently, both sides are discussing potential divergence from this very close alignment. There must be a qualitative discussion of what this will mean, because it cannot be done quantitatively. It will not be possible to predict perfectly, but there must be an understanding that neither side will 'tear up' the rulebook.

Responding to the Chair's query on whether equivalence has become politicised, the policy-maker disagreed. Ultimately, equivalence is a prudential tool

which in some cases can grant access to the single market. In Switzerland's case for example, there were problems around two fundamental elements of the single market: the Court of Justice and state aid rules. This decision was not a political decision per se; it was to do with the single market itself. If a country agrees to adopt the EU framework while maintaining that it will not accept any judgements the EU makes about the single market, the EU cannot grant equivalence. This is not politicisation; but the decision simply cannot be removed from the political context.

4.2 The challenge of monitoring equivalence agreements

A policy-maker described how equivalence was already a topic of discussion before Brexit. In a communication before Brexit, the Commission discussed some of the shortcomings around equivalence. One obvious disadvantage is that the Commission has limited resources to perform checks over time to determine whether the conditions under which an equivalence decision was granted remain still valid. There is a tendency to give equivalence once and for all. There could be periodic assessments of equivalence with a view to ensuring that a decision continues to be appropriate over time. Even before Brexit, the Commission was considering the possibility of introducing a more structured monitoring process. The policy-maker stated that there are between 250 and 300 equivalence determinations, depending on what counts as equivalence. It would be an 'operational nightmare' to monitor every single equivalence decision continuously, which means that EU authorities will have to define priorities depending on the relevance for the market. Tiny countries or tiny elements of the market will not be prioritised; more significant exposures will be the main priorities. The idea is not to monitor everything on a day to day basis, however, but to check that something equivalent in year one will be equivalent by year 20.

An official expressed sympathy with the comments expressed by the policy-maker. The UK has inherited the same 300 or so equivalence decisions, and it is faced with exactly the same set of questions. The UK wants to adhere to the notion of outcomes based equivalence. While the UK is very close to the EU, the underlying legal structures in almost all EU jurisdictions are very different, which means there is often no choice but to consider equivalence on the basis of economic and financial policy outcomes. This is a judgement basis, but it is certainly not a line by line piece of work. It is resource intensive, and it will require a considerable amount of focus.