



Post-Brexit regulatory divergence: potential magnitude and impacts

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David Wright (Chair)

David Wright noted that the Brexit referendum was held over six years ago and the EU-UK trade and cooperation agreement has been in force for over 18 months. The panel was asked to discuss the current state and magnitude of regulatory divergence between the EU and UK in the financial sector, how it may evolve and the potential impacts of this regulatory divergence post-Brexit.

Paulina Dejmek-Hack

Paulina Dejmek-Hack stated that Brexit is in essence a fragmenting event. There have been no immediate unexpected consequences or financial stability fallouts from Brexit, because financial industry players on both sides of the Channel were well prepared and had evaluated and anticipated the consequences for their businesses. Clearing, where the status quo remains, is a specific issue, due to the financial stability implications of a possible abrupt change of the current situation.

The discussion on the magnitude of divergence is somewhat misplaced. When the UK left the EU, the rules were the same in the UK and in the EU and, to a large extent, are still the same, since the UK had on-shored EU legislation. The UK has also embarked on a number of regulatory reviews, which will progressively be changing the UK regulatory framework. That is quite normal and inevitable and the same is happening in the EU, where reviews are undertaken to update the regulatory framework in order to better mitigate risks or adapt the framework to changes in the market. New legislations are also regularly brought in. Much work is happening in the Capital Markets Union (CMU) space for example, with on-going reviews of MiFIR and of the investment funds framework and new legislations being prepared such as the Listing Act and the Retail Investment Strategy.

Paulina Dejmek-Hack therefore expected regulatory divergence to develop over time, because regulatory

changes will be happening on both sides of the Channel and issues will be approached somewhat differently in the UK and the EU. That is not surprising and is a natural consequence of Brexit.

At the same time, the EU and UK are facing common challenges, including climate change and digitalisation and the whole of Europe is facing the same complex geopolitical situation at present. There is also a great deal of multilateral international cooperation happening in the context of the FSB (Financial Stability Board), the Basel Committee, IOSCO (International Organization of Securities Commissions) and other international fora, leading to the creation of global frameworks for the financial sector that concern both the EU and UK.

David Wright

David Wright asked Richard Knox to outline the perspective from the UK on regulatory changes and divergence and what can be expected from the UK financial services bill that has been proposed and is now being discussed in Parliament.

Richard Knox

Richard Knox agreed with Paulina Dejmek-Hack's points about divergence. The UK will take forward regulatory change, as will the EU. These changes will not be identical because political systems and markets differ. The appreciation of divergence however partly depends on what is meant by divergence. The rules may not be exactly the same but may lead to similar outcomes. The question of interest to financial services firms is the extent to which differences in rules impact cross-border activity or create material frictions for the industry.

Richard Knox confirmed that there is significant regulatory activity going on in the UK in the context of the flagship bill on financial services. The second reading in Parliament started at the beginning of September.

When the UK left the EU, the UK on-shored thousands of pages of EU law, incorporating it into UK law. These rules are quite difficult to amend, because primary legislation is needed in most cases. In addition, the regulatory framework was significantly extended following the 2008 financial crisis, resulting in a great deal of granular detail in legislation. This was never intended to provide the long-term approach for UK regulation of financial services. It created a complicated patchwork of regulatory requirements with detailed EU provisions in UK law that can generally only be changed through a very time-consuming process of primary legislation.

What the previous Government determined and the current Government is taking forward is a bill that puts in place a new regulatory architecture for the UK. The Bill implements the outcomes of the Future Regulatory Framework Review, which assessed whether the U.K. financial services regulatory framework is fit for purpose in light of Brexit and several other initiatives such as the Wholesale Markets Review. The UK independent financial services regulators, i.e. the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) will be given responsibility for creating firm-facing rules, with the related statute and the overall perimeter defined in law.

It is important to emphasise that the Bill is not actually changing the law. It will create the powers to put in place the new framework and then there will be a process for bringing all the law inherited from the EU into that framework and adapting it when needed. This will include a mechanism for democratic accountability which is comparable to the European system, where firm-facing rules are designed by the Commission and then adopted by the Parliament and the Council i.e. by political representatives. The UK is delegating the formulation of rules to independent regulators, but democratic accountability will be maintained by Parliamentary oversight and by ensuring that the regulators have broader considerations where appropriate, the underlying priority being an absolute focus on financial stability and market integrity.

David Wright

David Wright commented that the Treasury will be endowed with an oversight power and asked whether this would likely result in a call-back type of provision vis-à-vis the regulators or the Bank of England, or whether this was still under discussion.

Richard Knox

Richard Knox stated that this is the debate that is underway. Thousands of pages of law that were formulated by EU policy-makers and politicians are being given to independent regulators for review. The debate is about what the appropriate democratic input and accountability should be in that process given the fact that the UK will not have the same kind of direct democratic input as does the EU system.

There should be some mechanisms, probably by exception, as happens in some other jurisdictions. However, the UK system is also different from the US system for example, where the governance of the

regulators changes with the political cycle, whereas the UK has a very independent regulatory system. How to ensure democratic accountability within the UK system is the object of the current debate.

David Wright

David Wright asked Kristine Braden about the consequences of a potential divergence of standards between the EU and UK over the medium to long term for a global bank such as Citi and if the regulatory cooperation happening at the global level is sufficient for alleviating potential issues.

Kristine Braden

Kristine Braden stated that, starting with the G7, the continued dialogue keeping the international system together is very much welcomed. Over time, there will likely be divergence between the EU and UK, as mentioned by the previous speakers. From the perspective of a practitioner, while it was in development for six years, Brexit has just started. There has been a first wave of asset moves from the UK into the eurozone, but the next waves are coming and this will continue over the coming years. There is probably still a 5 to 10-year process ahead, where infrastructure, asset classes, competencies and talent will be continuing to shift into the eurozone.

In the Brexit context, it is really important that international standards are maintained. Citi is for example running a broker-dealer in Germany. This currently involves interactions with 14 regulators, so having regulatory consistency is very important for running the operations effectively. It becomes much more complicated if the rule sets and/or capital requirements differ.

A second important aspect of Brexit is that activities are still spread out over the UK and the rest of Europe. As a result of that, it is really important not to add unnecessary layers of friction across the Channel. It is in everyone's interest to consider how to build the most competitive financial markets, because the ultimate aim is to support the economy. Both sides of the Channel will look to their own interests in the longer term, so banks need to be prepared for that reality.

David Wright

David Wright noted that a divergence in standards would have commercial implications for an international bank such as Citi and asked how they would respond and adjust to such differences.

Kristine Braden

Kristine Braden stated that the commercial implications of divergence and where it is most effective to carry out business are evaluated as a matter of course. At present, the EU is continuing to seek commonality across the EU through projects such as the Banking Union and Capital Markets Union (CMU) and there is a great opportunity associated with these projects.

The anti-money laundering (AML) regulation is also welcomed because it will enable their group to operate on a much more efficient platform within the EU. In a post-Brexit environment, EU objectives to create a more efficient internal market are welcomed. There is huge potential scale within the EU with the size of the economy

and the size of the population. However economies of scale can only be achieved if some of the internal frictions that exist within the EU are adjusted.

David Wright

David Wright noted that this debate is reminiscent of the transatlantic financial services dialogue that was happening with the US at the time the European Commission was building the first phase of integration of the Financial Services Action Plan. Both sides recognised that they did not want to have conflicting laws that would get in the way of free trade. That should also be the objective for the EU and UK. The aim must be to get the memorandum of understanding (MOU) that has been agreed between the EU and UK to function. It has been frozen for some time.

If there is a belief in open markets, there needs to be a discussion about how this is going to work. From an economic perspective, cooperation is good for the UK and the EU, but this has not yet been achieved due to political issues. David Wright asked the panellists for their views on how cooperation could be developed over time.

Paulina Dejmek-Hack

Paulina Dejmek-Hack noted that cooperation is indeed important, but there is a broader political context of the EU-UK relationship post-Brexit, from which financial services cannot be decoupled. It is uncertain how that broader political context will develop over time. For the time being, there are international frameworks and international fora where these financial regulation issues can be discussed between the EU, the UK and many other jurisdictions.

David Wright

David Wright noted that the UK had, and probably still has, a very substantial balance of trade surplus on financial services with the European Union. This would suggest a strong incentive on the UK side to resolve obstacles as fast as possible, rather than risking markets closing off. David Wright asked Richard Knox how progress can be made on these issues, leaving aside the politics.

Richard Knox

Richard Knox stated that the UK's view is that there are genuine benefits to cross-border activity. It is hugely important and has been for a long time, not just with the EU but with a whole host of other jurisdictions.

There are three important factors to consider in this context. Firstly, international multilateral cooperation is essential. The UK and the EU are active in this area and this has allowed the agreement on broad guardrails defining in particular how international capital markets and market infrastructures should operate. The UK is a global financial centre and needs to rely on other critical market infrastructures where they exist, whether in the EU, the US or elsewhere. Large international firms also need to organise their booking models and capital allocation with a global perspective. Departure from this would make the system much less efficient, with costs that end up being passed back to the real economy. That underpins many of the conversations in multilateral engagement.

The second point is that dialogue, particularly bilateral dialogue, is essential. An MOU is ready and the UK is keen

to implement it to enable bilateral discussions between the UK and the EU.

The final point is that the rulemaking process that will happen in the UK will include industry consultation, as is currently the case in the EU, in order to take account of potential frictions and fragmentation that may be created by new rules or other impacts for the industry. The objective will be to try to minimise those impacts as they might potentially unfold.

David Wright

David Wright suggested that whether it is in the Basel process, the FSB, IOSCO's work, the International accounting standards, the more granularity that can be agreed at a global level, the less friction there should be when the EU and UK implement these international standards. The presumption resulting from Brexit was that the UK would be much keener on global rulemaking and that is turning out to be the case.

Kristine Braden

Kristine Braden emphasised Richard Knox's point on the need for continued dialogue with the industry. That is the most important objective from their perspective. Where there are frictions e.g. with various margining rules or capital requirements, it is vital that there is a conversation about where the differences are arising and whether they are actually achieving anything.

A second aspect that needs considering is the mandate of regulators. In the new UK framework there is the suggestion that regulators should be encouraged to foster the competitiveness of the industry. There is a similar idea in the Singapore model. This is an interesting position, because it can help to move the whole of the industry forward in the same direction. The European economy has the benefit of truly global corporations and financial institutions based within the Union. It is also in the interest of the EU to stay as globally coordinated as possible, so that its own economy has the ultimate benefit.

David Wright

David Wright asked what the Commission's views are on the competitiveness agenda, the regulatory competition agenda and the international regulatory agenda.

Paulina Dejmek-Hack

Paulina Dejmek-Hack agreed with many of the points raised by other speakers, in terms of the general ecosystem and frameworks needed for financial markets to flourish. When considering the CMU initiative for example, general regulatory objectives such as financial stability and investor protection are taken into account, but the competitiveness of the EU financial sector is also taken into consideration.

David Wright

David Wright summarised that the discussion showed that there should be as much regulatory convergence and supervisory cooperation as possible between the UK and the EU to minimise frictions and differences. That is to the benefit of everybody, firms, consumers and the broader economy. The message to the politicians is to start meeting on a regular and mature basis. That would be in everybody's interest.