European capital market integration post-Brexit

By Paul Richards

Summary: Maintaining European capital market integration post-Brexit would be of mutual benefit to the UK and to the remaining 27 EU Member States. There are limited ways of achieving this. Before and during the negotiations on Brexit, it will be important for the authorities to minimise uncertainty in capital markets, maximise continuity and, in the case of any changes, give sufficient time for capital market firms to prepare, so as to minimise disruption to capital markets and damage to the real economy, not just in the UK but across Europe as a whole.

Introduction

1 ICMA has encouraged capital market integration across national borders for almost 50 years.[1] The UK vote to leave the EU risks fragmenting capital markets in Europe between London as an international financial centre, on the one side, and financial centres in the remaining 27 EU Member States (EU27), on the other, particularly if the UK no longer has free unrestricted rights of access to the EU Single Market through the "single passport"[2] after withdrawal from the EU (ie Brexit).[3] This Quarterly Assessment considers possible ways of maintaining capital market integration post-Brexit, not just from the perspective of the UK, but from the perspective of Europe as a whole. Any settlement between the UK and the remaining EU27 will need to be acceptable, not only to the UK, but also to the European Council and the European Parliament, which will have a vote on it.

Capital market integration as a common European interest

2 In considering the implications of Brexit for capital market integration in Europe, a distinction needs to be drawn between policy issues which relate only to the euro area and those which relate to the EU as a whole. The euro area needs to be integrated in areas of policy that do not apply to the rest of the EU, as a result of:

- Economic and Monetary Union (EMU), under which the European Central Bank is responsible for the euro as the single currency of the 19 EU Member States in the euro area, but not of the nine Member States in the rest of the EU, which continue to use their national currencies; and
- Banking Union, which applies to the euro area – through the Single Supervisory Mechanism and the Single Resolution Mechanism – rather than the EU as a whole, though non-euro area Member States in the EU can opt in.

While all European countries have an interest in EMU and Banking Union working well, decisions about the operation of both EMU and Banking Union relate only to the euro area.

3 By contrast, Capital Markets Union is an EU project which relates, not just to the euro area, but to the European Economic Area (EEA) as a whole (ie 31 countries) and, indirectly, to Switzerland. (See Box 1.) What all these countries in Europe have in common is involvement in the

1. Capital market integration across borders helps to encourage trade in financial services in both directions, increasing market efficiency and economic growth, whereas fragmentation increases costs and reduces efficiency.

2. The "single passport" allows financial services operators legally established in one EU Member State to establish or provide their services in the other Member States without further authorisation requirements.

3. 8,008 firms passport into the UK from another EU (or EEA) Member State. 5,476 UK firms passport into other Member States: FCA evidence to the House of Commons Treasury Select Committee, 17 August 2016.

EU project for Capital Markets Union, which is designed to promote capital market integration across borders in Europe as a whole, so as to encourage economic recovery in Europe and to help Europe compete globally with the US and Asia. Under the programme for Capital Markets Union proposed by the European Commission, there are many further steps which need to be taken.[4] But the immediate question is how best to maintain the degree of capital market integration that has been achieved already, when the UK leaves the EU.

Box 1: Countries outside the euro area involved in Capital Markets Union

Apart from the UK, the countries outside the euro area involved in EU Capital Markets Union fall into a number of categories:

First of all, six EU Member States – Bulgaria, the Czech Republic, Croatia, Hungary, Poland and Romania – are obliged to join the euro area when they meet the Maastricht convergence criteria, though none of them meets these criteria at the moment. (For example, none is currently a member of the Exchange Rate Mechanism (ERM): being a member of the ERM for at least two years is one of the requirements for joining the euro area.)

Second, Denmark and Sweden are EU Member States which are either legally exempt from joining the euro area (in the case of Denmark) or exempt in practice (in the case of Sweden).

Third, Iceland, Liechtenstein and Norway are members of both the European Free Trade Area (EFTA) and the European Economic Area (EEA). As members of the EEA, they accept EU rules without a vote on them in exchange for unrestricted free access to the EU Single Market.

In addition, fourth, Switzerland – which is a member of EFTA, but not the EEA – has a series of bilateral agreements with the EU. Following a referendum in 2014 in which Switzerland voted in favour of imposing a quota on EU immigration, the deadline for resolving the quota issue is February 2017. If it is not resolved, there is a risk that bilateral agreements between Switzerland and the EU will not be renewed by the EU when they fall due.

Maintaining capital market integration post-Brexit

4 Following the vote in the UK referendum on 23 June 2016 to leave the EU, the UK Government announced on 2 October that it will invoke Article 50 of the EU Treaty by the end of March 2017. This interval will give the UK Government time to finalise its approach to the negotiation of UK withdrawal from the EU and new trading arrangements with the EU27 in future. It will then be for the EU27 to respond. (See Box 2.)

The EEA option

5 When the UK leaves the EU, it would be possible to maintain European capital market integration if the UK were to join the EEA: ie in exchange for accepting EU capital market regulation without a vote, the UK would continue to be a member of the EU Single Market and have unrestricted free rights of access through the single passport. But there would be a number of potential difficulties with this approach:

- In order to join the EEA, the UK would need to join EFTA. The UK would also need to sign an EEA accession treaty, which would have to be agreed and ratified by all 30 EEA Member States (ie the EU27 as well as the three EFTA members of the EEA.) It is not clear whether they would all support UK membership of the EEA.
- Following the vote in the UK referendum, the UK Government has stated that it will give priority to controlling immigration from the EU27, which may in turn be unwilling to grant unrestricted free access to the EU Single Market in response.
- The UK Government has also stated that it will give priority to the primacy of UK law[5] over EU law in the UK, whereas membership of the EEA effectively provides for the opposite.
- Members of the EEA contribute to the EU budget. The UK Government will want to avoid new commitments to the EU budget, if possible, when the UK leaves the EU.

For all these reasons, the UK Government is not expected to join the EEA when the UK leaves the EU.[6]

The alternative option of a bilateral agreement between the UK and the EU27

6 Assuming that the UK does not join the EEA, the main alternative is for the UK Government to negotiate a bilateral agreement with the EU27 which would be "unique" to the UK and take effect as soon as possible after the UK leaves the EU. Under such a bilateral agreement, the UK

4. Arguably, the need for progress on Capital Markets Union is even more relevant for the EU27, once the UK leaves the EU, as the share of capital market financing is lower, and the share of bank financing is higher, in the EU27 than in the UK.

5. ie English and Scottish law.

6. though an interim arrangement (see below) may have some similarities.

would no longer be a *member* of the EU Single Market, but the UK Government would seek to negotiate *access* to the EU Single Market on favourable terms.

7 For capital markets, a key element in any bilateral agreement between the UK and the EU27 is expected to be the negotiation of "equivalence" (under which the regulatory regime in the UK would be deemed to be equivalent to the regulatory regime in the EU27) in exchange for "reciprocity" (under which the EU27 would have access to the UK domestic market on the same terms that the UK had access to the Single Market of the EU27).[7] Demonstrating equivalence would be important for the UK in order to obtain access to the EU Single Market on favourable terms. Equivalence may have to be established for each relevant capital market sector (eg banking, asset management, market infrastructure) or regulation (eg MiFID II), case by case, though it is possible that a bilateral agreement between the UK and the EU27 would give scope for differentiation in the UK in particular areas. In the same way that UK equivalence with the EU27 would be important for capital market participants in the UK, EU27 equivalence with the UK would be important for capital market participants in the EU27.

Box 2: Withdrawal negotiations between the UK and EU27

The first formal step towards withdrawal from the EU is for the UK Government to notify the European Council of the UK's intention to withdraw by invoking Article 50 of the EU Treaty. Invoking Article 50 is considered to be the only legal way to leave the EU. It is for the UK Government to decide when to invoke Article 50.

The UK Government announced on 2 October 2016 that it will invoke Article 50 by the end of March 2017. The other 27 EU Member States have made it clear that "there can be no negotiations of any kind before notification has taken place", though there have been informal contacts in the meantime.

In preparation for notifying the European Council under Article 50, the UK Government also announced on 2 October 2016 that, following the Queen's Speech in spring 2017, it will introduce a Great Repeal Bill into the House of Commons to repeal the European Communities Act 1972. The Great Repeal Act would come into effect on the date on which the UK leaves the EU.

Once notification under Article 50 has taken place, there is a period of two years for the UK Government to negotiate withdrawal from the EU with the European Council, acting by enhanced qualified majority voting with the consent of the European Parliament. If no agreement is reached, the UK will leave the EU two years after Article 50 has been invoked, unless the 27 remaining EU Member States unanimously agree with the UK to extend that period.

During the negotiations on the terms of withdrawal (for example, on UK budgetary commitments to the EU), the UK Government is expected to seek a new agreement on UK/EU27 relations in future. While the two sets of negotiations are interconnected, it is not yet clear whether they will be conducted consecutively or in parallel. Article 50 states that the withdrawal agreement should take account of "the framework for [the UK's] future relationship with the Union". But future UK/EU27 relations may need to be approved unanimously post-Brexit and ratified in all 27 remaining EU Member States.[8]

In the period after Article 50 has been invoked and before UK withdrawal, existing EU legislation will continue to apply in the UK, as will any new EU legislation due to be implemented before withdrawal (eg MiFID II on 3 January 2018).

When it invokes Article 50, the UK Government formally states its intention to withdraw. If the UK Government's intention subsequently changes[9] and it wishes to remain in the EU, it appears that the Article 50 process can be stopped before Article 50 expires and the UK leaves the EU.[10]

7. The UK's legal and regulatory system, and in some cases also its supervision regime, would have to be deemed "equivalent" to the EU regime, on the basis of the technical advice of the relevant ESA to the European Commission, subject to a vote of EU Member States. Where there are differences, the equivalence assessment would normally be "outcome-based".

8. Jean-Claude Piris, *The Financial Times,* 20 September 2016.

9. eg if there were to be a second referendum in the UK on the outcome of the negotiations, or if EU immigration controls were to be introduced, not just in the UK, but in the EU27.

10. Jean-Claude Piris, *The Financial Times,* 1 September 2016.

8 It should technically be feasible for the UK to demonstrate equivalence, if existing EU capital market legislation in the UK is "grandfathered" when the UK leaves the EU: ie EU Directives, which have been transposed into UK law, would not be changed, whereas EU Regulations and Regulatory Technical Standards, which currently apply directly in the UK and will no longer apply once the UK leaves the EU,[11] would be reintroduced as UK law. While equivalence is "outcome-based" for other third countries (like Switzerland), as they have their own capital market legislation, the position in the UK would be different from other third countries, when the UK leaves the EU, as UK and EU27 legislation would initially be the same, subject to "grandfathering".

9 There are three potential problems with the existing provisions for third country "equivalence" which a bilateral agreement between the UK and the EU27 would need to address:

- EU capital market legislation provides for equivalence in some cases (eg MiFID II), but not fully in all cases (eg CRD IV);
- equivalence depends on a judgment by the EU authorities which may take time to establish and may become subject to the political negotiations between the UK and the EU27 more generally; and
- it can be withdrawn by the EU unless the UK Government keeps UK legislation up to date with EU legislation in future. This approach may be problematic for the UK Government, if it wants to demonstrate that UK law is not subject to EU law in future.

Bridging the gap between UK withdrawal and the start of the bilateral agreement

10 Given that the UK Government is due to invoke Article 50 by the end of March 2017, its objective must be to complete the negotiations with the EU27 before Article 50 expires two years later (ie before the next UK General Election, which is scheduled for 2020). But it is not clear whether it will be feasible to conclude a bilateral agreement by then. Bilateral agreements with the EU take time to negotiate and to ratify in all Member States and the European Parliament. (The proposed bilateral agreement between Canada and the EU has so far taken seven years.) And there are few precedents for the bilateral negotiation of financial services.

11 If agreement proves not to be possible in the two-year period after Article 50 is invoked, and there is not unanimity among the EU27 on extending negotiations at the end of that period, then the UK would need to fall back on trading with the EU27 under the rules of the World Trade Organisation (WTO) and General Agreement on Trade in Services (GATS)[12], unless an interim arrangement between the UK and the EU27 can be agreed to cover the period between UK withdrawal from the EU and the introduction of a bilateral agreement. This interim arrangement would be designed to minimise market disruption and reduce the risk of "cliff effects" (ie a sudden change in the regulatory regime when the UK withdraws from the EU and another sudden change when the bilateral agreement between the UK and the EU27 takes effect later).

12 Such an interim arrangement could be based on a "presumption of equivalence" between the UK and the EU27, not just in the case of selected EU regulations but across the board, to bridge the gap between the expiry of Article 50 and the point at which the bilateral agreement comes into effect. It is not clear whether the UK would be required to make a payment to the EU27 for access. The terms of the interim arrangement would need to be as close as possible to the existing UK arrangements within the EU, and be announced as early in the process as possible, to minimise market uncertainty and disruption, and to give capital market firms sufficient time to prepare for legislative changes as a result of Brexit. Preparations in the UK could also be complicated by the UK regulators' requirement that some banks should ring-fence their retail from their investment banking activities by the end of 2018.

EU27 and UK authorisations

13 If it proves not to be possible to bridge the gap, there is an increased risk that capital market firms – on the sell side and the buy side – will question whether a bilateral agreement between the UK and the EU27 on equivalence will be achieved, how long it will take and how far they will be able to rely on it. A number of the largest international capital market firms operating in London have a banking licence and authorisation to operate within the EU27 already. So they would have unrestricted free access across the EU27 from their European headquarters or an existing subsidiary in the EU27. It seems likely that different market firms would use different financial centres – eg Frankfurt, Paris, Luxembourg or Dublin – depending on their existing arrangements and client needs. But where market firms do not yet have sufficient authorisations to provide all relevant capital market products from the EU27, the length of time needed to obtain these authorisations could well become a constraint, particularly if a significant number of financial institutions all apply to the same authorities in

11. ie Under the Great Repeal Act, the European Communities Act 1972 would be repealed.

12. The implications of providing services from the UK to the EU27 under GATS are unclear, and could create market uncertainty.

the EU27 at the same time. While there may be competition between different EU27 financial centres to attract capital market firms by speeding up their authorisation processes, it is quite possible that, to be ready in time for Brexit, capital market firms will have to make decisions before they know the outcome of the Brexit negotiations, particularly if they are responding to pressure from their clients.

14 In the same way as capital market firms located in the UK would need authorisation to operate in the EU27 after Brexit, firms based in the EU27 would need authorisation to operate in the UK, where they do not have authorisation already. If restrictions were to be imposed in the EU27, there would also be a risk that similar restrictions would be imposed in the UK, though that would not necessarily be the case if the UK authorities took the view that it was preferable for London's role as an international financial centre not to impose them.

Implications for capital market integration in Europe

15 It is not clear to what extent a bilateral agreement between the UK and the EU27 would preserve capital market integration between London and financial centres in the EU27: for example, whether banks would have to maintain two separate balance sheets, one for the UK and one for the EU27, which would be more expensive – in terms of capital and liquidity – than the single balance sheet they need within the EU at present. Nor is it clear what proportion of market firms' operations would need to be located in the EU27 by their supervisors in order to obtain authorisation and to maintain it; nor – beyond the supervisors' requirements – to what extent market firms would choose to base their capital market activities in the EU27 or in New York, as opposed to basing them in London. That would depend, not just on the cost of moving from London to a location in the EU27, but also on their assessment of the future viability of their capital market business in Europe and on their perceptions of London's future as a stable and predictable centre for international business that is competitive in global terms: ie in terms of a critical mass of skills, legal and market infrastructure, use of the English language, labour market flexibility, corporate and personal taxation, exchange rate competitiveness etc. Pending a clearer idea of the UK's negotiating proposals and the EU27 response, many market firms are currently in "wait and see" mode, while undertaking contingency planning.

16 Both the UK and the EU27 have a mutual interest in reaching an agreement covering capital markets, given the importance of London's role as an international financial centre both in European and global terms, and given the mutual benefit from trade in financial services across borders for both sides and for the European economy as a whole. However, financial services form only part of the overall arrangements that need to be agreed between the UK and the EU27, and the outcome in financial services may be affected by the outcome elsewhere in the negotiations. If, in the event, agreement could not be reached, then it would be open to the UK authorities to make regulatory changes in the UK to the EU *acquis* with the objective of increasing London's competitiveness, both in European and global terms. But this would be expected to be a fall-back option, as both the UK and the EU27 would have a mutual interest in reaching an agreement.

17 If it was possible for the UK to negotiate with the EU27 a separate sectoral agreement covering capital markets, the result could be that the City of London – as a European financial asset – would in practice remain "in" while the UK as a whole would come "out" of the EU. But an outcome of this kind would depend on three preconditions. One is that a separate sectoral agreement covering capital markets could be negotiated within the overall agreement between the UK and the EU27. Second, provision would need to be made for free movement of highly skilled working people to and from the City. Third, "the City" would not be defined by its physical location but by the EU capital market regulation to which it would continue to be subject after Brexit under UK law. However, the City would not necessarily be subject to less regulation under UK law otherwise. The UK authorities have been in the forefront of proposing strict regulation of financial services since the global financial crisis in 2007-09, and the UK would still need to meet its international obligations, many of which originate from agreements at global level among the G20, of which the UK will continue to be a member when it leaves the EU.

UK trade agreements with the rest of the world

18 Trade agreements between the EU and the rest of the world are an EU rather than a national competence. So, if the UK leaves the EU Customs Union[13], new agreements will also need to be negotiated between the UK and 53 other markets in the rest of the world, unless the UK is going to trade solely under WTO and GATS rules. The UK is currently a member of the WTO through membership of the EU. To become a full member of the WTO when it leaves the EU, the UK would need approval of the WTO's 163 members. Potential trade agreements with the US, Canada and Australia have all been mooted by the UK Government, but some trading partners are likely to wait to negotiate with the UK until after negotiations between the UK and the EU are complete, and nothing can be signed until after the UK leaves the EU.

13. The EU Customs Union applies a common external tariff on imports from the rest of the world.

Governance of capital market integration in Europe

The increasing role of the euro area

19 The prospective withdrawal of the UK from the EU highlights potential concerns about the governance of capital market integration across Europe. This is because the UK's withdrawal increases substantially the relative importance of the euro area in the EU. The euro area will represent 84% of combined EU GDP, excluding the UK. That puts the euro area in a powerful position to make decisions relating to the EU as a whole when these decisions are taken by qualified majority voting (as opposed to unanimity, as in the case of tax matters), and when members of the euro area decide to vote together.

20 In addition, one of the consequences of the UK vote to leave the EU is that the safeguards negotiated by the UK Government as part of the New Settlement agreed by the European Council on 19 February 2016, which were designed to prevent discrimination between the euro area and the rest of the EU, will not now come into effect, as they would have done if the UK had voted to remain. (See Box 3.)

21 As a result, the euro area could become the effective "rule maker" in European capital markets, while its European neighbours – both inside and outside the EU – would become "rule takers". So, for example, the UK Government would no longer have a vote on new EU regulations affecting capital markets in future, when it leaves the EU, even though capital markets in London are currently larger than any other financial centre in Europe. After Brexit, the UK authorities would be solely responsible for regulating as well as supervising London as an international financial centre; and once UK law has supremacy in the UK over EU law, the UK Government would have the freedom to introduce different capital market legislation in the UK. But if it did so, this might put at risk the UK's terms of access to the EU Single Market, unless a bilateral agreement between the UK and the EU27 provided flexibility.

22 As the UK would not participate in EU27 decisions and would not have a vote on them, it would not have any direct influence over decision-making in the EU27. Instead, the UK's influence would be in the indirect form of competitive pressure on the EU27 to ensure that EU capital market regulation was "fit for purpose". Capital market participants in Europe would themselves also wish to ensure that new EU27 capital market regulation was fit for purpose. If it was not fit for purpose, there would be a risk that some international capital market activity in the EU27 would move elsewhere, not necessarily to the UK, but to financial centres in the US or Asia. The risk of a shift to the US or Asia would be

Box 3: The EU safeguards if the UK had voted to remain

If the UK had voted to remain in the EU, the New Settlement agreed by the UK Government in the European Council on 19 February 2016 would have come into effect, but will not do so given the UK vote to leave. The main provisions in the New Settlement affecting capital markets would have been as follows:

EU Member States not participating in the euro area will not create obstacles to further deepening of Economic and Monetary Union in the euro area. Conversely, any further integration by euro-area Member States will respect the rights and competences of non-participating Member States.

Discrimination between the euro area and the rest of the EU is prohibited. Any difference in treatment must be based on objective reasons.

EU law on Banking Union applies only to credit institutions in the euro area and in other EU Member States which have opted in to Banking Union. In these Member States, measures may be needed that are more uniform than in the rest of the EU, while preserving the level playing field within the EU Single Market and contributing to financial stability.

Crisis measures safeguarding the financial stability of the euro area will not entail budgetary responsibility for Member States not in the euro area nor opting in to Banking Union.

The supervision or resolution of financial institutions and markets, and macroprudential responsibilities, to preserve the financial stability of Member States not in the euro area are a matter for them, unless they join common mechanisms to which they can opt in.

Any Member State can ask the President of the European Council for an issue relating to the application of the European Council's Decision to be discussed in the European Council, and due account will be taken of the urgency of the matter.

greater, if capital market firms in Europe had to comply with two different regulatory regimes – in the UK and the EU27 – instead of one at present.

Other governance issues

23 There are a number of other issues relating to the governance of European capital markets arising from the UK's vote to leave the EU:

- Once the UK leaves the EU, the ECB may want to draw the euro market infrastructure (eg euro clearing) from London into the euro area, so that the ECB can exercise closer supervision for financial stability purposes.
- The European Banking Authority is expected to move its headquarters from London to a venue in the EU27.
- A new regime for regulatory cooperation will be needed between the UK and the EU in place of the current regulatory regime in which the UK participates in the three European Supervisory Authorities (ESAs), though it is likely to be in the interests of both the UK regulators (ie the FCA and the PRA) and the ESAs for a cooperative relationship to continue in practice.
- The EU27 may take the opportunity to establish a European Capital Market Authority in due course, bringing together the three ESAs: a step hitherto opposed by the UK, though also by some other Member States. A key question is whether the remit of any such Authority would relate to the EU as a whole, or only to the euro area, and whether a change in the EU Treaty would be needed to establish it.
- Once it leaves the EU, the UK will no longer be able to be a shareholder in the European Investment Bank (EIB), as the shareholders are the EU Member States, unless there is a change in the EIB's Statutes. An explicit and unanimous decision by the remaining EU27 Member State shareholders would be required for the UK to remain an EIB member and for any further lending to the UK, though it is not expected that existing finance contracts would be affected. Setting up a national development bank in the UK (like KfW in Germany) would take time.
- The withdrawal of the UK is likely to lead to budget cuts at EU institutions, in part linked to a reduction in activities associated with the UK's decision to leave the EU.
- UK nationals may not any longer be eligible after Brexit to work on open-ended contracts in EU institutions. It is not yet clear whether existing contracts will be "grandfathered".
- There may also be implications for the future use of English law in new cross-border European agreements.

24 Finally, there is uncertainty in capital markets about whether Scotland will in due course hold a second referendum on leaving the UK, with a view either to remaining in the EU when the UK leaves or, if that is not possible, applying as an independent country to join the EU.

Conclusion

25 If capital market integration between the UK, the euro area and its other neighbours both within and outside the EU can continue to be maintained after the UK leaves the EU, the result will be a single capital market in Europe much larger in size than if it were to be fragmented. A single European capital market would benefit economic growth across Europe as a whole and help Europe to compete globally with the US and Asia. Both the UK and the EU27 have a mutual interest in maintaining capital market integration. Avoiding fragmentation is one of the key issues arising from Brexit for the international capital markets.

26 Both before and during the negotiations on Brexit, capital market firms – whether based in the UK or based elsewhere with UK counterparties – are likely to have a number of concerns which the authorities need to address: (i) the need to minimise uncertainty; (ii) the need to maximise continuity; and (iii) in the case of any changes, the need to give capital market firms sufficient time to prepare, so as to minimise the disruption to capital markets and to minimise damage to the real economy, not just in the UK but across Europe as a whole. It would also be helpful if the capital market provisions in the European Council decision of 19 February, which were designed to prevent discrimination between the euro area and the rest of the EU, could be reformulated to support capital market integration across Europe as a whole.

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