EU/UK capital market fragmentation in a global context

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Summary

This assessment considers the risks of capital market fragmentation arising between the EU and the UK, a year after the end of the post-Brexit transition period, and it examines the scope for regulatory cooperation in future in a global context, in six parts: the EU and UK as two separate markets; the limited scope for equivalence; regulatory divergence; differences in approach to regulation; the opportunity for regulatory and supervisory cooperation; and the importance of a global approach.

Introduction

1 At the end of the post-Brexit transition period on 31 December 2020, the UK left the EU Single Market, passporting rights ceased and the EU and UK markets became two separate markets. This assessment updates previous assessments since the UK referendum on Brexit, a year after the end of the post-Brexit transition period. In doing so, it considers the risks of capital market fragmentation arising between the EU and the UK, and it examines the scope for regulatory cooperation in future in a global context. A common objective is to ensure that international capital markets are efficient and resilient so that they can finance sustainable economic growth and development.[1]

2 The global context has become increasingly important since the global financial crisis in 2008/09, when the Financial Stability Board (FSB) was established under the aegis of the G20 to oversee financial services regulation globally, alongside the International Organization of Securities Commissions (IOSCO) as a global standard setting body for securities markets, the Basel Committee on Banking Supervision (BCBS) on banking regulation and the Committee on Payments and Market Infrastructures (CPMI). This year, an agreement has also been reached in the OECD on a global minimum level for corporate tax and, under the aegis of the UN, COP26 in Glasgow has resulted in global agreement on implementing measures relating to climate change, including by setting up an International Sustainability Standards Board (ISSB).

3 While the remit of these boards and committees and the agreements that they reach are global in scope, the legislation arising generally needs to be implemented in different jurisdictions (eg the EU and the UK) separately. The power to take decisions about whether, when and in what form to introduce legislation lies ultimately with the regional or national governments concerned, and they frequently need to take account of distinct local factors. For example, the FSB Official Sector Steering Group oversees the transition from LIBOR to risk-free rates globally, but legislation has been introduced separately in the US, UK and the EU, among others, and the authorities in each jurisdiction are aware of the importance of avoiding a conflict of laws between them. There are other cases in which legislation in a particular jurisdiction is intended to have an extra-territorial effect.

The EU and UK as two separate markets

4 Since the end of the post-Brexit transition period on 31 December 2020, the cross-border securities market

1. Financial services regulation is only one of the external influences on international market firms operating in financial markets in different jurisdictions: others include the political context, monetary and fiscal policy, corporate and individual taxation, labour laws, the legal, market and technological infrastructure, as well this year as the impact of the recovery from the COVID-19 pandemic.

has continued to function as efficiently as it can, largely because capital market firms were well prepared for the cessation of passporting rights and the fragmentation of the Single Market into two separate EU and UK markets. Preparations by market firms involved ensuring that they had authorisation to operate in both the EU and the UK separately, instead of being able to rely on passporting rights to provide services across borders between them:

- In the UK, the authorities' objective has been to ensure that regulated firms based in the UK are subject to UK authorisation and supervision. From the end of the post-Brexit transition period at the end of 2020, the Temporary Permissions Regime (TPR) has provided a period of up to three years in which EEA firms and funds previously using a passport can seek authorisation in the UK from the PRA/FCA; and the Temporary Transitional Power (TTP) has given regulated firms a 15 month period until 31 March 2022 to comply fully with UK law by implementing changes to EU legislation onshored in the UK at the end of the post-Brexit transition period, with limited exceptions where compliance has been required earlier.
- In the EU, there is no equivalent to the TPR at EU level. While there is a patchwork of arrangements and waivers at national level, the European Commission is planning to clamp down on them.[2] The ECB and ESMA have both set out requirements for UK firms dealing with EU customers. These requirements, which the EU authorities are seeking to enforce, include the transfer of EU-related capital, assets and operations to authorised and regulated EU legal entities, but also the transfer of key staff to ensure that these entities are not just "letter boxes" or "brass plates".
- Where market firms have transferred activities from London to the EU, they have transferred them to different locations within the EU. In securities markets, ESMA has the task of preventing regulatory competition within the EU by encouraging convergence in the implementation of regulations in different EU national centres.

5 At one level, the separation of the Single Market into two separate EU and UK markets has made the European Commission's objective of achieving Capital Markets Union (CMU) more important.[3] The CMU Action Plan launched in September 2020 recognises this, and has been followed by a Communication by the Commission accompanied by a package of measures announced in November 2021 to ensure that investors have better access to company and trading data.[4] It is also important to emphasise that the EU initiative to finance the recovery from the COVID-19 pandemic through joint debt issuance is a major step towards closer financial market integration in the EU.[5] But at another level, the departure of the EU's largest financial centre has made CMU harder to achieve in practice without international cooperation involving a closer working relationship with third countries, including the UK. The EU would be more effective in addressing capital market fragmentation internally if this was also addressed by the EU with third countries externally.

The limited scope for equivalence

6 Granting equivalence is the way in which the EU promotes international cooperation in capital markets by recognising regulation in third countries as equivalent to its own.[6] When the UK left the EU Single Market and EU regulations were onshored to the UK, capital market regulations in the EU and the UK were initially the same. So the question to be addressed was whether the EU and the UK would grant each other equivalence as third countries. The EU/UK financial services MOU which both sides agreed at the end of March 2021 was intended to enable progress on equivalence determinations "without prejudice to the unilateral and autonomous decision-making process on each side".[7]

7 In November 2020, the UK Government offered a package of equivalence decisions to EEA firms. The EU has not so far made significant grants of equivalence to the UK, with the exception of equivalence for UK CCPs – which are of systemic importance to the EU economy – until the end of June 2022. Time-limited equivalence has been granted in this case so

2. eg through proposals for bank capital requirements under Basel III. The implications for relations between EU and UK regulators are not yet clear.

3. "EU capital markets remain fragmented, hampering companies' ability to raise capital across the EU. … The EU's global competitiveness is weakened by the fragmentation of its capital markets": European Commission Communication: *CMU: Delivering One Year After the Action Plan:* 25 November 2021.

4. CMU Action Plan, 24 September 2020; CMU Communication and CMU Package, 25 November 2021. The Package includes: the European Single Access Point (ESAP); the Review of the European Long-Term Investment Funds (ELTIFs) Regulation; the Review of the Alternative Investment Fund Managers Directive (AIFMD); and the Review of the Markets in Financial Instruments Regulation (MiFIR).

5. Next Generation EU. In addition, in implementing monetary policy, the ECB has helped to keep sovereign bond spreads in the euro area low through market intervention, though there is a risk that rising inflation, coupled with tapering and rising interest rates, will lead to market fragmentation in the form of higher spreads between different sovereign borrowers in the future.

6. There are around 40 specific provisions which provide for equivalence in 17 EU Regulations and Directives, mostly in more recent EU legislation. Around 240 such decisions have been taken by the EU so far affecting 30 countries.

7. The MOU has not yet been signed.

that the EU can build up the resilience of its own market infrastructure in the meantime with the aim of achieving open strategic autonomy. However, the European Commissioner has stressed that, while the EU needs to achieve strategic autonomy in the medium and long term, the Commission wants to avoid a cliff-edge which might cause market disruption in the short term.[8] In November 2021, the Commission announced that equivalence for UK CCPs would be extended beyond the end of June 2022.

8 One of the European Commission's main concerns about granting regulatory equivalence to the UK is the prospect of regulatory divergence in future, given that the UK has left the Single Market.[9] The UK authorities consider that regulatory divergence is consistent with equivalence where both the EU and the UK are committed to the same regulatory outcomes (as in the case of global international standards set by the FSB and IOSCO). But the EU authorities consider that the outcomes are only likely to be the same if the rules are the same. The rules are not the same between the EU and some other third countries to which the Commission has granted equivalence. But in those cases, equivalence is designed to bring the two parties together, whereas the future relationship between the EU and the UK is not yet clear. In any case, too much reliance should not be placed on equivalence: it is a patchwork which can apply in the case of some EU regulations, but cannot apply in others, and where it does apply it can be withdrawn by the Commission at short notice (ie a minimum of 30 days).

Regulatory divergence

9 The Governor of the Bank of England has made it quite clear that, as London is a global financial centre, the UK will not be a rule-taker from the EU. "Rule-taking pure and simple is not acceptable when UK rules govern a system ten times the size of the UK GDP."[10] In the UK, HM Treasury, the FCA and the PRA are reviewing EU financial services regulation onshored in the UK to check whether it is appropriate in a UK context.[11] There is already evidence that UK regulation will begin to diverge from EU regulation with the objective of improving EU regulations onshored in the UK and adapting them to changed circumstances:[12] eg in the cases of the BMR, SFTR, CSDR Settlement Discipline, PRIIPs, the Prospectus Regulation, MiFID II/R and Solvency II. Regulatory divergence will occur, not just in response to measures taken by the UK, but also in response to measures taken by the EU: eg following EU reviews of MAR, MiFID II/R, the Prospectus Regulation, PRIIPs regime, ELTIFs and the AIFMD. A number of these separate EU and UK initiatives cover the same regulations but, if the EU and UK decide to change the regulations in different ways, the result will increase rather than reduce divergence.

10 It is important to remember that the UK had a significant influence in drawing up capital markets regulation during the long period in which the UK participated in the Single Market. So UK changes to most existing regulations are not expected to be fundamental, at least for the time being. It is more likely that divergence will occur in the case of new regulations: ie the UK will not necessarily follow new EU regulations, given that the UK no longer has any say in making them, and may propose financial services regulation of its own (eg relating to sustainable finance and to FinTech). By taking this approach, the UK will not have any direct influence over EU regulation now that it has left the Single Market. But it is possible that the UK will exercise influence indirectly by setting an example (eg by not implementing CSDR mandatory buy-ins). The UK authorities have made a point of saying that they will not reduce regulatory standards, and that UK standards will be at least as high as the EU.[13]

11 While the EU and UK both make changes to their rules independently in order to improve them, and supervisory cooperation is designed to ensure that the rules are applied effectively, the risk is that the market fragmentation arising from the replacement of the Single Market by two separate EU and UK markets will make European markets as a whole less competitive in global terms (for example in relation to New York or financial centres in Asia.) A loss of competitiveness could occur, for example, if the need for market firms to operate in two separate markets leads to duplicated roles and less efficient allocation of resources.[14]

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8. Mairead McGuinness, EU Financial Services Commissioner, 18 October 2021.

9. Mairead McGuinness, EU Financial Services Commissioner: "There is no recreating the Single Market for financial services when [the UK has] decided to leave the Single Market": 22 January 2021.

10. Andrew Bailey, Governor of the Bank of England: *The Case for an Open Financial System,* 10 February 2021.

11. John Glen, Economic Secretary to the Treasury: "With the development of the EU's Single Market, much of our regulatory approach to capital markets was set in Brussels. Now that we have left the EU, we can tailor our rules more closely to the unique circumstances of the UK, improve standards and make regulation more proportionate.": Ministerial Foreword to the UK Wholesale Markets Review.

12. "Now that we have left the EU, we can tailor our rules more closely to the unique circumstances of the UK, improve standards and make regulation more proportionate.": HM Treasury Wholesale Markets Review, July 2021.

13. John Glen, Economic Secretary to the Treasury: "This review is not about lowering standards for wholesale capital markets. Instead it is about the need for regulation to be adjusted on the basis of evidence and experience to ensure it effectively addresses risks.": Ministerial Foreword to the UK Wholesale Markets Review.

14. Noel Quinn, HSBC Chief Executive: "There is the risk of fragmentation increasing costs, that is a reality. But that is outside my control: FT Global Banking Summit, 2 December 2021.

Differences in approach to regulation

12 Underlying the separation of the Single Market into two separate EU and UK markets is a difference in approach to markets and their regulation between the EU and the UK:

- One difference in approach is that the EU puts more emphasis than the UK on the need for a location policy, under which EU customers should be served by market firms located in the EU, except in limited cases where regulatory equivalence has been granted, on the grounds that this will help ensure EU financial stability. The UK puts more emphasis on the need for an open financial system globally, together with the need to ensure that this is safe and consistent with financial stability.
- Another difference in approach is that the UK is proposing to delegate detailed technical rules to regulators (eg the PRA and the FCA), who will be accountable to Parliament, so that detailed changes can be made by the regulators in future without taking up Parliamentary time.[15] By contrast, the EU includes detailed technical rules in primary legislation. This should make UK regulation more agile than EU regulation, which needs to be negotiated and requires a common approach across the 27 Member States.[16]

The opportunity for regulatory and supervisory cooperation

13 Despite these different approaches to regulation, the EU and the UK have a common interest in regulatory and supervisory cooperation to ensure financial stability, market integrity, investor and consumer protection, fair competition and the prevention of regulatory arbitrage, and to avoid extra-territorial conflicts between them. Both the EU and the UK also have similar concerns to ensure as far as possible that their respective regulatory systems are not undermined by risks arising from the activities of financial firms in third countries outside their control. Where systemic risks are greatest, regulatory and supervisory oversight is likely to be most needed. A degree of joint supervision is also needed in some cases (eg colleges of supervisors for the financial market infrastructure). Referring to the joint supervision of CCPs, the Bank of England has said: "We recognise that a system in which every jurisdiction that uses a CCP insists on imposing its own regulation and supervision on the CCP cannot work."[17]

The importance of a global approach

14 It has become increasingly clear that regulatory divergence between the EU and the UK will continue. So the question is how best to manage this. Both sides have common outcome-based regulatory objectives at global level, share information and explain the approach they take to each other. One option would be for the EU and the UK to develop a common regulatory framework of a similar kind to the common framework that has already been developed between the EU and the US. There are also other technical ways of encouraging regulatory and supervisory cooperation between the EU and the UK. But the political context between the EU and the UK has not been favourable over the past year and is an overriding constraint. An example is the delegation of fund management from the EU to third countries, which is a global principle, but has become caught up in the post-Brexit negotiations between the EU and the UK.

15 Although the EU has not in most cases granted equivalence to the UK, it has granted equivalence in a number of cases to other third countries with different rules. The question here is whether third countries are being treated in a consistent way by the EU and how relations between the EU and third countries are going to develop in future. One option would be for the EU and third countries to seek a long-lasting settlement on capital market regulation consistent with the global regulatory framework established by the G20 through the FSB and IOSCO. If this was to be considered, it would need to relate not just to the regulatory relationship between the EU and the UK alone, but between the EU and third countries in general (including the US and Switzerland).

16 If that is not practicable, there is a risk of market fragmentation globally in the form of inconsistent legislative requirements in different jurisdictions (eg in defining taxonomies for sustainable finance), with an additional risk of conflict of laws where legislation in a particular jurisdiction is intended to have extra-territorial implications. And in the case of EU and the UK, there is a risk that continuous negotiation will be required (eg to take account of changes in regulation and technology). This has already been the experience of Switzerland and Norway. That will mean that capital markets in Europe are not as efficient and resilient as they could be, and that the Commission's objective of Capital Markets Union is more difficult to achieve in practice.

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15. John Glen, Economic Secretary to the Treasury: "The Government and Parliament will set the policy framework for financial services and the strategic direction of financial services policy. Working within this framework, the regulators will design and implement the regulatory requirements that apply to firms, using their expertise and agile rule-making powers to ensure regulation is well-designed and keeps pace with market developments": Ministerial Foreword to the UK's Future Regulatory Framework.

16. "The issues raised in this document sit alongside our intention to make regulation more agile, by devolving rules to regulators and giving more space for expert judgement." HM Treasury Wholesale Markets Review, July 2021.

17. Christina Segal-Knowles, Executive Director, Financial Market Infrastructure Directorate, Bank of England: *The UK's approach to cross-border cl*earing: FIA, 8 November 2021.