ICMA International Capital Market Association

Brexit: can capital market fragmentation be avoided?

By Paul Richards

Summary

CMF

1 The international capital markets have been facing three possible outcomes on Brexit by 31 October 2019: either (i) the UK leaves the EU with a deal by 31 October; or (ii) the UK leaves by the same date without a deal; or (iii) there is a further extension of Article 50.[1] In the absence of agreement on a deal by 31 October, or agreement on a further extension of Article 50, the default position is for the UK to leave the EU on 31 October without a deal.

2 This Quarterly Assessment does not address the pros and cons of Brexit, nor its economic impact, but focuses instead on the implications of Brexit for the fragmentation of international capital markets: both the need to avoid cliff-edge risks arising from Brexit; and the scope for regulatory and supervisory cooperation between the EU27 and the UK after Brexit.

Cliff-edge risks arising from Brexit

3 Current British Government policy is still to leave the EU Single Market in financial services when the UK leaves the EU. If the UK leaves the EU Single Market, the Single Market will become two separate markets when passporting rights between the EU27 and the UK cease: either on Brexit, if there is no deal; or at the end of the transition period after Brexit, if there is a deal. The end of the transition period specified in the original Withdrawal Agreement is the end of 2020. Following the delay in Brexit from 29 March to 31 October 2019, there is a case for extending the transition period, which could be extended until the end of 2022, if both sides agree.

4 When passporting rights cease, cliff-edge risks between the UK and the EU27 markets will arise as a result of restrictions on market access. The UK is proposing to address these cliff-edge risks through a Temporary Permissions Regime (TPR), which has been extended to the end of 2020 following the successive extensions of Article 50 from 29 March to 31 October 2019.[2] But there is no equivalent of the TPR in the EU27. While the authorities in the UK and the EU27 have made progress in addressing cliff-edge risks case by case, there are still unresolved issues, and potential gaps, and in some cases the equivalence decisions made by the EU27 are conditional and temporary, with short deadlines before they lapse. On 5 August, the European Commission stated that it would provide no further help relating to a no-deal Brexit beyond the contingency measures already agreed, and no guarantee that these contingency measures would be extended, despite the short deadlines. (See Box A.)

1. The British Government has been committed to (ii) if it cannot achieve (i). In the case of (iii), Parliament in the UK has passed a law requiring the Government to request an extension of Article 50 until at least 31 January 2020, if a Brexit deal is not agreed by 19 October (ie immediately after the European Council on 17/18 October).

2. Firms regulated by the FCA which use a passport to operate in the UK will be able to continue existing and new business in the UK while seeking full authorisation.

Box A: Addressing cliff-edge risks on a no-deal Brexit

The position on addressing cliff-edge risks in capital markets in the event of a no-deal Brexit can be summarised as follows:[3]

Memoranda of Understanding: The UK authorities have concluded new cooperation agreements with the EU markets, insurance and banking authorities, which will take effect in the event of a no-deal Brexit. These MOUs provide a framework for the sharing of confidential information, which will assist in carrying out functions; allow UK or EU-based firms to delegate or outsource certain activities to firms based in the other jurisdictions; and support future market access and equivalence decisions.

Banking: The British Government has legislated to ensure that UK households and businesses can continue to be served by EU-based banks after Brexit. EU authorities have not taken similar action. As a result, major UK-based banks are transferring their EU clients to subsidiaries in the EU so that they can keep providing services to them. The Bank of England reports that all material subsidiaries are now authorised, fully operational and trading, but that some operational risks remain, including if many clients seek to migrate to EU entities at the last minute, which could amplify any other disruption in the market.

OTC derivatives (cleared): The British Government has legislated to ensure that UK businesses can continue to use clearing services provided by EU-based clearing houses for three years from Brexit. The European Commission has provided a temporary and conditional equivalence decision for UK CCPs. ESMA has subsequently announced the recognition of three UK CCPs until end-March 2020 in a no-deal Brexit and agreed the cooperation arrangements to support this with the Bank of England. Without greater clarity on the regulatory status of UK CCPs after this date, the contracts that EU members clear with UK CCPs will need to be closed out or transferred by then. This process would need to begin by the end of 2019 and would impose significant costs on EU firms as well as potentially straining market capacity. Further action may therefore be necessary to prevent this. Ultimately, the best solution in the view of the UK authorities is for the EU to grant permanent recognition to UK CCPs.

OTC derivatives (uncleared): The British Government has legislated to ensure that EU banks can continue to perform lifecycle events on contracts they have with UK businesses. The European Commission does not intend to reciprocate in the case of UK-based banks' contracts with EU businesses. The Bank of England reports that most EU27 Member States with material uncleared derivatives activity have implemented legislative measures which seek to address this risk at national level, but the scope and effectiveness of these measures will vary between jurisdictions.

Ability of EEA firms to trade on UK trading venues: The EU's Trading Obligations require EU investment firms to trade EU-listed or traded shares, and some classes of OTC derivative, on EU trading venues. The UK will also have reciprocal trading obligations when it leaves the EU. The Bank of England considers that the EU and UK could deem each other's regulatory frameworks as equivalent, thereby mitigating risks of disruption.

Asset management: The cooperation agreements reached between the FCA, ESMA and EU NCAs enable EU asset managers to delegate the management of their assets to the UK after Brexit. The British Government has legislated for EU asset management firms to continue operating and marketing in the UK after Brexit. To continue to operate in the EU, the Bank of England reports that the largest UK asset managers have completed their establishment of EU authorised management companies.

Insurance contracts: The British Government has legislated to ensure that the insurance policies that UK households and businesses have with EU insurance companies can continue to be serviced after Brexit. The Bank of England reports that UK insurance companies continue to make good progress in restructuring their business in order to service EU liabilities after Brexit.

Increased prudential requirements: EU regulations subject EU banks' and insurance companies' non-EU exposures to stricter capital and liquidity requirements, as well as imposing some restrictions on holdings of non-EU assets. UK legislation is aligned with EU rules. Secondary legislation passed in the UK allows regulators to delay the impact for UK firms.

Personal data: The British Government has legislated to continue to allow the free flow of personal data from the UK to the EU. The European Commission has indicated that it does not intend to take similar action to ensure the free flow of personal data from the EU to the UK in a no-deal Brexit. There are risks in the event of disruption to cross-border flows of personal data from Brexit day.

Contract repapering: Progress on repapering has been gradual. The absence of repapering may have an impact on business in the EU post-Brexit. Several EU Member States have legislated to allow UK firms to continue temporarily to provide certain services in their jurisdiction following a no-deal Brexit. But these access provisions are not EU-wide, and they vary in respect of the activities and durations they cover. There is therefore uncertainty about how some of these provisions will be applied.

3. Source: Bank of England Financial Stability Report, July 2019, and Record of Financial Policy Committee meeting, 2 October 2019; Andrew Bailey, Chief Executive of the FCA, *Preparing for Brexit in Financial Services: the State of Play:* Bloomberg, 16 September 2019.

5 Legislative preparations in the UK for Brexit also need to be completed. The UK authorities' objective is to onshore all EU legislation into law in the UK on Brexit. If a Withdrawal Agreement is reached between the EU27 and the UK, the British Government will need to secure the passage of a Withdrawal Agreement Implementation Bill to enable the Withdrawal Agreement to be ratified in the UK, and the European Parliament will need to approve the deal in the EU27. In the event of a no-deal Brexit on 31 October, it appears that there is still some outstanding legislation that needs to be approved by Parliament in the UK before 31 October;[4] and it is not yet clear whether and to what extent "in flight" EU legislation will continue to be taken into law in the UK after Brexit, in the event of no deal.

6 Market firms are in a better position to avoid cliff-edge risks if they are authorised to operate in both the EU27 and the UK.

- Most large market firms are now authorised to operate in both the EU27 and the UK. In some cases, this has involved significant one-off costs: eg in transferring staff, offices, technology, capital and financial assets from London to one or more locations in the EU27; and extra running costs from operating in two separate markets in the EU27 and the UK rather than in one Single EU Market. There are also expected to be implications for the bond, repo and collateral markets, with dealer liquidity provision being split between EU27 and UK entities.[5]
- In the case of relocation planning, the ECB reports that the majority of authorisation procedures related to the establishment of new banks or the expansion of existing banks in the euro area have been completed, and the remaining ongoing authorisation procedures are expected to be finalised before the end of October 2019.[6] However, the ECB expects banks to speed up the implementation of contingency plans for a no-deal Brexit, including: addressing operational challenges associated with transferring staff and clients; building up their local risk management capabilities and governance structures; preparing for changes in the application of prudential provisions; implementing the novation of contracts; ensuring that they have sufficient onshore capacity to access key financial market infrastructure; and adjusting their business and booking models.[7]
- The European Commission's assessment is that "firms have largely prepared for a withdrawal without an agreement, including by novating their outstanding contracts to replace UK counterparties, and that they now have to finalise their preparations in the timeframe given by these contingency measures. The Commission therefore does not consider that the adoption of additional contingency measures is necessary. It will continue to assess the situation in the markets after the withdrawal date, … taking into account in particular the framework introduced in EMIR with regard to the requirements for the recognition of third-country CCPs."[8]
- The FCA's assessment is that "firms in the UK have stepped up their preparations, the authorities in the UK have made good progress and, in the EU, authorities have mitigated risks of material disruption to cleared derivative markets by announcing temporary recognition and conditional equivalence decisions for the UK's CCPs and the regulatory framework for them, though there will need soon to be agreement to renew this arrangement."[9]
- The remaining concerns in financial markets are less about the state of preparations of large market firms than about the awareness and state of preparations of smaller firms and clients; the long lead-time needed for repapering; and the immediate market impact of Brexit taking place on a Thursday (rather than at a weekend).

7 With more time to prepare as a result of the successive extensions of Article 50 from 29 March until 31 October, capital markets should be better prepared for a no-deal Brexit. But the risks to financial stability remain. In the view of the authorities, there is still a risk of market disruption. Although, for example, the ECB considers that the adverse impact of a no-deal Brexit "is expected to be modest for the EU, on average, there are nevertheless tail risks concentrated in particular countries and banks with close links to the UK. A no-deal Brexit could cause significant

4. "We [the FCA] have been working closely with the Treasury and the Bank of England to make sure that EU financial services legislation is effectively on-shored by exit date. To date, over 50 statutory instruments have been made to achieve this. This Is most of what needs to be done on this front – only a small number of SIs remain outstanding.": Andrew Bailey, Chief Executive of the FCA, *Preparing for Brexit in Financial Services: the State of Play:* Bloomberg, 16 September 2019.

5. In addition, the European Stability Mechanism announced on 26 September that, in response to Brexit, it would use Luxembourg law for its borrowing in future instead of English law.

6. ECB Financial Stability Review, May 2019.

7. ECB: *Brexit: Stepping UP Preparations,* 15 August 2019.

8. European Commission Communication: *Finalising Preparations for the Withdrawal of the UK from the EU on 1 November 2019,* 4 September 2019.

9. Andrew Bailey, Chief Executive of the FCA: *Preparing for Brexit in Financial Services: the State of Play,* Bloomberg, 16 September 2019.

market turbulence, potentially resulting in tighter financing conditions". The Bank of England considers that "most risks to financial stability that could arise from disruption to cross-border financial services in a no-deal Brexit have been mitigated. In the absence of actions by EU authorities, some risks remain.[10]

The scope for regulatory and supervisory cooperation after Brexit

8 There is still no detail on the shape of future trade relations between the EU27 and the UK after Brexit. The Political Declaration accompanying the original Withdrawal Agreement refers to financial services only briefly and at a high level of generality, and it is not clear what the status of the Political Declaration will be if the UK leaves the EU without a Withdrawal Agreement. But the Political Declaration does state that the future relationship between the EU27 and the UK will be governed by regular arrangements regarding third countries and that both the EU and the UK are committed under the Declaration to undertake equivalence assessments and endeavour to conclude these before the end of June 2020.[11]

9 Both the EU27 and the UK will have the same rules regulating financial services after Brexit at the outset. So there should in principle be scope for the EU27 and the UK to negotiate regulatory equivalence between them. This is the EU's preferred method of negotiating market access with third countries, which the UK will become when it leaves the EU. The European Commission's position on regulatory equivalence is summarised in Box B.

10 At the G20 Summit in Osaka in June 2019, the G20 leaders stated: "We welcome the work on market fragmentation [by the FSB and IOSCO], and will address its unintended, negative effects, including through regulatory and supervisory cooperation."[12] In considering the opportunities for regulatory and supervisory cooperation between the EU27 and UK after Brexit, both the EU27 and the UK will start with almost identical rules regulating financial services. But in looking to the future, there are a number of additional considerations to take into account:

Consistency with the G20 regulatory system

11 Both the EU27 and UK regulatory and supervisory systems are intended to be consistent with the global system, overseen by the G20 and established in response to the international financial crisis. The G20 has called for "jurisdictions and regulators to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes".[13] The implications are that the arrangements in the EU27 (as host) for regulatory equivalence should provide access to EU27 markets for third country-firms by relying on the rules and supervision in the home country; and that the EU27's equivalence rules should apply in the same way to firms based in the UK as to firms based in other third countries without discrimination between them.

Different legal approaches

12 Although both EU27 and UK rules are intended to be consistent with the G20, there are different ways of achieving this in different national jurisdictions. The English and Continental European legal systems have different approaches: the UK's legal approach is based on common law and developed through case law, while the EU27 system is based on codification and greater use of statute rather than regulatory rules. In the FCA's view, wholesale financial markets are more commonly found in countries with common law systems and work better in systems that base their rules and principles to a greater extent on experience.[14]

Open market access and systemic risk

13 While capital markets are global in scope and capital market integration depends on open access, capital markets are subject to regulation and supervision at national or regional level (eg at EU level). The FSB has noted that, although regulatory reforms in response to the financial crisis have been supportive of global financial integration, there are concerns that some markets may be fragmented along jurisdictional lines: "In places, such fragmentation of markets can have a positive effect on financial stability: eg by reducing the transmission of economic shocks between jurisdictions and increasing the resilience of domestic or global financial markets. But other types may reduce resilience, eg where fragmentation limits opportunities for cross-border diversification and risk management, impairs market liquidity or prevents capital and liquidity from being channelled to where it is needed in periods of stress."[15]

10. ECB Banking Supervision Risk Assessment for 2020, October 2019. Record of Bank of England Financial Policy Committee meeting, 2 October 2019.

11. This deadline may also need to be extended, if the transition period itself is extended.

12. G20 Leaders Declaration, Osaka Summit, 28-29 June 2019. See David Hiscock: *Avoiding Unnecessarily Fragmented Global Bond Markets:* ICMA Quarterly Report for the Fourth Quarter of 2019.

13. G20 conclusions, 2013.

14. Andrew Bailey, Chief Executive of the FCA: *The Future of Financial Conduct Regulation*, 23 April 2019.

15. FSB *Report on Market Fragmentation,* 4 June 2019.

Box B: The European Commission's Communication on financial services equivalence

In July 2019, the European Commission published a Communication on *Equivalence in the Area of Financial Services,* in which it states that the EU has consistently pursued the objective of strengthening the Internal (ie Single) Market in financial services through a single rulebook and a common supervisory architecture for its Member States. The Communication considers how the EU's domestic framework covers cross-border activities and exposures to risks in third countries and explains how its framework interacts with other regulatory regimes. At the very least, in the Commission's view, this means aiming to avoid conflicting requirements and reducing opportunities for regulatory arbitrage.

Both the EU and third countries draw on international standards developed jointly by the FSB, BCBS, IAIS and IOSCO, under the G20. The EU approach to third countries is based on equivalence, which depends on a positive assessment of the third-country framework so that the EU can rely on third-country rules and the work of the third-country supervisor. EU financial services law currently includes around 40 provisions which allow the Commission to adopt equivalence decisions; and the Commission has taken over 280 equivalence decisions involving more than 30 third countries.

EU equivalence policy has three objectives: (i) reconciling the need for financial stability and investor protection in the EU, on the one hand, with the benefits of maintaining open and globally integrated EU financial markets, on the other; (ii) promoting regulatory convergence around international standards; and (iii) establishing or upgrading supervisory cooperation with relevant third-country partners. In some instances, this can enable a coherent prudential regime to apply to EU banks and other financial institutions operating outside the EU, thus lowering the cost of EU firms' investments and exposures in third countries by facilitating capital management in particular.

An equivalence decision is a unilateral and discretionary act of the EU, conducted and concluded by the Commission, in accordance with EU priorities and the interests of EU financial markets. In its assessment, the Commission's focus on risk implies that, as a rule, high-impact third countries, for which an equivalence decision is likely to be used intensively by market participants, will represent a more significant set of risks which the Commission will need to address. If there were to be shortcomings or gaps in the equivalence assessment of such third countries, these would be likely to have a negative impact on financial stability or market integrity in the EU.

While equivalence decisions are unilateral and discretionary acts of the EU, they bring benefits to both the EU and its third-country partners. Some categories of equivalence decisions are taken after due consideration of the treatment that the third country affords to the EU regulatory framework, the supervisory work performed by EU authorities and the local presence of EU market participants.

Third-country regimes do not need to be identical to the EU framework, but they do need to ensure in full the outcomes as set out in that framework. As part of its discretion, the Commission may decide formally to adopt, suspend or withdraw an equivalence decision, as necessary. If withdrawn, equivalence could be restored at some subsequent time if and when all necessary conditions are met. The Commission may also grant time-limited equivalence or set conditions or limitations to equivalence decisions.

The possibilities for granting equivalence are set out in dedicated equivalence provisions included in a number of EU financial services legislative acts. There are several recent decisions relating to equivalence:

First, the amendments of the ESAs' regulations strengthen the role of those authorities in monitoring equivalence with third countries.

Second, the amendment of EMIR reinforces the supervisory framework for CCPs that provide clearing services to EU firms. Third-country CCPs that are, or are likely to become, systemic and relevant for financial stability in the EU will be subject to specific and proportionate requirements reflecting the degree of systemic risk involved. As a last resort, a third-country CCP may be required to provide services to EU firms from an entity authorised in the EU.

Third, under MiFIR, for jurisdictions where the scale and scope of the services provided is likely to be of systemic importance for the EU, equivalence can only be granted following a detailed and granular assessment by the Commission; and the role of ESMA in monitoring the activities of such firms in the EU is enhanced.

14 The EU27 is concerned to ensure as far as possible that its regulatory system is not undermined by risks affecting the EU27 arising from the activities of financial firms in third countries outside its control: in cases in which the EU27 considers that systemic risks are greatest, EU27 regulatory and supervisory oversight can be expected to be the most intense. One way in which the EU27 has sought to address this risk has been by encouraging financial market firms in the UK to relocate clearing, trading, banking, risk management and fund management from London to the EU27 by establishing subsidiaries in the EU27 and booking transactions with EU counterparties through those subsidiaries.

15 Brexit also raises a number of other important issues for capital markets in the EU27.[16]

- First, Capital Markets Union will become of greater importance for the EU27 once the UK has left the EU, as its largest financial centre. But Capital Markets Union in the EU27 is still work in progress, with different insolvency, corporate and tax laws at national level and dependence on bank lending proportionately much greater in the EU27 than in the US or the UK. Capital Markets Union also requires further steps being taken towards Banking Union: eg a common EU27 system of bank deposit insurance.
- Second, decisions by market firms to relocate from London to the EU27 have involved relocation to a number of different financial centres (eg Paris, Frankfurt, Amsterdam, Dublin and Luxembourg) rather than to a single centre. The authorities at European level (such as ESMA) will seek to ensure that different financial centres within the EU27 compete on a level playing field without scope for regulatory arbitrage between them.
- Third, there is an outstanding question about the relationship within the EU27 between the euro area and non-euro area Member States, an agreement on which was reached with the UK in February 2016, but which was subsequently abandoned after the result of the UK referendum in June 2016.

Equivalent outcomes

16 As London is a global financial centre, the UK does not intend to be a "rule taker" from the EU27 after Brexit.[17] Senior UK officials have emphasised the importance of equivalent outcomes between the EU27 and the UK (eg ensuring financial stability, market integrity[18] and investor protection) rather than the same rules.[19] After Brexit, this approach would enable the UK authorities to seek ways of improving onshored EU legislation in the UK so as to achieve the same outcome as the EU27, but in a way that is more effective in the UK.

17 It is clear that the European Commission is also concerned to achieve equivalent outcomes.[20] In addition, some EU27 regulators have indicated that new EU rules should be more flexible in future, particularly at Level 1. Without more flexibility by legislators at Level 1, it is very difficult for regulators to set technical standards for implementing them at Level 2 (eg if market conditions change). But even with a greater degree of flexibility, this does not mean that negotiations between the EU27 and the UK on equivalence would be successful without trust and reliance on both sides. And even when EU27 and UK rules are the same, the way in which these rules are supervised is critical to delivering the same outcomes.

Enhanced equivalence

18 Nor is agreement on equivalence a panacea. EU27 regulatory equivalence is currently a patchwork: EU financial services law currently includes around 40 provisions which allow the European Commission to adopt equivalence decisions, but this does not cover EU financial services regulation as a whole. Regulatory equivalence will not be complete unless it can be enhanced. It is not clear whether this will be possible, even though EU27 and UK rules will be virtually identical at the outset. UK proposals for mutual recognition of each other's regulations have been ruled out by the EU27 as a way of achieving enhancement. But there may be other ways of achieving enhancement in practice: eg through continuing exchanges of information about regulatory priorities and continuing supervisory cooperation between the authorities in the EU27 and the UK, even if this does not take legal form.[21]

16. See David Hiscock, *The Importance of Integrated Capital Markets and CMU,* ICMA, July 2019.

17. Prime Minister: "When the UK leaves the EU and after any transition period, we will leave the Single Market and the Customs Union. Although we will remain committed to world-class environmental, product and labour standards, the laws and regulations to deliver them will potentially diverge from those of the EU: Letter to the President of the European Council, 19 August 2019.

18. Ie orderly, resilient, transparent and clean markets.

19. For example, see Andrew Bailey, Chief Executive of the FCA: *The Future of Financial Conduct Regulation,* 23 April 2019.

20. Steven Maijoor, Chair of ESMA: "EU equivalence decisions taken in financial markets have been overwhelmingly outcome-based resulting in reliance on home country regulation and supervision.", June 2019.

21. Sir Jonathan Faull and Simon Gleeson: *The Capital Markets Union: Should the EU Shut Out the City of London?* CER, 2019.

19 There is also a risk that the Commission will withdraw its determination of regulatory equivalence at short notice. That could happen if EU27 and UK rules diverge after Brexit, even though the UK may argue that outcomes remain the same. One key part of the EU approach consists of more frequent monitoring and review of equivalence decisions to detect emerging differences between EU and non-EU frameworks on time.[22] For example:

- The recent Swiss case on share trading – under which the EU allowed the grant of equivalence for trading of Swiss shares in the EU to lapse rather than agree to an extension – is regarded by some market commentators as a potential precedent.
- Another potential precedent is the Commission decision at the end of July that Argentina, Australia, Brazil, Canada and Singapore no longer meet EU standards under the Credit Rating Agencies Regulation, with the result that equivalence has been withdrawn.

20 The UK will want to ensure that processes for making assessments for reviewing and, if necessary, withdrawing equivalence are predictable and work in in a similar way for both sides, drawing on the experience of other recent cases with third countries.

Conclusion

21 There is a much better prospect of an EU27/UK deal on regulatory equivalence if the EU27 and UK reach a deal on a Withdrawal Agreement with a sufficiently long transitional period thereafter than if there is a no-deal Brexit. While UK and EU27 rules would be virtually identical on Brexit, and both the EU27 and the UK would be in a position to negotiate on equivalence at the outset, a no-deal Brexit would in practice make the question of whether to negotiate into a political issue on both sides. It is not yet clear whether a no-deal Brexit would lead to a political standoff or whether it would swiftly lead to a resumption of negotiations.

Contact: Paul Richards
paul.richards@icmagroup.org

22. Steven Maijoor, FESE Convention, Dublin, 4 June 2019.