The post-Brexit impact on the international bond market

by **Paul Richards**

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 UK and EU markets became two separate markets. What impact has the UK's withdrawal from the Single Market had on international capital markets, particularly the international bond market? This report gives an overall assessment, and more detailed assessments follow for primary markets, secondary and repo markets, and asset management.

The experience so far

Overall impact on the bond market

2 The preliminary conclusion is that there has not been a significant impact on the effective functioning of the international bond market since the end of the post-Brexit transition period; primary and secondary bond and repo markets, and asset management, have continued to work well; and financial instability has been avoided so far. But it is too early to form a definitive judgment, and difficult to distinguish between the post-Brexit impact on the international bond market and the impact from other factors, such as the official response to the COVID-19 pandemic and the growth in electronic bond trading.

Preparations by market firms

3 The bond market has continued to function well so far largely because capital market firms were as well prepared as they could be for the cessation of passporting rights at the end of 2020 and the fragmentation of the Single Market into two separate EU and UK markets. Although the EU/UK Trade and Cooperation Agreement was only reached a week ahead of the deadline, the agreement did not cover international capital markets in any detail. This was anticipated by market firms, because any common ground between the EU and the UK on financial services would have been reached largely outside the agreement (eg through regulatory equivalence). But in practice the regulatory equivalence granted by the European Commission to the UK was strictly limited, even though the UK Government offered EEA firms a package of equivalence decisions on 9 November. Market firms therefore took the view that there would not be a significant difference between an EU/UK deal and "no deal", and that it was prudent to prepare on a "worst case" basis. In the event, the main advantage of the deal is that it provides an opportunity for EU/UK relations to improve in future, including in financial services.

Authorisation in the EU and the UK

4 The 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 continuing to provide services across borders. On the UK side, the Temporary Permissions Regime provides a period of up to three years in which EEA firms can seek authorisation in the UK. On the EU side, there is no equivalent to the Temporary Permissions Regime at EU level, though there is a patchwork of arrangements at national level.

5 The ECB and ESMA[1] have both set out requirements for UK firms dealing with EU customers. These include not only the transfer of EU-related capital, assets and operations to authorised and regulated EU legal entities, but also the transfer of key staff (including those who are client-facing) where otherwise EU entities would be deemed to consist of "letter boxes". EU and UK supervisors are both monitoring the relocation of EU activities of UK firms to the EU. The main

1. eg ESMA's "reminder to firms of the MiFID II rules on reverse solicitation in the context of the recent end of the UK transition period": 13 January 2021.

constraint on the transfer of staff in practice has not been unwillingness, despite the social impact, but uncertainty about the precise requirements and inability to transfer staff in the middle of the COVID-19 pandemic. In response to the pandemic, it is also not clear how much the location of key staff matters from an operational point of view when many of them are working remotely from home, though there are regulatory, tax and other implications relating to their location. And in the event, a degree of tolerance appears to have been granted by the ECB and ESMA for the time being.

National centres in the EU

6 Where market firms have transferred activities from London to the EU, they have not all transferred them to the same EU location. So, for example, some banking activities have been transferred to Frankfurt and Paris, trading venues to Amsterdam, and fund management to Luxembourg and Dublin. Many market firms are authorised to operate in a range of different EU centres. ESMA's role is to prevent regulatory competition within the EU by encouraging convergence in the implementation of regulations in different EU national centres. It is also important to note that all the large international capital market firms on both the sell side and the buy side continue to have extensive operations outside the EU in London. Given London's role as a global financial centre, competition comes not just from Frankfurt, Paris, Amsterdam, Luxembourg and Dublin, but also from New York, Singapore and Hong Kong.

Changes in other parts of the capital market

7 Although the division of the Single Market into two separate markets along these lines was anticipated by market firms, and the separation itself has not so far led to a substantial further impact on the effective functioning of the international bond market, there have been changes in other sectors of the capital market. For example, trading venues shifted trading in EU shares from London to Amsterdam at the beginning of January, while the UK has proposed to lift the EU ban on trading Swiss shares in London; and, in the absence of equivalence, the EU Derivatives Trading Obligation has led to the transfer of some euro interest rate swaps trading from London, including to US Swap Execution Facilities in New York and to Singapore.

Use of English law and national laws in the EU

8 It is still very early to tell whether the end of the post-Brexit transition period will have a significant impact upon the predominant usage of English governing law for international bonds and associated documentation. But there does not appear to have been a significant shift so far. Local law has been used by several sovereign issuers in the EU for some time, and by some EEA banks in respect of the status of their regulatory capital securities.[2] The question for the market is whether the use of a number of different local laws may lead to more market fragmentation. It is widely considered that English law is likely to remain the preferred choice of law among UK and EU27 market participants.

9 Market firms have been taking a case-by-case approach in considering any change to the use of an asymmetric non-exclusive jurisdiction clause in favour of bondholders and underwriters or dealers. There does not appear to have been a significant change to the *status quo* so far. One factor here is likely to be whether the UK is admitted to the Lugano Convention.

Operational resilience in the EU

10 There is an outstanding issue about the location of CCPs. With effect from the end of 2020, the European Commission has granted regulatory equivalence to UK CCPs, which have also been recognised by ESMA, on the grounds that otherwise there would have been a risk of financial instability in the EU. The grant of equivalence has been limited to 18 months to enable the EU to build up its own operational resilience and to enable UK CCPs to transfer contracts to EU CCPs in the meantime, so that a further extension is not necessary. In a decision by the Commission on 27 January, equivalence was also granted to the US SEC, following an earlier grant to the CFTC.

11 In the case of CCP-cleared repo, most euro-denominated trades were cleared in CCPs located in the EU prior to the end of the post-Brexit transition period. The most significant shift in location occurred in February 2020, when LCH successfully concluded the migration of its euro repo clearing activity from LCH Ltd in London to LCH SA in Paris. The rationale for the shift was only partly related to Brexit, given the existing drive to consolidate repo clearing in one location so as to maximise the scope for netting and ensure access to settlement in TARGET2 Securities. CCP-cleared repo accounts for well over 50% of the repo market (in terms of volume). Trade repositories have set up separate authorised entities in the EU and the UK to serve their EU and UK clients in transaction reporting (including EMIR and SFTR).

12 Before the end of the post-Brexit transition period, Euroclear acted as issuer CSD not only for UK but also for Irish corporate securities from its London-based company. Since 15 March, Euroclear's ICSD in Brussels has acted as issuer CSD for Irish corporate securities.

---

2. The European Banking Authority and Single Resolution Board have also indicated that EU banks should consider issuing instruments that are intended to be eligible to meet the MREL target under the governing law of one of the EU Member States.

The period ahead

EU/UK Memorandum of Understanding (MOU)

13 Looking ahead, the joint declaration on financial services that accompanied the EU/UK Trade and Cooperation Agreement provides for "structural regulatory cooperation on financial services, with the aim of establishing a durable and stable relationship between autonomous jurisdictions based on a shared commitment to preserve financial stability, market integrity and the protection of investors and consumers".[3] As EU and UK regulations currently remain much the same and are significantly more convergent than with other third countries, there should in principle be scope for agreement on equivalence in future. The MOU which both sides agreed at the end of March is intended to enable progress on equivalence determinations "without prejudice to the unilateral and autonomous decision-making process of each side".[4] In practice, the MOU provides only a Joint EU/UK Financial Regulatory Forum for regulatory cooperation in future. There is already a network of MOUs between the EU and the UK on supervisory cooperation.[5]

Regulatory equivalence

14 One of the European Commission's main concerns about granting regulatory equivalence to the UK is the prospect of regulatory divergence in future. The UK considers that this is consistent with equivalence if 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). The EU considers 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 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 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 in the UK

15 The Governor of the Bank of England has recently 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 and is not the test up to now to assess equivalence."[6]

16 There is already evidence that UK regulation will begin to diverge from EU regulation, with the objective of improving EU regulations onshored to the UK and adapting them to changed circumstances:

- Examples in the bond markets include: differences between the UK and EU BMR; SFTR (which now has two separate reporting regimes); CSDR Settlement Discipline; and the PRIIPs Regulation, where the UK may reduce the circumstances in which a KID is required. The FCA has already announced that it will not be applying the PRIIPs regime to UK UCITS. There is a question about whether the MiFID II/R transparency regime should be altered to make it more effective and useful.
- In addition, the UK Listing Review has called, among other recommendations, for a fundamental review of the UK Prospectus Regulation with the aim of moving the UK regime much closer to the regime that existed in the UK before the EU Prospectus Directive and Prospectus Regulation were introduced.
- Cases being considered in banking and insurance include: whether the Basel regime for banks should cover all banks (as in the EU) or only internationally active banks (as in the US and Switzerland); whether software should count as bank capital (as proposed by the EU); and the need for a review of Solvency II.
- In the longer term, under the UK's future regulatory review of financial services, technical rules (such as those relating to MiFID II/R) onshored from the EU may be transferred from primary legislation (as in the EU) into the FCA and PRA rulebooks, subject to accountability of the regulators to Parliament.

17 But 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 substantial, 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 FinTech). By doing this, it is possible that the UK will exercise influence by setting an example. The UK authorities have made a point of saying that they will not reduce regulatory standards, and that these will be at least as high as the EU.

---

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

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

5. The EU may also deem the UK's data regime adequate.

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

Regulatory divergence in the EU

18 Regulatory divergence will occur, not just in response to measures taken by the UK, but also in response to measures taken by the EU. For example:

- The EU is due to review MiFID II/R to make it work more effectively.[7] An EU review of MAR is due later this year, and the EU prospectus regime is due to be reviewed next year. The EU PRIIPs regime is also due to be reviewed, though the timing is not clear. The Prospectus Regulation and MiFID II/R product governance regimes were amended in February 2021 in response to the EU Capital Markets Recovery Package.
- Under the EU review of the AIFMD, consideration is being given to tightening the EU's rules for the delegation of fund management. Delegation of fund management is a global issue, not a post-Brexit issue, but has become caught up in the negotiations post-Brexit.
- There is also potential for divergence between the EU and the UK on sustainable finance regulation.

In addition, the ECB's rules on eligible collateral contain jurisdictional limitations so that instruments issued by UK issuers and denominated in sterling, US dollars or Japanese yen, and unsecured UK bank debt instruments, are no longer eligible.

Market fragmentation and international competitiveness

19 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). Replacing a single operation with two separate operations, with the resulting need to deal with different regulatory requirements in different jurisdictions, involves substantial costs for large market firms; and some smaller firms may find it more cost-effective to cease business in the alternative market altogether (for example in the case of some small UK-based fund managers). Market fragmentation can also lead to operational risks, split liquidity, price volatility and execution costs, and may carry risks to financial stability.

Differences of approach

20 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 consistent with financial stability.
- Another difference in approach is that the UK is considering the delegation of detailed technical rules to regulators who will be accountable to Parliament, while the EU includes detailed technical rules in primary legislation. This should make UK regulation more agile than the EU, which needs to be negotiated and requires a common approach across the 27 Member States.

ICMA's post-Brexit role and approach

ICMA's role is to encourage efficient, integrated and resilient capital markets, which are necessary to support sustainable economic growth.

ICMA's approach has been to focus on the potential impact of the UK's withdrawal from the Single EU Market on international capital markets.

ICMA is not lobbying for any particular financial centre. ICMA's members are based in the UK, the EU and more broadly.

ICMA has been discussing the impact of the UK's withdrawal from the Single EU Market with members and is reporting to the ICMA Board.

ICMA is keeping in contact with the authorities in the UK, the EU and the euro area.

ICMA is cooperating with other trade associations by sharing information, wherever possible.

ICMA is keeping members up-to-date by giving them regular assessments through the ICMA Quarterly Report, conference calls, podcasts and webinars, and ICMA is also keeping its post-Brexit webpage up-to-date.

Contact: Paul Richards
paul.richards@icmagroup.org

7. The EU has stated that in the short to medium term it will not assess the equivalence of the UK's regulatory and supervisory regime to its own for the purposes of MiFIR Article 47, which covers investment services.