Capital Markets Union and Brexit

By Paul Richards

Summary

What are the prospects for EU Capital Markets Union and how will they be affected by Brexit? At one level, Brexit makes Capital Markets Union in the EU27 a more important initiative, as capital markets are less developed in the EU27 than in the UK. The prospects for Capital Markets Union in the EU27 would also benefit from renewed political momentum in the euro area to strengthen the economic pillar of Economic and Monetary Union. But at another level, Brexit divides Capital Markets Union into two between the EU27, on the one side, and the UK – as the largest international financial centre in the EU – on the other. There is a risk that the negotiations between the EU27 and the UK could lead to international capital market fragmentation and financial instability, to the disadvantage of both sides. This paper considers possible alternatives which would be in their mutual interest.

Introduction

1 The paper addresses three related questions:

- First, what are the prospects for making further progress in the EU towards Capital Markets Union?
- Second, how can the prospects for Capital Markets Union be improved by strengthening the economic pillar of Economic and Monetary Union?
- Third, how will the prospects for Capital Markets Union be affected by Brexit, and what can be done about this?

The European context

New prudential regulations have been introduced in response to the international financial crisis of 2007-2009 to improve bank resilience by increasing capital and liquidity requirements, though the process of bank recapitalisation has taken longer in the EU than the US; and new regulations also provide that, in the event that banks fail in future, selected creditors as well as shareholders should be bailed *in* rather than relying on taxpayers to bail them *out*. In addition, new conduct of business regulations have been introduced to improve market standards, backed by fines for mis-selling. These measures are all designed to rebuild and maintain public trust in the stability, safety, soundness and fairness of the financial system.

Following the sovereign debt crisis of 2010-2012 in several euro area countries, which led to the ECB's initiative in 2012 to do "whatever it takes" to save the euro, the ECB has introduced quantitative easing (QE), accompanied by negative short-term interest rates, to bring inflation in the euro area back towards its target of close to, but below, 2% per annum.

There is increasing evidence that, in response, the European economy is at last recovering on a sustainable basis, and that unemployment in the euro area is declining, though youth unemployment is still very high in some euro area countries. The economic recovery appears to be extending to those euro area countries whose governments had to be bailed out in response to the sovereign debt crisis of 2010-2012. But there are still questions about their long-term economic competitiveness with Germany.

Following the elections this year in France and Germany, there may be a new political opportunity for closer economic integration in the euro area, supported by the European Commission. The UK, by contrast, has voted to leave the EU and triggered Article 50 of the EU Treaty, leading to negotiations with the European Commission on behalf of the EU27 on the terms of UK withdrawal from the EU by 29 March 2019.

EU Capital Markets Union

2 The European Commission's initiative on Capital Markets Union (CMU) is designed to develop capital markets in the EU27 through greater capital market integration across national borders, with the objective of strengthening the EU economy and stimulating investment to create jobs. In developing EU capital markets, the Commission does not intend to replace bank financing, but to complement it. This is particularly important in the EU27, whose capital markets are not as developed as in the UK or the US. The CMU Mid-Term Review[1] has provided an opportunity to assess progress to date. There are five main ways in which to make further progress towards CMU in the medium term:

3 *New EU measures:* CMU involves the introduction of new EU measures by 2019 to develop and integrate capital markets across the EU.[2] Out of 33 measures originally envisaged as part of the CMU work programme, 20 had been introduced by the time of the Mid-Term Review. New measures planned but not yet fully implemented (eg measures relating to insolvency reform and taxation) could potentially make a significant difference to capital market integration across national borders in the EU, though agreement in the EU on measures which make the most significant difference have often proved politically the most intractable in the past.

4 *Review of existing measures:* CMU also involves ensuring that existing EU measures are fit for purpose. Review clauses in EU legislation provide an opportunity to check this. The Commission's Call for Evidence was designed to assess regulatory reforms introduced in response to the international financial crisis, without altering the broad thrust of the reforms. Respondents drew attention to the need for a number of regulatory improvements (eg to offset the potentially harmful effects of some specific regulatory calibrations on market liquidity),[3] and these improvements need to be implemented following the Mid-Term Review.

5 *Supervisory convergence:* The effectiveness of CMU depends on achieving greater supervisory convergence across the EU. This involves completing the Single EU Rulebook[4] and ensuring that new legislative measures are implemented and enforced across the EU in a consistent way.[5] Following the CMU Mid-Term Review, the European Commission has proposed greater powers for the European Securities and Markets Authority (ESMA) to ensure supervisory harmonisation across the EU27.[6] ESMA already has direct responsibility for supervising credit rating agencies and trade repositories, and the Commission proposed in June that ESMA should take direct responsibility for the oversight of central counterparties, in close consultation with the ECB. By 2019, the Commission envisages that the first steps may also be taken towards establishing a single EU capital markets supervisor.[7]

6 *Financial stability:* CMU is intended to increase financial stability in the EU by diversifying funding channels and sharing risks across national borders to make the EU financial system more resilient, recognising that international capital flows are now only half their pre-crisis levels in relation to world output.[8] In a Monetary Union such as the euro area, risk sharing across national borders through the capital markets is particularly important because a single monetary policy is not able to address asymmetric shocks, which affect some countries more than others. Risk sharing can also help to offset the potential threat to financial stability arising from financial integration. Without risk sharing, financial stability may be vulnerable to cross-border contagion.[9]

1. European Commission Communication: *Mid-Term Review of the Capital Markets Union Action Plan*, 8 June 2017.

2. The objectives of the measures are summarised by the European Commission as to: "strengthen the capacity of EU capital markets; encourage finance for innovation, start-ups and non-listed companies; make it easier for companies to raise capital on public markets; invest for the long term in infrastructure and sustainable investments; foster retail investment; strengthen banking capacity to support the wider economy; and facilitate cross-border investment": *Mid-Term Review of the Capital Markets Union Action Plan,* 8 June 2017.

3. See, for example, the ICMA response to the European Commission consultation on the Capital Markets Union Mid-Term Review, 10 March 2017.

4. See: Danièle Nouy, Chair of the Supervisory Board of the ECB: "In Europe, we have 19 versions of the Single Rulebook, and each one is slightly different from the others. Such a fragmented set of rules is a problem. It increases risks, and it makes European banking supervision more complex and costly for banks.": *Regulation and Supervision in Europe – Can Many Cooks Make a Good Broth?* Frankfurt, 15 May 2017.

5. This will be easier if the EU makes greater use of Regulations, which apply directly in EU Member States, rather than Directives, which have to be transposed by EU Member States into national law.

6. European Commission Communication, *Reinforcing Integrated Supervision to Strengthen CMU and Financial Integration in a Changing Environment,* 20 September 2017.

7. European Commission: *Reflection Paper on the Deepening of EMU:* 31 May 2017.

8. ECB: *The Future of Globalisation*, November 2016.

9. See: Vitor Constancio, Vice-President of the ECB: *Risk Sharing and Macroprudential Policy in an Ambitious Capital Markets Union,* Frankfurt, 25 April 2016.

7 *Market infrastructure:* In parallel with the Commission's work on CMU, the ECB has made considerable progress in developing and integrating the financial market infrastructure for the euro through the TARGET2 payment system and the TARGET2-Securities settlement system linking national and international Central Securities Depositories. The ECB now has plans: to consolidate TARGET2 and TARGET2-Securities; to provide settlement services to support instant payments; and to establish a potential Eurosystem collateral management system.[10] Even so, there are still many barriers to post-trade services across financial markets which remain to be addressed. The European Post-Trade Forum's recent report on these barriers has provided the basis for a Commission consultation, which will inform a Communication on post-trade, planned for the end of 2017.[11]

CMU and euro area integration

8 The prospects for EU capital market integration through CMU would be improved if accompanied by policy changes to strengthen the economic pillar of Economic and Monetary Union in the euro area. Following the elections this year in France and Germany, there may be a new political opportunity for closer economic integration in the euro area, and a proposal has been put forward by the President of the European Commission, though the response in Germany is not yet clear and the question of the secession of Catalonia from Spain has arisen again.[12] Economic and Monetary Union still represents a "half-way house", in which there is a fully developed Monetary Union, with the ECB taking responsibility for monetary policy in the euro area, but not a fully developed Economic Union, where responsibilities remain largely at national level.[13] Strengthening the economic pillar will require closer economic convergence within the euro area; agreement on a path to fiscal integration; and a settlement between the euro area and other EU countries, which will still represent 15% of EU GDP after Brexit.[14] But it will also depend on resolving two specific issues which are closely related to CMU: the completion of Banking Union; and the search for a European safe asset as a euro area benchmark.

(i) Banking Union

9 Progress has been made towards Banking Union, which is intended both to increase the resilience and integration of the euro area banking system and, by doing so, to support the integration of capital markets in the EU.[15] Banking Union and Capital Markets Union are seen as complementary parts of a complete Financial Union. But in the case of Banking Union, it is important to distinguish between three separate steps. More progress has so far been made on some steps than others:

10 First, the ECB has taken direct responsibility for supervising 130 key banks in the euro area through the *Single Supervisory Mechanism*. This should help to improve bank resilience by ensuring that there is a fully consistent approach to bank supervision across the euro area, including on stress testing; and that the interdependence between some banks and their national governments through bank holdings of government debt, and the overhang of non-performing bank loans, are both reduced to more manageable levels, particularly if supported by a sustained economic recovery in the euro area.

11 Second, the *Single Resolution Board* has been established to ensure that failing banks are resolved without recourse to the taxpayer. Under the Bank Recovery and Resolution Directive (BRRD), bank resolution is to be financed by banks' shareholders and selected creditors, and by a Single Resolution Fund, pre-financed by the banking industry. But if this is not sufficient, a credible fiscal backstop to the Single Resolution Fund is still needed (eg through a credit line to the Single Resolution Fund from the European Stability Mechanism).[16] The new arrangements for bank recovery and resolution have been put to the test this year. In Spain, Banco Popular was sold in June to Banco Santander for €1 after equity and junior debt holders

10. Yves Mersch, Member of the ECB's Executive Board: September 2016.

11. European Commission: *Post-trade in a CMU: Dismantling Barriers and Strategy for the Future: Consultation Document,* 23 August 2017. The main barriers identified by the European Post-Trade Forum, and subject to consultation, include: diverging corporate action processes; lack of convergence and harmonisation in information messaging standards; lack of harmonisation and standardisation of ETF processes; complexity of post-trade reporting; unresolved issues on reference data and standardised identifiers; legal uncertainty about risk mitigation techniques; deficiencies in the protection of client assets; inadequate EU rules on finality; lack of harmonisation of registration and investor identification rules; and inefficient withholding tax procedures.

12. See: Jean-Claude Juncker, European Commission President: State of the Union Address, 13 September 2017.

13. See: European Commission: *Reflection Paper on the Deepening of EMU:* 31 May 2017; and *The Five Presidents' Report:* June 2015.

14. The settlement negotiated by the British Government with the EU27 in February 2016 failed when the UK voted to leave the EU in the Referendum in June 2016. There is a case for reviving the settlement to protect the position of EU countries still in the EU outside the euro area.

15. See: Vitor Constancio, Vice-President of the ECB: *Synergies Between Banking Union and Capital Markets Union,* Brussels, 19 May 2017.

16. European Commission: *Reflection Paper on the Deepening of EMU:* 31 May 2017 (page 20).

were bailed in without a cost to the Spanish taxpayer. But in Italy, Banca Monte di Paschi di Siena was recapitalised and restructured, and the regional banks of Vicenza and the Veneto were bailed out by the Italian Government in June and sold to Banca Intesa Sanpaolo, following a decision to exempt them from the BRRD. The head of the Single Resolution Board has since proposed that this potential loophole should be reviewed.

12 The third issue, which remains to be resolved, is the need to reach agreement on a *European Deposit Insurance Scheme* to insure deposits with banks up to €100,000 across the euro area in place of existing national schemes. Agreement has not so far been reached, mainly because of concern in Germany that German banks would be required to bail out insured depositors with banks in other euro area countries. But German resistance to common deposit insurance may become less pronounced if banking reform in the euro area is successful in ensuring that banks – especially in Italy and Spain – are more resilient.

(ii) A European safe asset

13 The issuance of government debt in the euro area remains largely a national responsibility.[17] German Bunds are treated in the market as the "safest" national asset (eg when there is a flight to safety in financial markets). Various options have been considered for creating a European safe asset (ie a "eurobond") which would be intended to act as a benchmark for the euro area equivalent to Treasuries in the US, provided that there is sufficient political and economic integration in the euro area to ensure that the euro project itself is considered "safe". There are two main options currently under consideration:

14 One option would be for euro area governments to provide *joint and several guarantees* on new issuance of euro-denominated national government debt in the euro area. The provision of joint and several guarantees would result in a euro area benchmark which would reduce the cost of funding for those sovereign issuers in the euro area which currently have lower credit ratings, but might increase the cost of funding for those which currently have triple A ratings. In addition, there is a concern that the provision of joint and several guarantees would weaken financial discipline among the governments of less creditworthy euro area countries. More fundamentally, there would be political resistance, particularly in Germany, to the provision of taxpayer guarantees of this kind. Joint and several guarantees would also require a change in the EU Treaty.

15 The other option under consideration (eg by the European Systemic Risk Board) is for the issuance of euro-denominated *sovereign bond-backed securities* (SBBS), which would effectively carry several, but not joint, guarantees by sovereigns in the euro area. The pool of sovereign assets in the SBBS would be weighted (eg by GDP). SBBS would be designed to promote risk sharing and reduce the interdependence between banks and their own sovereigns. However, it is not clear to what extent SBBS would increase risk sharing in practice, as there is a high correlation between most euro area sovereign risks. Nor is it clear whether risk sharing would significantly increase the resilience of banks which buy SBBS (rather than buying the debt of their own sovereign) unless the pool of sovereign assets underlying the SBBS were split between a senior (ie "safe") and a junior (ie less "safe") tranche. This might make the junior tranche less liquid and more difficult to sell to junior investors without a significantly higher yield, leaving a much lower yield for senior investors. A major uncertainty is the regulatory treatment of SBBS: whether SBBS would be treated as securitised products or sovereign assets for regulatory purposes; and whether and, if so, how the current regulatory treatment of sovereign exposures (which are generally risk-free for capital purposes) will be changed. At present, given that sovereign debt in less creditworthy countries carries a relatively high yield and is generally treated as risk-free for capital purposes, there is little incentive for bank holders of the debt of their own sovereign to diversify. To demonstrate the authorities' commitment to SBBS, a public sector issuer might need to test the market first, and possibly also provide liquidity in the secondary market.[18]

CMU and Brexit

16 Brexit will make Capital Markets Union in the EU27 a more important initiative, as capital markets are less developed in the EU27 than in the UK. But the immediate impact of Brexit will be to reduce the scope of CMU, given the size of London as a European as well as a global financial centre, even if there is a transfer of business in response to Brexit from London to financial centres in the EU27. Costs for end-users of capital markets will also increase as a result of Brexit, if capital market firms have to operate in two centres rather than one. While it may become easier and quicker for the EU27 to reach decisions on capital markets regulation without the UK, the market-

17. However, the European Investment Bank and the European Stability Mechanism, among others, borrow at European level. It is also important to note that there are already very substantial claims by creditor countries on debtor countries in the euro area which have been accumulated through the TARGET2 payment mechanism.

18. The issuance of euro bills has also been suggested as a pilot project.

friendly influence of the UK on decision-making at EU level will be lost, though the UK will still influence decision-making at global level.

17 CMU is designed to encourage capital market integration across national borders in the EU, and capital market integration could potentially also benefit from closer economic integration in the euro area. The question posed by Brexit is whether capital market integration is solely of benefit to the EU27 across national borders *internally* in the EU27, or whether open and competitive markets would benefit the EU27 *internationally* as well. Clearly, it is important that promoting international capital market integration should be consistent with ensuring financial stability, which is in the EU's public interest. In order to assess these issues, this section is divided into three: capital market preparations for Brexit; capital market operations after Brexit; and capital market regulation after Brexit. The conclusion is that a sensible agreement between the EU27 and the UK on the terms of Brexit is in their mutual interest.

(i) Capital market preparations for Brexit

18 Following the UK Referendum on 23 June 2016, the British Government proposed that the UK should leave the EU Single Market when it leaves the EU by 29 March 2019, and instead negotiate – as a third country – a new free trade agreement with the EU27.[19] There is still considerable uncertainty in international capital markets about the prospective outcome of the negotiations between the UK and the EU27. Two key issues affecting international capital markets relate to the need for sufficient time to prepare for changes resulting from Brexit, and the need for legal certainty when Brexit takes place:

19 *Time to prepare:* A free trade agreement is very unlikely to be reached before the UK leaves the EU because the length of time likely to be needed to negotiate a free trade agreement is much greater than the length of time until Article 50 expires, and because the European Commission insists that only the framework of an agreement can be negotiated before Article 50 expires, while a detailed free trade agreement can only be negotiated afterwards and will take time to ratify. Capital market firms will need long lead-times to prepare for Brexit, and have already drawn up contingency plans to ensure that they can continue to serve all their clients without disruption.[20] The outcome of the Brexit negotiations will be uncertain until a late stage, as "nothing is agreed until everything is agreed". Consequently, a transition period[21] between the UK and the EU27 will need to be agreed before Brexit to cover the period after Brexit (until a free trade agreement comes into effect) in order to avoid the risk of a regulatory "cliff edge". There would be a "cliff edge" if the UK were to leave the EU either with no withdrawal agreement at all or an agreement involving substantial regulatory change at the outset. This would be disruptive to capital markets and risk damaging financial stability on both sides.[22]

20 Agreement between the UK and the EU27 on a transition period needs to be reached as early as possible during the Article 50 negotiations, and publicly announced (even if the announcement is subject to finalisation of the withdrawal agreement later), to avoid market uncertainty. Capital market firms will also want to be confident that regulatory changes will be made only once (ie at the end of the transition period) and not twice (at both the beginning and the end), and that they have a clear idea of the changes planned.[23] If that is not possible, given the long lead-times, capital market firms will need to implement their contingency plans on the grounds that they may not be able to rely on a transition period after Brexit. Some have already started to do so.

21 In Florence on 22 September, the British Prime Minister proposed such a period of "implementation" (ie transition) during which "access to one another's markets should continue on current terms" for a "strictly time-limited period" of "around two years", and under which the framework "would be the existing structure of EU rules and

19. This is because the British Government's objectives on Brexit involve taking back control of the UK's borders by limiting EU immigration to the UK, and taking back control of UK laws by bringing an end in the UK to the direct jurisdiction of the European Court of Justice. These objectives are not consistent with remaining in the EU Single Market when the UK leaves the EU.

20. In addition to preparing for Brexit, banks with headquarters outside the EU have been required since 2016 to set up a holding company for their EU subsidiaries; and in the UK banks are preparing to ring-fence their retail from their investment banking activities in separate entities by January 2019.

21. A transition period is described by the British Government as an "implementation period" or an "interim period".

22. See Andrew Bailey, Chief Executive of the FCA: "We need to preserve close regulatory and supervisory links with the EU. Looking ahead, strong coordination is a sensible approach to take in order to demonstrate the strength of the system. I would point to four permanent features: comparability of rules, but not exact mirroring; supervisory coordination; exchange of information; and a mechanism to deal with differences. I would add to this importance of transitional arrangements being put in place which allow for a smooth path to the new post-Brexit world.": *Why Free Trade and Open Markets in Financial Services Matter:* Reuters Newsmaker, London, 6 July 2017.

23. On 27 August, the Opposition spokesman for Exiting the EU stated that Labour's policy would be to stay in the EU Single Market and Customs Union during the transition period after the UK leaves the EU.

regulations", so that businesses "should only have to plan for one set of changes in the relationship between the UK and the EU". The detailed arrangements for this implementation period would need to be agreed "as early as possible". However, the Prime Minister recognised that "the EU Institutions will need to adopt a formal position" on the UK's proposal.[24]

22 *Legal certainty:* In order to avoid legal uncertainty over Brexit, the British Government has accepted that EU law will continue to apply in the UK until the UK leaves the EU; and has introduced into Parliament the Repeal Bill to take EU law into UK law when Brexit takes place.[25]

- In the *narrow* sense in which contractual provisions may be invalidated or disrupted, these measures may not in themselves avoid legal uncertainty with respect to jurisdiction and choice-of-court clauses in cross-border financial contracts outstanding when Brexit takes place, and for new cross-border financial contracts entered into after Brexit. Recognition of the governing law, including contracts governed by English law, should not alter, with the EU courts continuing to give effect to non-EU law under Rome I. The position is less clear in relation to jurisdiction. The Brussels I Regulation, which provides for recognition and enforcement of judgements between EU Member States, will cease to apply to the UK after Brexit. It is not yet clear which measures will be taken to support jurisdiction enforcement: possibilities include a revival of pre-Brussels Convention bilateral treaties, adherence to the Lugano Convention and ratification of The Hague Convention.
- In the *broader* sense of contractual uncertainty arising from the risk that capital market firms may no longer all be authorised to operate across the EU27 if passporting ends when Brexit takes place, the UK and EU27 authorities need to reassure market participants that the continuity of their cross-border financial contracts will not be affected by Brexit. One way of providing such reassurance would be for the UK and the EU27 authorities jointly to announce as soon as possible that cross-border financial contracts between market participants in the UK and the EU27 outstanding when Brexit takes place would be "grandfathered", for example by providing for this in the UK/EU27 withdrawal agreement.[26] An alternative would be for legislation to be introduced in both the UK and the EU27 to protect the long-term validity of existing contracts.[27] The objective would be similar to the provisions for continuity and freedom of contract in the Regulation under Article 235 of the Treaty (EC/1103/97) in all EU Member States, including the UK, when the euro was introduced in 1999.[28]

(ii) Capital market operations after Brexit

23 It is in the interests of both the UK and the EU27 for capital market operations to continue after Brexit with the minimum of disruption. Subject to the outcome of the negotiations between the UK and the EU27, there appear to be two main options for capital market firms operating in both the UK and in the EU27:

24 *Mutual recognition of regulatory equivalence:* One option is to rely on mutual recognition of regulatory equivalence between the UK and the EU27, to the extent that this is practicable. At present, regulatory equivalence consists of a patchwork of equivalence, endorsement, recognition and third country passporting for some – but not all – EU capital market regulations. There are provisions for determining equivalence in some EU regulations but not others and, where equivalence does apply, it is not always complete; determining equivalence involves a judgment by the European Commission as well as a technical assessment, and takes time; and the determination of equivalence can be withdrawn at short notice, though this has not happened to date. It is also relevant to note that the assessment of regulatory equivalence is based on measuring outcomes, but that outcomes are not straightforward to measure. For an equivalence assessment in the case of the

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24. British Prime Minister, *A New Era of Cooperation and Partnership Between the UK and the EU,* Florence, 22 September 2017. During the implementation period, the Prime Minister said that "people will continue to be able to come and live and work in the UK", subject to a registration system; and that the UK's partners will not "need to pay more or receive less over the remainder of the current budget plan as a result of our decision to leave."

25. The British Government won a vote in the House of Commons on the EU (Withdrawal) Bill – ie the Repeal Bill – on 11 September 2017. But it is not yet clear whether, and if so how, the Repeal Bill will be amended during its remaining passage through Parliament.

26. See also: HM Government: *Providing a Cross-Border Civil Judicial Cooperation Framework:* 2017; The Financial Markets Law Committee: *Issues of Legal Uncertainty Arising in the Context of the Withdrawal of the UK from the EU – The Application of English law, the Jurisdiction of English Courts and the Enforcement of English Judgement:* December 2017; and *Issues of Legal Uncertainty Arising in the Context of the Withdrawal of the UK from the EU – The Provision and Application of Third Country Regimes in EU Legislation:* July 2017; ISDA: *Brexit – CCP Location and Legal Uncertainty:* August 2017 (pages 6-8); and AFME: *Impact of Brexit on Cross-Border Financial Services Contracts:* September 2017.

27. Bank of England Financial Policy Committee, 25 September 2017.

28. Bank of England: "Continuity and freedom of contract are safeguarded. The introduction of the euro will not have the effect of altering any term of a contract, or discharging or excusing performance, or entitling a party unilaterally to alter or terminate the contract, subject to whatever the parties may have agreed.": *Practical Issues Arising from the Euro:* 14 December 1998.

Location, supervision and systemic risk

The European Commission has proposed that, as a result of Brexit, the framework for the recognition of third country – ie non-EU – central counterparties (CCPs) and their supervision needs to be enhanced, because of the "potential risks to the EU's financial stability".[29] Under the Commission's proposal, ESMA, in agreement with the relevant central banks, will recommend to the Commission whether or not a non-EU CCP is of "substantial systemic importance". If so, the Commission will then have the power to decide whether or not the CCP should be required to relocate activities within the EU27 as a condition for obtaining the regulatory approvals needed to operate in the EU Single Market.[30]

In a similar way, ESMA has published a cross-sectoral opinion on supervisory convergence and three opinions on sector-specific principles on relocations from the UK to the EU27 relating to investment firms, investment management and secondary markets in response to Brexit. ESMA's opinions are concerned with two main points. First, "firms need to be subject to the same standards of authorisation and ongoing supervision across the EU27 in order to avoid competition on regulatory and supervisory practices between Member States".[31] Second, delegation (eg of investment management) and outsourcing of market activities beyond the EU27 by firms authorised to operate in the EU27 need to be overseen and properly supervised from within the EU27.[32]

There are differing views about the links between the location of CCPs and systemic risk. The ECB has argued that CCPs have become effective vehicles for reducing systemic risk in the financial system, and the challenge is to ensure that they do not themselves become a risk to financial stability;[33] and the Governor of the Banque de France has argued: "Do not let sources of systemic risks for the EU grow outside the EU."[34] The alternative view is that clearing does not need to take place in the jurisdiction in which a financial asset is denominated, as central bank swap agreements can counter any systemic risks, and it is more efficient to clear on an international basis, regardless of currency, because this allows firms to net their risk in different currencies.

If mandatory relocation of derivatives contracts in CCPs from London to the EU27 is required by the EU27 authorities, it would involve costs and risks for users of capital markets, given current economies of scale in London from pooling liquidity in several currencies, which allow multilateral netting of transactions and a reduction in the collateral needed.[35] There is also a risk that mandatory relocation would cause market disruption, particularly if relocation is not properly organised over a sufficient period of time; and there may be implications, not just for the UK, but for the US and other third countries.

But if sufficiently robust arrangements can be established between the UK and the EU27 supervisors, mandatory relocation may not be needed. The ECB's concern is that "the current EU regime regarding third-country CCPs was never designed to cope with major systemic CCPs operating from outside the EU."[36] As a potential solution, the Governor of the Bank of England has proposed that cross-border arrangements for the supervision of CCPs "should be based on deep cooperation between jurisdictions and authorities who defer to each other's regimes where they meet international standards and deliver similar outcomes."[37]

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29. CCPs play a critically important role in providing the market infrastructure for managing risk. Market firms are required to clear certain derivatives trades through CCPs authorised for the activity concerned, and CCPs are also used to clear other products (eg repo), where use of CCPs is discretionary rather than mandatory. Most central euro-denominated clearing currently takes place in London as an international financial centre.

30. European Commission proposal to amend EMIR, 13 June 2017. In addition, the ECB is seeking to amend its Statute so that it has clear legal competence in the area of central clearing.

31. It remains to be seen whether there will be competition between different national competent authorities in the EU27 (eg for the relocation of financial services business). Commissioner Dombrovskis said in Tallinn on 15 September: "We think that national supervisors in the EU should follow the same supervisory priorities." See also the European Commission Communication, *op. cit.*, 20 September 2017.

32. ESMA: *Opinion on General Principles to Support Supervisory Convergence in the Context of the UK Withdrawing from the EU:* 31 May 2017; and *Sector-Specific Principles on Relocations from the UK to the EU27:* 13 July 2017.

33. Benoit Coeuré, Member of the Executive Board of the ECB: *European CCPs After Brexit:* GFMA, Frankfurt, 20 June 2017.

34. François Villeroy de Galhau, Governor of the Banque de France: FESE Convention, 22 June 2017.

35. ISDA has estimated that "a requirement that euro-denominated interest rate derivatives be cleared post-Brexit in an EU-based CCP would result in an overall initial margin increase in the range of 15 to 20%": Letter to Commissioner Dombrovskis, 8 June 2017.

36. Benoit Coeuré, Member of the Executive Board of the ECB: *European CCPs After Brexit:* GFMA, Frankfurt, 20 June 2017.

37. Mark Carney, Governor of the Bank of England: *A Fine Balance:* Mansion House speech, 20 June 2017. See also the Chancellor of the Exchequer: "We acknowledge that there are legitimate concerns among our EU colleagues about the oversight and supervision of financial markets here in the UK that are providing vital financial services to EU firms and citizens. We will address them by making forward-leaning proposals for greater transparency, cooperation, and agreed standards based on international norms. But, let me be clear, we will not accept protectionist agendas, disguised as arguments about financial stability. We will seek to agree new mechanisms around key issues, from dispute resolution to data protection.": UK Finance Dinner, 13 September 2017.

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UK to be workable upon Brexit, the European Commission would need to make the assessment before Brexit takes place.

25 *Authorisation in both the UK and the EU27:* If it is not possible to rely solely on regulatory equivalence, the other option is for firms involved in the international capital markets to be authorised, capitalised and staffed in both the UK and the EU27, where that is not the case already.[38] This would increase costs for international capital market firms, which would need to operate from two jurisdictions in Europe rather than one,[39] and could complicate the task for supervisors.[40] As a condition for providing authorisation to operate in the EU27, the question is whether – and to what extent – EU27 supervisors would insist on relocation of capital market activities and the market infrastructure from the UK to the EU27 on the grounds that location within the EU27 is necessary to ensure financial stability, or whether an acceptable alternative would be an agreed form of coordination between UK and EU27 supervisors over capital market activities and the market infrastructure needed to support them, where these are located outside the EU27 (eg in London). Clearly, the UK and EU27 supervisors would need to agree that the supervisory arrangements would be sufficiently robust to ensure that financial stability would not be put at risk. Indeed, avoiding financial instability would be one of the main reasons why coordination between supervisors would be necessary.

(iii) Capital market regulation after Brexit

26 When Brexit takes place, as capital market regulation in the UK and EU27 will be the same, there should be an opportunity for the UK and the EU27 to negotiate a free trade agreement which would provide mutual recognition of each other's regulatory regime.[41] In this respect, the UK will be unlike any other third country, because it starts from a position in which its regulatory and supervisory system is the same as the EU27, whereas other third countries have a different regulatory and supervisory background. Mutual recognition of the regulatory equivalence provisions in existing EU capital market legislation would not on its own be sufficient to achieve this, as there are gaps which would need to be filled. The free trade agreement between the UK and the EU27 could fill these gaps.[42]

27 Mutual recognition of regulatory equivalence would mean that regulatory provisions in the UK and EU27 would need to continue to be comparable in future after Brexit, while allowing the UK and the EU27 to implement agreed outcomes in their own way; and that there would also need to be provisions in the free trade agreement for enforcement and for settling disputes.[43] However, that should be less difficult to achieve in future than it would have been in the past, for two reasons. First, there is less new financial regulation in the pipeline now, as so much has been introduced in response to the crisis already. Second, in so far as further new regulatory initiatives are needed, they are likely to originate at global level from the G20 through the FSB, BCBS and IOSCO, which will affect both the EU27 and the UK in the same way, and in which both the EU27 and the UK will have a say.

38. In the EU27, this would normally be through subsidiaries. In the UK, it needs to be clear whether branches would be an acceptable alternative to subsidiaries. See Andrew Bailey: "Even if UK firms lose passporting rights to the European Single Market after Brexit, we should do what we can to maintain inwards activity into the UK": 19 July 2017.

39. Boston Consulting Group (for AFME) estimates that "approximately €1,280 billion of bank assets may need to be re-booked from UK to EU27 following a hard Brexit, unless alternative arrangements can be agreed. These assets are supported by €70 billion or approximately 9% of the (Tier 1) equity capital of the banks affected.": *Bridging to Brexit: Insights from European SMEs, Corporates and Investors:* AFME, June 2017. Oliver Wyman estimates that costs for banks will increase by up to 4% and capital requirements by up to 30%: FT, 1 August 2017.

40. Letter from the Head of the Prudential Regulation Authority to the Treasury Select Committee, 8 August 2017.

41. The alternative approach would consist of regulatory divergence after Brexit, which would risk leading to a regulatory "race to the bottom". This approach was implicitly rejected in the British Prime Minister's Florence speech on 22 September, in which she said: "We share a commitment to high regulatory standards."

42. An alternative might be the adoption of an Equivalence Regulation in the EU27 and reciprocal UK measures, if feasible in time. See Barnabas Reynolds: *A Template for Enhanced Equivalence:* Politeia, 10 July 2017.

43. The British Government has proposed a number of options, including a new UK/EU27 legal body that takes account of the European Court of Justice's rulings (like the EFTA Court), but ends the "direct" jurisdiction of the European Court of Justice in the UK: August 2017. In her speech in Florence on 22 September, the British Prime Minister said: "It would not be right for one party's court to have jurisdiction over the other. But I am confident we can find an appropriate mechanism for resolving disputes."

Conclusions

- There are five main ways in which to develop capital market integration across the EU: completing the programme of new EU measures under CMU; ensuring that existing EU measures are fit for purpose; achieving greater supervisory convergence across the EU; sharing risks across the EU to promote financial stability; and developing and integrating the financial market infrastructure.

- The prospects for CMU would be improved if accompanied by policy changes to strengthen the economic pillar of Economic and Monetary Union. This would involve agreement in the euro area on a path to fiscal integration. But it would also depend on resolving two specific issues which are closely related to CMU: the completion of Banking Union; and the search for a European safe asset as a euro benchmark.

- The question posed by Brexit is whether capital market integration is solely of benefit to the EU27 across national borders *internally* in the EU27, or whether open and competitive markets would benefit the EU27 *internationally* as well, and also be consistent with ensuring financial stability.

- Given the long lead-times for capital market firms in preparing for Brexit, agreement on a transition period needs to be reached by the UK and the EU27 as early as possible before Brexit to cover the period after Brexit until a free trade agreement is reached. Capital market firms will also want to be confident that they will need to make changes only once, and that they have a clear idea of the changes required.

- To avoid the risk of uncertainty about the continuity of cross-border financial contracts between market participants in the UK and the EU27, if passporting ends when Brexit takes place, the UK and EU27 authorities need to reassure the market by announcing as soon as possible that existing contracts outstanding when Brexit takes place will be "grandfathered", for example by providing for this in the UK/EU27 withdrawal agreement.

- There are two main options for capital market firms operating in the UK and the EU27. One is to rely on mutual recognition of regulatory equivalence. But this is currently a patchwork. The other is to be authorised, capitalised and staffed in both the UK and the EU27, which would increase costs for firms and could complicate the task for supervisors.

- As a condition for providing authorisation to operate in the EU27, the question is whether – and to what extent – EU27 supervisors will insist on relocation of capital market activities and the market infrastructure from the UK to the EU27 on the grounds that location within the EU27 is necessary to ensure financial stability, or whether an acceptable alternative would be an agreed form of coordination between UK and EU27 supervisors.

- When Brexit takes place, as capital market regulation in the UK and EU27 will be the same, there should be an opportunity for the UK and the EU27 to negotiate a free trade agreement which would provide mutual recognition of each other's regulatory regime, by filling in the gaps in the current regulatory patchwork. Regulatory provisions in the UK and the EU27 would need to continue to be comparable in future after Brexit, with provisions for enforcement and for settling disputes.

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