The impact of the Brexit vote on European Capital Markets Union

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The Brexit vote was a clear setback in the effort to integrate European capital markets. It slowed down the implementation of the Capital Markets Union agenda to avoid pre-empting the Brexit negotiations, and risks an inefficient break-up in the activities of clearing houses that deal in euro-denominated securities. This column, the second in a two-part series, argues that there is a strong case for the Capital Markets Union project to continue with the remaining EU27 members after Brexit, including stronger central oversight.

Editors' note: This is the second column in a two-part series. The first column, available here, discussed the progress made in the CMU agenda and argued that a more ambitious vision is needed to achieve true CMU.

The UK's eventual departure from the EU represents a clear setback to the CMU project, in view of the dominance of London as Europe's financial centre. The Brexit vote has slowed the implementation of the CMU Action Plan (European Commission 2015), as the attention of European institutions shifted toward managing the future relationship with the UK. The draft securitisation directive came close to becoming the first casualty of the Brexit vote: while recognising that most of the financial institutions that can help kick-start securitization are in the UK, France and Germany were reluctant to set a precedent on financial market access before Brexit negotiations had even started (*Financial Times* 2017a). The Brexit vote also revived a long-standing controversy over the supervision of London-based clearing houses that trade euro-denominated swaps. To address systemic risk concerns, proposals have been tabled for joint supervision of the London clearing houses by the ECB after Brexit (*Financial Times* 2017b, 2018).

The current state of play

The two-year countdown to Britain's departure from the EU started on 29 March 2017, when Prime Minister Theresa May triggered Article 50 of the EU Treaty,[1] but negotiations only started after the June 2017 general election. A 21-month transition period was agreed on 19 March 2018, during which EU law will still prevail, pushing the effective Brexit date back to December 2020. The transition agreement would avoid economic disruption if the two-year period provided for in Article 50 ends without agreement on a future relationship. However, the transition agreement will not be legally binding until and unless an overall Brexit deal is agreed and ratified, giving rise to regulatory uncertainty.

Prime Minister May initially signalled a “clean and hard Brexit” by announcing that Britain would not seek membership of the EU’s single market, but would renegotiate both its internal market and customs union agreements with the EU. Controlling immigration, terminating UK contributions to the EU budget and ending the jurisdiction of the European Court of Justice were the government’s key priorities. Exiting the EU single market would leave financial services (as well as automakers and aerospace industries) most vulnerable. It is presumably with these sectors in mind that May said she would like to preserve “elements of the single market”. Whether London can remain Europe’s financial hub will depend on its access to the EU market.

The UK’s approach to the Brexit negotiations softened after the general election held on 8 June 2017, in which the Conservative Party failed to hold on to its majority in Parliament, while the UK Independence Party (UKIP), the leading Brexit advocate, lost more seats than expected. This inconclusive outcome provided Britain the opportunity to step back from the ‘hard Brexit’ stance and to revisit the decisions to exit both the customs union and the single market. The least disruptive option for the UK would have been to seek membership in the European Economic Area (EEA), or negotiate a special deal like the Swiss agreement, which would preserve the parts of EU law and regulations relevant to the four freedoms underlying European unification (free movement of goods, services, labour, and capital),[2] which EU leaders consider inseparable. Access to the single market is thus inextricably linked to free movement of labour, which the UK considers incompatible with its objective of controlling immigration from Eastern Europe.[3] A business-friendly ‘softer Brexit’ scenario that would leave open the possibility of UK financial institutions maintaining their ‘passporting’ rights[4] after Brexit is thus not on the cards.

The EU has said it would give the City “appropriate” market access after Brexit through ‘equivalence’ — the system whereby the EU unilaterally grants or withdraws market access for non-EU countries, on terms dictated by member states. Firms under ‘equivalent’ regulatory standards would be able to trade freely across borders under their home rules and supervision. By contrast, ‘mutual recognition’, which the UK lobby groups originally supported, is a bilateral arrangement whereby the UK and the EU jointly decide the terms of access to the single market.

After the UK triggered Article 50, some UK-based financial firms, notably HSBC and Standard Chartered, announced a move of certain operations to Paris or Frankfurt. Faced with a loss of passporting rights, many UK-based insurers have also been looking for a new EU base. Lobby groups for the City of London have dropped plans to pursue passporting rights for financial services post-Brexit, instead shifting their focus to an ‘equivalence’ agreement with the EU. If equivalence is granted, the UK regulatory authority would need to remain in close collaboration with EU regulators to ensure that regulatory standards evolve in parallel over time. Equivalence rules also could apply to securitisation, insofar as non-EU financial companies could be allowed to package securitised loans compliant with the EU 'Simple and Transparent Securitisation' legislation, on the condition that their home country has strong regulation and supervision.

Euro-denominated derivatives

The issue of clearing euro-denominated derivatives came to a head soon after Article 50 was triggered. Traditionally, the UK has been the top global trading hub for interest rate derivatives. Three-quarters of euro-denominated OTC interest rate derivatives contracts are executed by clearing houses in the UK— a dominance that the ECB has challenged in the past, only to find its attempts to move the euro-clearing business to a euro area country blocked by the European Court of Justice. Proposals to move the multi-billion euro business to, say, Frankfurt, gained new impetus after the Brexit vote, with advocates arguing that euro-denominated derivatives should not be cleared outside the EU. But UK lobby groups have argued that keeping clearing in London is vitally important and should be one of the government's core aims of negotiations with the EU. Post-Brexit, UK-based firms will lose access to the euro settlement and clearing systems unless the UK agrees to surrender oversight to EU institutions. Existing EU rules give the ECB joint oversight of London-based clearing houses, but do not allow for supervision of clearing houses outside the EU.

The European Commission initially wanted the clearing of euro-denominated securities to move to the euro area, but subsequently backed down from such a move. It is now considering a proposal requiring clearing houses located outside the EU to meet tougher standards, including providing data sharing and allowing on-site inspections, similar to the standards imposed by US regulators on clearing houses located outside the US. Non-complying clearing houses could be forced to relocate their euro-clearing business to the EU or be barred from doing business there. However, it is unclear whether the UK would accept a degree of EU supervision after Brexit. From a systemic perspective, breaking up clearing houses would carry a cost: the more broad-based the membership of a clearing house in terms of markets, instruments and currencies covered, the more diversified the risks and the safer the financial system it covers. Pooling of risks requires service providers of significant size relative to the market.

The case for CMU among the remaining EU members

There is a strong case for the CMU project to continue with the remaining EU members (the 'EU27') after the UK leaves. Capital market financing represents a lower proportion of total financing in the EU27 than in the UK, and the need to develop capital markets is correspondingly greater. Moreover, Brexit makes pan-European capital markets supervision in the EU27 more urgent. A relocation of the European hub from London to the continent is most likely in the banking and retail insurance markets, though asset and fund managers might remain in the UK. ESMA Chair Steven Maijoor warned that UK firms would not be allowed to use 'letterbox' companies in Europe to preserve their market access. Last year ESMA set out principles for national regulators to observe regarding UK companies seeking to relocate, "to safeguard investor protection, the orderly functioning of financial markets and financial stability" (ESMA 2017).

A single EU supervisor is necessary to avoid the current regulatory fragmentation and ensure that the common rules – notably, the MiFID II provisions that took effect in January 2018 – are consistently applied across the EU. As the influx of businesses from the City of London to continental Europe continues, several EU countries are competing to attract business, prompting the Irish government to complain that a supervisory 'race to the bottom' is under way. European officials are concerned that the rules are being enforced unevenly and that local supervisors may be tempted to turn a blind eye in a bid to attract business from London. To address concerns about supervisory arbitrage, the European Commission has proposed giving ESMA an enhanced role in vetting the activities of fund managers and monitoring how local supervisors apply the rules, but this falls short of pan-European oversight powers (European Commission 2017). An effort to overhaul the European Market Infrastructure Regulation (EMIR) to centralize supervision of derivatives clearing houses also fall short of an integrated supervisory and resolution structure (Lannoo 2017).

While the Commission's proposals would help promote supervisory convergence, they do not go far enough in centralising supervisory power in ESMA. There is room to strengthen ESMA's direct supervision in areas like accounting rules and practices for listed companies, licensing procedures for EU passport rights, and supervision of all funds listed across borders. ESMA could also be responsible for the direct supervision of all EU-listed companies, or at least for entities that operate across national borders. A more centralised structure would reduce the regulatory and supervisory arbitrage that tends to shift activities to certain jurisdictions. As ESMA's Chair has pointed out, it is also essential to strengthen ESMA's sanctioning powers, including the level of fines it can levy in order for the authority to be seen by market participants as a credible supervisor.

Author's note: This column draws on a paper published by CIGI (Xafa 2017).