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#8BEBC
BREXIT AND EUROPEAN FINANCIAL MARKETS

2017 # EIGHTH BRUGES EUROPEAN BUSINESS CONFERENCE

CONFERENCE REPORT

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Brexit and European Financial Markets
Policy Developments and Business Prospects

College of Europe, Bruges

25 April 2017

The 8th Bruges European Business Conference, organised by the College of Europe and Deloitte, brought together high-level policy makers, business leaders and eminent academics to discuss developments in the European financial sector following the decision of the United Kingdom (UK) to withdraw from the European Union (EU).

The European financial sector is in a state of flux. The UK has formally notified the European Council of its intention to withdraw from the EU, creating uncertainties around market access, the evolution of EU financial regulation and possible policy fragmentation. The prospects of businesses across Europe will be affected by the forthcoming negotiations between the EU and the UK. London, one of the leading international centres for investment banking, currency exchange and expert financial services may lose its special position in Europe, as financial institutions, market operations and regulators move to other EU Member States.

In addition, the economy of the Eurozone is still languishing. The contraction of government spending and the apparent ineffectiveness of monetary policy have certainly not helped economic recovery. Growth is flat and unemployment too high.

Europe needs more investment to stimulate innovation and ultimately growth. Novel public measures have sought to incentivise private participation in large infrastructure projects backed by public guarantees. The recently established but as yet incomplete Banking Union is closely followed by the nascent Capital Markets Union.

These developments move in opposite directions. Deeper financial integration between some countries is counteracted by the prospect of disintegration and disengagement of financial institutions between other countries.

EU and national policy makers, investors, financial institutions and businesses in general are pondering the likely impact of these developments and considering their next steps. It is, therefore, appropriate to take stock of recent development in policy and corporate strategies in the European financial sector, and identify possible outcomes.

The 8th Bruges European Business Conference was centred around the concept of Brexit (the UK's withdrawal from the EU) and its ramifications on European financial markets. The conference began with a keynote speech reviewing Brexit and its implications on the financial sector. The main plenary session examined the challenges to European cooperation and integration and attempted to identify risks, suggesting possible ways to mitigate negative consequences. In the afternoon session, specific workshops were conducted to review the future of the global insurance and banking sectors in a European context. A final plenary session ended the conference, drawing conclusions from all panel discussions.

Keynote speech

Brexit and the financial sector

Speaker: Valdis Dombrovskis, Vice-President for the Euro, Social Dialogue, Financial Stability, Financial Services and Capital Markets Union (European Commission)

Chair: Prof Phedon Nicolaides, Jan Tinbergen Professor of European Economics (College of Europe)

Since 2010, the European economy has shown signs of recovery and after a long period of low productivity, future growth prospects seem positive. Real GDP in the Euro area has been growing for 15 consecutive quarters. Europe's banks are stronger and better capitalized. The next steps require further development, investment and structural reforms, together with responsible fiscal policy. It is important to stay on this present course. However, this positive outlook remains surrounded by uncertainty. Many Member States (MS) still have high levels of private and public debt. Furthermore, Europeans do not yet feel the economic recovery in their pockets. And now for the first time, a Member State is leaving the EU. This is a defining and challenging moment for the EU. During the Brexit negotiations, the EU will act as one to preserve the interest of its citizens. The EU's priority is to decrease the uncertainties of Brexit and mitigate its negative implications for European citizens, businesses, and the remaining MS. The remaining 27 MS are determined to stand together.

Minimisation of all Brexit-related uncertainties is especially pressing given the needs of the financial markets. To combat this, the EU aims to accelerate the completion of the Capital Markets Union (CMU), with additional financing for growth, acting in cooperation with international partners. The CMU will have deep implications for the regulatory and supervisory framework, which will need to adapt and develop to address the new challenges.

So far, the Commission already delivered 19 out of 37 points on the blueprint of the CMU action plan. The proposal for a common prospectus regime was agreed on last year, enabling easier, faster and cheaper credit issuance. A proposal for strengthening the EU's venture capital market has been discussed by the European Parliament (EP). A pan-European venture capital fund, which could facilitate access to capital for start-ups has been launched. A proposal for simpler and more transparent provisions on CMU is being discussed, as well as negotiations to unlock €100 million of additional capital. The MS needed to reach an agreement how to raise the capital but this was delayed in the EP. Amidst these proposals, Brexit raises the prospect of Europe's largest financial centre exiting the Single Market. This further emphasises the pressing nature of progress on the CMU.

The UK financial sector manages capital from EU markets and provides significant risk management services to the whole continent. Brexit has transformed financial market integration into an existential question for the EU. Only by working together can it be possible to strengthen the economy, by ensuring that the underlying issuers of debt are better capitalised and providing deeper liquidity guarantees. Only as a Single Market can sufficient scale be achieved for innovative finance to develop sustainably in the EU. Therefore, it is time to accelerate the completion of the CMU. The consultation on the CMU multi-review shows strong support for the CMU and the action plan. The focus of the CMU action plan is on removing remaining barriers, increasing investment, improving access to risk finance for SMEs and more effective and rewarding engagement with retail investors. In the second phase, the focus will be on efficiency and on sustainable (or "green") finance. Rules for pan-European private pensions will also be proposed and the rules on EU passporting of investment funds will be streamlined. Also, the need to deliver financing in long term projects (particularly infrastructure project) is addressed due to its significant importance.

The EU promotes a common approach to global financial governance. The underlying logic is that the free flow of capital is essential for the effective functioning, development and stability of the EU's financial system – in other words a functioning CMU. However, the financial system is international and global stability cannot be achieved by EU action alone. Deepening and strengthening the integration of European financial markets with other parts of the globe, such as the US and Asia are therefore crucial. International financial governance is negotiated together with global partners (such as the Basel Committee, G20, etc.) to establish a common agenda. International partnerships and cooperation are understandably necessary in order to maintain efficient and stable financial systems.

The EU has an open approach to recognizing and relying on effective regulatory frameworks of third countries (non-EU/EEA countries). The EU equivalence regime is regarded as one of the most advanced in the world, and is often used as a reference point for financial policy makers and businesses. Nevertheless, establishing an equivalence regime with a third country is not a simple or obvious process, since every sector and country is associated with specific risks. It is therefore necessary to review every equivalence case by its merit, considering also the principle of proportionality. Furthermore, equivalence regimes with third countries are not international agreements and they can thus be changed unilaterally (recognition of equivalence is a decision of a competent EU regulatory authority), and any regulatory transition period will still require continuous monitoring of compliance with EU standards. The European Supervisory Authorities (ESAs) will play a crucial role in this process.

Preparations for mitigating the effects of Brexit on the Single Market have been ongoing. Nonetheless, the risk of a race to the bottom is present. Different supervisory authorities within the Single Market must work together to safeguard financial stability and establish mutual trust. The EU's supervisory agencies have developed a single European rulebook for financial services, although further convergence is required to maintain financial stability. Europe's vision is clear: consistent supervision and common rules. In this context, the European Supervisory Authorities are working with consumers and investors, attempting to streamline their operations and promote more regulatory convergence. The ESAs have a major role also for future FinTech developments. The EU should grasp such development while addressing the risks, and indeed, the EU has launched a public consultation on this subject.

The UK's decision to leave the Union will profoundly influence financial markets but the EU will work to ensure the process proceeds in an orderly fashion. The EU stands ready for the challenges of Brexit, and will take forward steps for the completion of the CMU.

Q&A session:

The opening question explored the compatibility of the aforementioned case by case management of equivalence process with WTO standards. Equivalence aims to make sure that the regulatory frameworks of partner countries yield similar market consequences for firm behaviour as is foreseen in the EU framework. This process is well established and carried out on sector by sector and legislation by legislation bases. There is no obligation for the EU to grant equivalence. Assessment is carried out in greater depth for those countries who entail more systemic risks for Europe. Equivalence is a unilateral decision of competent European authorities, and there is no requirement for reciprocity or link to the World Trade Organization.

Turning to Brexit, debates are often framed in terms of a race to the bottom and supervisory convergence. MS have already publicly accused each other of lax regulations to attract business and investment. The prospect of a regulatory race to the bottom is damaging to all stakeholders. For this reason, supervisory convergence must be emphasised in the negotiations between the UK and the EU.

In this regard, it should be mentioned that the Commission and European Securities and Markets Authority (ESMA) put forward a proposal dealing with the securitization market, focusing on simple, transparent and standardised (STS) regulation of this market. The proposal is however delayed in the EP.

The CMU initiative, which was launched in 2014, could lose some of its momentum without London as a contingent part of the EU. However, Brexit could also provide a new opportunity for the EU to promote deeper financial integration. For this reason, the CMU action plan has become even more important and urgent than before.

It is evident that the current regulatory framework allowing for the clearing of Euro-denominated transactions in London must be re-assessed, as ever taking into account the principle of proportionality. The geographic requirements regulating Central Counterparties, clearing houses and derivatives market activities should be focused on market efficiency and risk reduction.

Some argue that the exit of London from the EU's financial market could actually make the UK even more attractive for global investment. This view highlights the need for a revision of the ESAs (which was already scheduled and simply coincides with Brexit). The implications of Brexit must be carefully considered in this revision process. For instance, the European Banking Authority is located in London, whilst other EU institutions must be located in the EU. This issue any many others will need to be addressed.

The pan-European "Financial Passport" allowing businesses and banks to operate in the Single Market will no longer be available for London based financial firms and institutions. This raises many concerns for business and consumers interested in purchasing or offering financial products and services, especially due to London and the UK's special role in global and European financial markets. This concern further stresses the importance and need for a convergence of different regulatory regimes.

It is also important to emphasise that the status of the UK will have to be decided consensually between the country and the remaining 27 member states. The UK will have to decide how close to the Union it wants to stay, considering the various international agreements the EU already maintains. The relationship of the EU with Norway for example is different than most post-Brexit regulatory framework models being discussed. The Norwegian model entails being a part of the EEA and paying financial contributions, an unlikely prospect in the case of Brexit. Nevertheless, whatever the UK and the EU will decide regarding their future relationship they will remain direct neighbours, and economic and political ties will naturally be maintained.

Main plenary session

The evolving financial services landscape in post-Brexit Europe: How financial institutions are adjusting and what it means for policy makers.

Financial markets operate on a global scale and move across regions in line with market conditions. However, cross-border integration of financial services has not fully recovered from the financial crisis. Is Brexit, along with the increasingly protectionist rhetoric in the USA, and rising tensions in Basel, a portent of increasing decentralization in financial services?

Discussants:
Jean-Paul Servais, President (Autorité des Services et Marchés Financiers)
Linette Field, Dpt. Director General (European Central Bank)
Aerdt Houben, Director (De Nederlandsche Bank)
Karel Lannoo, Chief Executive Officer (Centre for European Policy Studies)

Chair: Prof Christian de Boissieu, Professor of economics and banking (College of Europe)

The direct consequence of Brexit

Uncertainties regarding the effects of Brexit on financial markets have created shock waves at the EU and national levels and will have significant implications on economic growth, as well as on global financial developments. Brexit will have asymmetrical effects on relevant stakeholders. For example, countries with strong trade relations with the UK stand to be disproportionately affected by its exit from the EU.

The prospect of the UK's liberalised, market-oriented, transparent and open economy leaving the EU market is understandably to the detriment of the EU and the remaining MS. Market-oriented economies with advanced financial systems are regarded as more resilient in case of economic downturn (although an excessive focus on banking relative to the size of a country's GDP may have detrimental effects). In this sense, the exit of the UK economy from the EU could reduce the overall economic resilience of the European economy.

Therefore, once the UK is out of the internal market, the EU must maintain its solidarity and provide benefits and incentives to MS that seek a more integrated capital market. Nonetheless, a fundamental change might be needed to shift the focus of the EU to promote a more market-oriented approach rather than a "managed" (*"dirigiste"*) once.

The future collaboration between the UK and MS

The relationship between the UK and the EU should be as close as possible to avoid disruptions to the growing robustness of the European financial system. However, the form of the agreement between the EU and the UK is still unclear. Core issues that require attention are the need for an adequate regulatory equivalence regime and the future of the pan-European passport.

While Brexit is obviously a political game requiring creative financial arguments from all negotiating parties, it could also eventually lead to more collaboration between EU and UK authorities and institutions, as well as a beneficial revision of the EU's finance and banking directives with regards to their requirements concerning third countries.

A global regulatory framework is more important than ever to reduce the fragmentation of the financial system. This could be based upon the principles set in place by the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors.

It is also possible that the relocation and dispersion of London-based financial services towards Europe or other parts of the world will have positive repercussions, as it could decrease the systemic risk associated with concentration and agglomeration of massive financial activity in one territorial unit. This is a lesson from the financial crisis, during which countries with large financial sectors relative to their GDP suffered more than the ones with less important banking sectors.

Therefore, regulatory convergence and competition are prospective challenges that should be carefully managed, preferably at the European level by ESMA. In this way, ESMA would be responsible for avoiding a race to the bottom between supervisory and regulatory authorities with regards to the re-location of banks and financial institution to the continent. In certain ways, Brexit is a test to the abilities and unity of the common supervisory system.

In the current uncertain environment, the assumption is that the European passport will no longer be available for British based enterprises and institutions. Therefore, many banks operating from the UK will need to consider their operations in a post-Brexit era and the different ways to retain their access to European clients and European markets, mostly by expanding or creating new entities and subsidiaries. Depending on the structure of activities after re-location, their supervision might fall under the European Central Bank (ECB) and partly under a National Regulatory Authority (NRA). This is possible only under a common framework of transnational agreement, and a case by case approach until the system is fully established and operational. For this matter, the fact that the transition process should be conducted as smoothly as possible must once again be emphasised.

The reaction of Member States and the future of the European Banking Union

The route towards a stronger European capital market is neither clear nor simple. Given for example that most euro denominated derivative financing is conducted in London, a failure to provide effective regulatory equivalence between the EU and the UK may simply lead to growth in New York, which is already a global centre of derivative financing. This will result in a more fragmented and imbalanced global financial markets structure.

The absence of the third pillar of the banking union, the European Deposit Insurance Scheme (EDIS), partially explains the absence of a pan-European bank. The EDIS is blocked due to political debates between Germany and other MS. This has raised a debate over the levels of importance attributed to the three Pillars by various actors. The second Pillar (the Banking Resolution Framework) has not yet been used, and is regarded by some as being of limited importance in economic terms. Others have added that the lack of harmonized consumer protection rules is a major handicap for the banking union. For this reason, the ECB is working to create conditions for a stronger banking union and for the emergence of pan-European banks.

There is however a real risk of “Colbertism” and opportunism, given the disparity in market power amongst MS. As an example, Germany is performing competitively on the global market. Other MS have experienced greater difficulties, and may indeed take a different view on the role of transnational capitalism in their economy. They may also seek alternative social goals, meaning that a common EU approach inspired in the German image may not acceptable to stakeholders. Deeper financial integration in the EU could also mean for example that several

MS will have more power to resist public risk sharing, thus possibly leading to fragmentation and regional disparities of private and public risk sharing.

It is clear that Brexit is a real concern for the financial sector and a real "game changer" in global finance (a disruption that can perhaps be equated to the undergoing "FinTech" revolution). All stakeholders agree that a smooth transition would benefit the UK, the EU and the global financial system. The creation of a smooth transition period should allow all stakeholders to benefit from a post-Brexit agreement that will enable the efficient and free flow of capital between the EU, the UK and the rest of the world.

Workshop I
Challenges for Global Banking and Capital Markets

Discusants:
Slavka Eley, Head of Unit: Supervisory Convergence (European Banking Authority)
Alan Houmann, Managing Director (Citi)
Jean-Pierre Casey Head of Investment; Professor (Edmond de Rothschild (Europe); College of Europe)
Prof Barbara Casu Director (Cass Business School, Centre for Banking Research)

Chair: David Strachan, Partner (Deloitte)

The purpose of the workshop was to examine, analyse and debate the costs, risks and challenges associated with Brexit, particularly those related to global banking and capital markets. Three main topics were identified as important in this regard. The first associated risk concerned the fragmentation of global banking and financial markets. As mentioned, fragmentation of financial markets is a real concern for the EU. In a post-Brexit perspective, the main concern is how the forthcoming agreement will affect mutual market access between the UK and the EU. Second, is the interconnection between EU and UK markets, which represents a great challenge in face of Brexit. It is clear that the UK plays an important role in the EU's financial markets and ongoing reforms. Lastly, the uncertainty of the Brexit outcomes and the eventual implications for the financial sector need to be examined in the relevant political, institutional and supervisory context.

It is interesting to reflect on developments in the financial sector in the first year since the Brexit referendum outcome. From a general institutional point of view, Brexit was roundly unforeseen. However, most financial stakeholders did plan and prepare for such a contingency. The overnight depreciation of the Pound Sterling following the Brexit vote can be directly linked to the referendum outcome. However, financial markets showed considerable resilience to this external shock. In terms of bond spreads, there was no significant change in the UK spreads as most of the outstanding UK government bonds are held by domestic clients. In the days which followed the referendum outcome, financial systems were nevertheless under an enormous pressure to prepare for the future. The priority of stakeholders in the days that followed the referendum was developing different scenarios (from best to worse), contingency plans for what could happen next, and possible recourse. Having this in mind, the priority should be to dampen the tensions, uncertainties and ambiguity caused by the Brexit negotiations, reassuring businesses and consumers in the financial sector that the disruption to market activity will be minimised. This could be accomplished by providing for a transition period of two years. Whilst helpful, this leaves the longer-term outcome of the negotiations in considerable doubt.

Pan-European financial passports, having been a topic of wide discussion during the pre-referendum period, present one of the greatest challenges to any new regulatory system in light of the outcome. Under the current framework, financial companies could establish a branch in one MS of the EU and provide services to the whole EU internal market. In the most extreme form of "hard" Brexit, it is conceivable that all UK-based banks operating via branches could lose their passporting rights overnight. This is a serious threat to the operations of over 5,000 regulated bodies in the UK according to UK Financial Conduct Authority estimates, since it would prevent them from providing services in the EU (they would be considered a third country financial institutions). A more likely scenario involving some form of equivalence or mutual recognition could still mean that hundreds of financial institutions will need to be re-licensed in order to adjust to the new circumstances. The final consequences will depend on the ongoing negotiations and the agreements between EU and UK leaders.

The concept of equivalence can thus be considered as a tool which could be applied to mitigate some of the potential risk for the financial sector post-Brexit. However, the equivalence principle was originally designed to benefit EU market participants by providing access to goods and services based outside the EU, not necessarily the other way around. While mutual recognition seems like a viable solution, it is inevitable that it would require improved cooperation and understanding between MS authorities, the EU and the UK, and adjustments to the legislation of all parties. Developing, negotiating, agreeing and implementing a new equivalence regime between the UK and the EU would therefore be a very complex, difficult and time-consuming endeavour.

Is also important to reflect on the impact on the rest of the EU of a loss of access to London's state of the art financial expertise and services. For example, Brexit could also negatively affect financial innovation in Europe, considering London's historic role as a bridge to New York and Silicon Valley.

Recapping the issues reviewed in the workshop, the undeniable interdependence of the EU and the UK's financial markets will be a factor of great importance to consider during the Brexit negotiations. This again points to the benefits of an orderly and clear solution to allow mutual access between the EU and UK's financial markets. The real challenge will be the extremely brief period of time allotted for negotiation under Article 50. Much attention should be given in the negotiations to equivalence, as the way it is currently poorly understood and its potential is underdeveloped. A review is needed before it could be applied in the case of Brexit. A potential solution might then lie in the framework of mutual recognition. Nevertheless, this would take the EU and UK's regulators and policy makers into uncharted territories, and require a strong commitment to cooperation and mutual trust among all parties.

Workshop II
How to maintain a global insurance sector in the face of Brexit

Discussants:
Anna Maria D'Hulster, Secretary General and Managing Director (The Geneva Association)
Hugh Savill, Director of Regulation (Association of British Insurers)
Guy Soussan, Partner (Steptoe & Johnson LLP)

Chair: Jonathan Burdett, Partner (Deloitte)

The workshop examined several challenges the insurance sector is now facing in light of Brexit. It is helpful to frame Brexit in the broader context of cost pressure and fierce competition in the insurance sector. Further, income from investment activities is suffering from the low interest rate environment, thus the core profitability of the insurance business is threatened. Given that the sector as a whole has been growing by a mere 2-3% yearly since the financial crisis, Brexit brings new uncertainties that insurance companies will have to deal with. The historic response to these challenges has been pursuit of scale to achieve financial and operational efficiencies on a global scale.

Clearly, a major issue for British insurance firms is access to the EU's Single Market. Brexit is somewhat of an irony from the insurance market point of view. The UK was instrumental in setting up a liberalized single insurance market, and it is now on the brink of leaving it. Much like in the banking sector, passporting rights are a key part of the EU's insurance market - the ability to offer insurance services and products in different Member States on the basis of a single license issued in a home country based in the EU. This was achieved by developing and adhering to common prudential and supervisory rules.

The pan-European passporting rights which allow easy access to the EU's internal market for British based insurers will most likely be lost after Brexit. The concept of equivalence could theoretically make it possible for UK-based insurers to have some market access in terms of reinsurance, but this does not stretch to direct insurance under current rules. It will likely be impossible for UK-domiciled firms to provide insurance services in the EU without local presence. This presence or location requirement can however be satisfied in several ways, for example by a subsidiary with a legal personality that will be granted permission to sell insurance products and gain passporting rights within the EU. Many UK insurance firms have already set up subsidiaries in the EU to secure passporting rights for the future.

A distinction must be made between retail and commercial insurance. Retail insurance most commonly deals with local particularities and risks and markets are more domestic based. Commercial insurance is characterized by greater cross-border activity, with a relatively well-functioning single insurance market in the EU. Nevertheless, the ongoing fragmentation of the insurance sector incentivises a more local approach in some cases. Also, many countries such as the US are beginning to implement protectionist measures which may reduce the global scale and cross-border nature of insurance.

In such an environment, novel means of reaching new markets might be explored, such as digital insuring. Digitalization and a more intensive use of IT could potentially change the business model of insurers, allowing for higher efficiency and more flexible products, tailored to local customer needs. Nevertheless, the industry's focus on the local level could make it more difficult for market participants to benefit from economies of scale.

In the context of local or global reach of insurers, London has a key role as a global insurance hub. London is a centre mainly for commercial insurers, who have most of their interests outside of the EU as it will be after Brexit (in the US, Canada, Japan, China and the UK). Due to this reason Brexit would not necessarily mean that this hegemony will disappear. Also, the fact that it insurance is a cluster-focussed business makes it harder to disrupt, as insurers interact greatly between each other. It is necessary to consider that setting up a subsidiary in the EU does not mean closing the head office in UK, as many operations can still be performed by the London office. Nevertheless, it is clear that if post-Brexit conditions change to the detriment of the UK insurance sector, insurance companies will not hesitate to change their location.

Recapping the issues reviewed in the workshop, the insurance sector would benefit from a productive negotiating approach from both the EU and the UK, focused on long term goals instead of a short-sighted solution. The public criticism of European policies by British leaders might make a compromise harder to reach. Also, the process of revision and transposition of EU and UK legislation may lead to mistakes and new interpretations which legislators should try to avoid. Differences between retail and commercial insurance should be carefully addressed in the Brexit negotiations. The post-Brexit insurance sector "deal" should try to maintain as many regulatory bridges between the UK and the EU as possible. This will require promoting convergence of regulatory regimes, cooperation and some form of equivalence in the insurance sphere. Insurance firms will need to reflect on their business models and monitor their operations to minimize the risks and uncertainties associated with Brexit until the final outcome of the negotiations is reached.

Conclusions

Banking activity in Europe may be seriously disrupted due to initial adjustment and ongoing compliance costs of operating following Brexit. The high degrees of interdependence and complexity in the banking sectors of the EU and the UK mean that mutual market access would be in the best interest of all parties. The negotiations should attempt to maintain as many beneficial parts of the current legislative and regulatory framework as is feasible. However, the sheer lack of time and political uncertainty pose real challenges to a constructive conclusion of Brexit negotiations.

The impact of Brexit on the insurance sector is expected to be rather limited due to its local nature. Particularly in term of the retail side, the negative effects were regarded to modest. The reinsurance sector was seen to be less exposed to Brexit related risks due to its global scope. However, certain parts of the industry, such as motor insurance or life insurance, may be exposed to greater degree.

In term of the ongoing debates over equivalence, the current regulatory framework does not provide a lasting solution for a mutual access regime between the EU and the UK. In this regard enhancing mutual recognition based on global frameworks might provide a solution. It is a clear that such a solution would require strong trust and the willingness of stakeholders to explore new regulatory frameworks.