Brexit: Uncertainties and challenges in the financial sector

Paloma Marín Bona, Susana Moreno Sánchez and María García Lecuona (*)

(*) Paloma Marín Bona is Director of the International and European Relations Department of the Banco de España. Susana Moreno Sánchez and María García Lecuona are European affairs experts in the European Relations Division of the Department.

Abstract

The European Union's financial services map is changing as financial institutions relocate ahead of Brexit and financial centres become more dispersed. This transformation has been especially motivated by the uncertainty surrounding the withdrawal process and the possibility of a no-deal Brexit. Added to which there is the lack of definition of the framework for the future relationship.

There has been little discussion of financial services during the exit negotiation process. As no other solution for future relations with the United Kingdom has emerged, this article focuses on the third-country regimes and equivalence. These regulatory frameworks were not designed to address relations with a country that decides to leave the European Union and with which there is extensive cross-border activity. In addition, the possibility of financial services being largely provided by a third country raises concerns regarding appropriate supervision and potential financial stability risks.

In this setting it is more important than ever that the financial markets of the EU27 (exUK) become more deeply integrated. The capital markets union opens up a window of opportunity to curb the market fragmentation that may be prompted by Brexit and fill the role currently played by the UK markets. Brexit has also reopened the debate on the model for integrated European capital markets and the degree of ambition desired for the project.

1 Introduction

Today, the financial services markets of the European Union and the United Kingdom are highly interconnected, a reflection of more than three decades of internal market deepening.

The United Kingdom's financial services exports to the rest of the European Union amount to almost €31 billion, and its financial services imports from the other Member States to approximately €5 billion. The European Union is the United Kingdom's biggest export market for financial services, accounting for 43% of total net exports of these services. In turn, the United Kingdom makes up 24% of the European Union's financial sector, although the figures vary by

market segment[1] [see European Parliament (2017a), TheCityUK (2018) and PWC (2018) on Eurostat data].

This extensive cross-border activity has largely been pursued under EU passporting rights, with no need to establish a subsidiary to gain access to the respective markets. In 2016, the year of the Brexit referendum, 8,008 financial institutions in the European Economic Area (EEA)[2] were using 23,532 European passports to provide financial services in the United Kingdom, while 5,476 financial institutions established in the United Kingdom were using 336,421 European passports to gain access to the EEA [see European Parliament (2017a)].

Given the essentially regulated nature of the financial services industry, much of the current cross-border activity will not be able to continue after Brexit, or it will foreseeably be pursued in a more restricted, unstable and/or costly environment.

Numerous financial institutions have anticipated the consequences of the break-up, expanding structures already in place or setting up new legal entities that will grant them continued access to the respective markets. Thus, despite the costs that this entails, financial institutions are relocating operations, assets and staff. This is especially significant in the case of the United Kingdom, where many international groups have their European headquarters. By March 2019, when the United Kingdom was originally set to leave, 39% of the 222 largest financial services firms with significant operations in the United Kingdom had opted to relocate part of their business to the European Union. The assets transferred are estimated at almost £1 trillion, with some 7,000 employees affected [see EY (2019) and New Financial (2019)].

This incipient transformation of the European financial map is a direct consequence of the high level of uncertainty surrounding the Brexit process.[3]

---

1 The United Kingdom's share of EU financial markets is higher in asset management (41%) than in the banking sector (26%) or insurance (22%). In infrastructures it plays an essential role; thus, for example, the United Kingdom accounts for more than three-quarters of euro-denominated interest rate derivatives clearing activity in the European Union [see European Parliament (2017a) and PWC (2018) on Eurostat data].

2 The EEA comprises all EU Member States, plus Norway, Liechtenstein and Iceland which participate fully in the EU internal market. These three countries are, in turn, members of the European Free Trade Association (EFTA), together with Switzerland which does not belong to the EEA.

3 On 25 November 2018, the European Council endorsed the draft Withdrawal Agreement and approved the Political Declaration setting out the framework for the future relationship between the European Union and the United Kingdom. The Withdrawal Agreement had to be ratified by 30 March 2019, which was the original date set for the United Kingdom to leave the European Union according to the deadline envisaged in Article 50 of the Treaty on European Union (TEU). However, on 20 March 2019 the United Kingdom submitted a request for an extension of that deadline, provided for in Article 50(3) TEU, up to 30 June. That extension was approved by the European Council up to 12 April or 22 May 2019, according to when the House of Commons approved the Withdrawal Agreement. In view of the difficulties for the Withdrawal Agreement to be passed by the House of Commons, on 5 April 2019 the United Kingdom submitted a request for a further extension. On 11 April 2019 the European Council agreed to a further extension up to 31 October 2019.

More than three years since the Brexit referendum, it is still not certain when the present regulatory framework will cease to apply, either in the near term or in several years' time, nor whether the move towards a new framework – yet to be determined – will be abrupt or eased by a transition period.

Added to the political uncertainty is the fact that the negotiations have barely touched on financial services.

There are no specific provisions in the Withdrawal Agreement on the financial sector, for example to ensure the continuity of financial transactions or resolve unwanted situations arising as a result of Brexit. Accordingly, although the Withdrawal Agreement guarantees the status quo for a time-limited transition period,[4] at the end of that period there is a risk of disruption for the financial sector. This could be mitigated in some subsectors insofar as the European Union and the United Kingdom first recognise their respective equivalence (see section 3).

The Political Declaration setting out the framework for the future relationship between the European Union and the United Kingdom attached to the Withdrawal Agreement[5] provides no more than a glimpse of the outline of the possible future regime for access to the respective financial markets, which is expected to have the equivalence regimes at its core.

Accordingly, the specific framework for access and the definitive consequences of Brexit will not be known until there is an agreement on the future framework.

It seems unlikely, however, that such an agreement will be reached in the near future. The European Union has refused to enter into formal talks on the future relationship until after the Withdrawal Agreement has been ratified.[6] Moreover, owing to the scope and the political and economic implications of the framework for the future relationship, these negotiations are far more complex than has been the case for any other international agreement entered into so far by the European Union.[7] In this case national interests will be paramount, so perhaps

After negotiation of a revised text of the Withdrawal Agreement and, specifically, of the Protocol on Ireland and Northern Ireland, and of the Political Declaration setting out the framework for the future relationship between the European Union and the United Kingdom, on 29 October 2019 the European Council, in agreement with the United Kingdom, approved a further extension up to 31 January 2020.

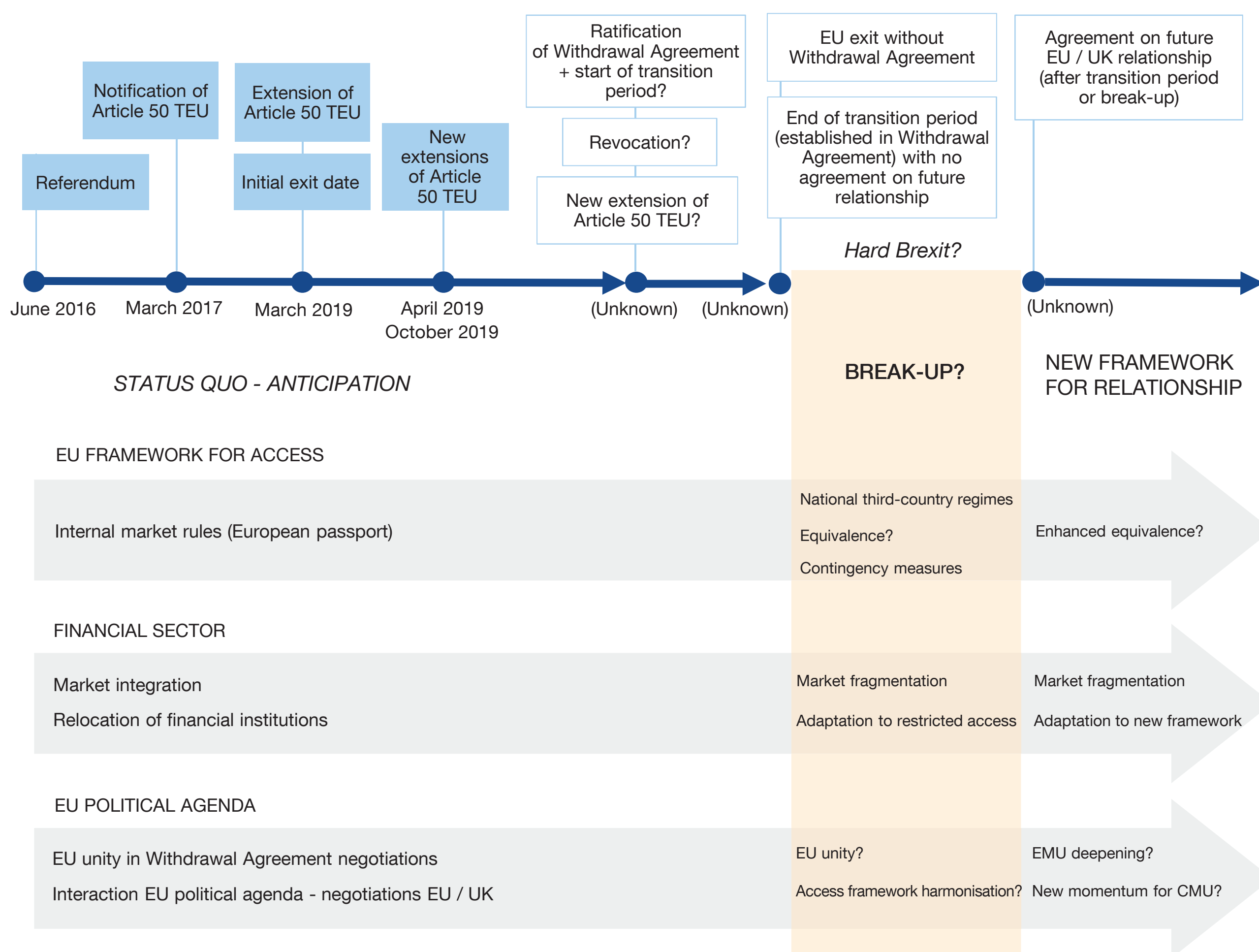
4 The Withdrawal Agreement provides for a transition period (initially up to 31 December 2020, although it may be extended by up to two years) during which the European Union will treat the United Kingdom as a Member State, but without the right to participate in EU institutions and governance structures.

5 See footnote 3.

6 See European Council conclusions of 13 December 2018.

7 The process for approval of the most ambitious trade agreement entered into to date – the Comprehensive Economic and Trade Agreement between the European Union and Canada (CETA) – ran for seven years from the start of the talks. This may serve to indicate the difficulties that defining the even more complex framework for the relationship between the European Union and the United Kingdom will involve.

Figure 1
BREXIT: UNCERTAINTIES AND CHALLENGES IN THE FINANCIAL SECTOR



SOURCE: Devised by authors.

we cannot expect the same level of unity between the Member States as has been observed to date. Considering also the need for a unanimous Council decision on international agreements of this kind, and the particularities of the different national ratification processes, it seems unlikely that the framework for the future relationship may come into force in the near future. In this respect, it would be desirable for financial services to be subject to a specific agreement not depending on progress in other areas. Paragraphs 118 and 119 of the Political Declaration (agreements outside the general agreement, with their own governance) appear to envisage this possibility.

We are faced, therefore, with a highly uncertain situation, characterised by prolongation of a more or less imperfect status quo, combined with a risk of

disruption until a new framework for the relationship between the European Union and the United Kingdom is in place.[8]

This prolonged uncertainty is not only transforming the financial map, but it is also reflected in the European Union's political agenda.

The influence of Brexit on some of the legislative initiatives is evident. This is the case, for instance, of moves to strengthen the supervision of central clearing counterparties (CCPs) or make changes to the prudential framework for investment firms, and of the Commission's proposal to involve the European Supervisory Authorities (ESAs) in the monitoring of equivalence decisions [see European Parliament (2019)].

This influence is also especially evident in the case of the capital markets union (CMU), a project which, as analysed below, should be revitalised to strengthen EU capital markets after Brexit.

2 Frameworks for access for third-country financial institutions

In the absence of an agreement, once the framework for access for third-country financial institutions is applied to British financial institutions, their access to EU financial markets will be much more limited, restricted and fragmented than at present under the European passport regime.

In order to gain access to EU financial markets, British financial institutions, as third-country institutions, will have to establish a subsidiary in a Member State (and operate throughout the European Union through that subsidiary under EU passporting rights) or obtain authorisation in each Member State in which they wish to provide services. In this case, they will have to check, on a case-by-case basis, if it is possible to provide a specific financial service in the Member State concerned, and on what conditions. As an alternative form of access, some EU regulations allow third-country financial institutions to provide certain financial services throughout the European Union on the basis of the authorisation granted by the competent authorities in their home country in cases where the regulatory and supervisory framework is recognised as equivalent by the Commission.

8 Unless the United Kingdom revokes its decision to withdraw from the European Union. The Court of Justice of the European Union (CJEU) has ruled that this is possible for as long as the withdrawal has not taken place [see Wightman and others (Case C-621/18)].

Table 1
FRAMEWORKS FOR ACCESS TO EU FINANCIAL MARKETS

Framework	Legal provisions	Financial institutions	Access		Authorisation
			Services	Territory	
Passport	EU	EU institutions	All (in principle)	EU	Home Member State
Equivalence	EU	Third-country institutions	Limited	EU (in principle)	Third country (+ equivalence decision)
National regimes	Member State (+ EU limitations)	Third-country institutions	Limited	Member State	Host Member State

SOURCE: Devised by authors.

2.1 National third-country regimes

The provision of financial services in the European Union by third-country institutions is essentially subject to national regimes and conditions. By and large these national regimes are not harmonised and nor are they subject in general to strict limitations at EU level.

Thus, for example, CRR II[9]/CRD V[10] allow Member States to authorise third-country branches in their respective countries but they make no mention of direct provision of services from third countries. In turn, MiFIR[11]/MiFID II[12] allow Member States to decide on the provision in their respective countries of investment services to professional clients and eligible counterparties by third-country institutions, for as long as the Commission does not adopt an equivalence decision. By contrast, under the Payment Services Directive, only Member States' institutions may provide payment services in the European Union.

9 Capital Requirements Regulation II. Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No. 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No. 648/2012.

10 Capital Requirements Directive V. Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures.

11 Markets in Financial Instruments Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No. 648/2012.

12 Markets in Financial Instruments Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

Within these limitations, national regimes are essentially heterogeneous and do not grant the freedom to provide services or the right of establishment in other EU Member States. Some Member States do not allow third-country institutions to provide certain financial services in their countries, or if they do, they require some form of physical presence, or place limits on the type of clients to whom the services may be provided, or establish other conditions. The scope of supervisory powers also varies; they may be focused on prudential supervision, or they may have other objectives such as, for example, investor protection. In consequence, the level of scrutiny over institutions varies considerably according to the Member State in which they provide their services.

2.2 Equivalence regimes

In cases where it is provided for in the applicable sectoral regulations at EU level and has been effectively recognised by the European Commission, equivalence grants third-country financial institutions more uniform, albeit limited, access to EU financial markets.

Equivalence is the process whereby the Commission assesses and determines that a third country's regulatory and supervisory framework is equivalent to that of the European Union. An equivalence decision enables EU competent authorities to recognise the third country's framework for the purposes of assessing compliance with certain EU regulatory or supervisory standards. Specifically, equivalence regimes prevent duplication of obligations and allow for a less burdensome prudential regime to be applied or for access to be granted to EU markets [see European Commission (2017a)].

There is no single equivalence framework for all financial services; rather, each sectoral legal act determines its respective scope, the criteria and conditions applicable and the process for granting of equivalence.

Equivalence permits only partial access to EU financial markets. Many core banking or financial services, such as deposit taking, lending or provision of investment services to retail customers are not covered by an equivalence-based regime for market access. In addition, some equivalence regimes allow Member States to apply exceptions and thus limit the possibility of financial services being provided in their countries.

Also, some equivalence frameworks include extra conditions for institutions or other market participants that effectively place constraints on access for third-country institutions. This is the case, for example, of the requirement for registration with or

Table 2
DIRECT ACCESS TO EU MARKETS UNDER EQUIVALENCE REGIMES

Sector	Direct access to EU markets under equivalence regimes	
	Professional	Retail
Banking (lending/deposit-taking)	No	No
Payment services	No	No
Investment services	Yes	No
Alternative investment funds	Yes	No
Undertakings for the collective investment in transferable securities (UCITS)	No	No
Regulated markets (MiFID)	Yes	
Market infrastructures (EMIR)	Yes	
Credit rating agencies	Yes	
Central securities depositories	Yes	
Trade repositories	Yes	
Financial benchmarks	Yes	

SOURCE: European Parliament (2019). “Third country equivalence in EU banking and financial regulation”, In depth analysis, March.

recognition by the ESMA (MiFID II, CSDR[13]) or of the imposition of certain substantive provisions (AIFMD[14]).

Accordingly, if British financial institutions become subject to equivalence regimes, even if combined with national access frameworks, it is difficult to envisage how the current level of UK-EU trade relations will be maintained [see Hohlmeier and Fahrholz (2018)].

The European Commission (DG FISMA) is responsible for assessing equivalence, with the technical support, where envisaged, of the ESAs (EBA, ESMA, EIOPA).[15] The assessment generally also includes dialogue with the competent authorities of the third country. The Commission has no set time period for this process, which generally runs for two to four years before the relevant administrative decision is taken.[16] Equivalence decisions may be granted for an indefinite or time-bound duration [see European Commission (2017a)].

13 Regulation on settlement and central securities depositories. Regulation (EU) No. 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No. 236/2012.

14 Alternative Investment Fund Managers Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No. 1060/2009 and (EU) No. 1095/2010.

15 European Banking Authority, European Securities and Markets Authority and European Insurance and Occupational Pensions Authority.

16 Equivalence decisions may take the form of a Commission Delegated Decision (thus granting some voice to the European Parliament) or a Commission Implementing Decision (involving the representatives of the Member States on the corresponding regulatory committee).

The decision whether or not to grant equivalence is ultimately at the discretion of the Commission, which is free to launch the process and to amend or revoke the equivalence granted. This offers market operators little certainty.

2.3 Implementing third-country regimes in the context of Brexit

Applying third-country regimes to British financial institutions poses varies difficulties and challenges for the European Union.

The European Union and the Member States have already had to address the disruptive effects of a possible no-deal Brexit with no transition period to allow institutions and other market players to adapt to the new situation.

The European Commission has adopted a limited number of contingency measures to mitigate significant disruptions in strictly defined areas where public measures at the European level were considered necessary. In the financial field, the Commission has only deemed it necessary to adopt measures to address financial stability risks relating mainly to the derivatives markets.[17]

Individual Member States have taken a relatively disparate approach, guided solely by a series of general principles set out by the European Commission in successive Communications on Brexit preparedness [see European Commission (2018a), (2018b), (2018c), (2019a), (2019b) and (2019c)].

Not all the Member States have adopted contingency measures for the financial sector. Some have introduced temporary authorisation regimes that will allow British financial institutions to continue to provide mainly investment services in their countries (Italy, Austria, Sweden, Finland, Denmark and Ireland), while others have concentrated on ensuring the continuity of financial services contracts entered into before Brexit. This was the aim of Royal Decree-Law (RDL) 5/2019 of 1 March 2019[18] approved by the Spanish government, which grants British financial institutions a period of nine months from the date of withdrawal to terminate or transfer pre-existing contracts or to request authorisation in Spain to operate as a Spanish or third-country institution.[19] These measures are similar to the contingency measures

17 Specifically, the Commission has adopted two temporary and conditional equivalence decisions, one on CCPs and the other on CSDs, and has drawn up two Delegated Regulations to facilitate the novation of certain derivatives contracts not traded on regulated markets.

18 Royal Decree-Law (RDL) 5/2019 of 1 March 2019 on contingency measures ahead of the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union without the agreement envisaged in Article 50 TEU.

19 The RDL seeks to ensure legal certainty and to safeguard financial stability and the interests of financial services customers. It states that pre-existing contracts will remain valid and with full effect after the United Kingdom's withdrawal, even though British financial institutions will have lost their EU passporting rights [Article 19(1)]. It also sets out the cases where, without prejudice to the above, new authorisation will be

adopted in Germany, which grant British financial institutions a period of 21 months to continue to provide financial services, on the condition that such services are closely related to a pre-existing contract.

With these measures, both the European Union and the Member States have sought to establish a balance between ensuring legal certainty and protecting financial stability, on the one hand, and safeguarding the European Union's negotiating position, on the other. This explains why the main responsibility for making the necessary preparations has been left in the hands of economic operators. It also explains the limited scope of the public measures taken.

Apart from the contingency measures, at a second stage the European Union will also have to address the effects of the widespread use of third-country national regimes by UK financial institutions.

The large-scale provision of certain financial services from outside the European Union raises, in particular, financial stability concerns.

The power to supervise the provision of financial services through branch offices or directly from a third country lies not with the European Central Bank (ECB) but with the national authorities. This could circumvent the ECB's supervisory expectations, designed to ensure, in the context of relocation, that all risks are managed at the local level.[20] National authorities, for their part, lack a complete picture of the activities pursued by third-country institutions in the European Union, and also the capacity or power to respond to aggregate risk in the euro area [see Lautenschläger (2019)]. In this setting, a subsidiary-based market access model that would fully ensure risk management from within the European Union might be appropriate.[21]

Lastly, regulatory fragmentation becomes particularly important when a significant portion of EU financial services is provided from outside the Union. In this respect, Brexit should prompt reflection on the advisability of some harmonisation of the

---

required to manage pre-existing contracts and thus ensure their continuity [Article 19(2)]. Moreover, for cases in which new authorisation is required to manage pre-existing contracts, the RDL provides that the authorisation initially granted by the competent British authority will provisionally remain in force for a period of nine months from the date of entry into force of the RDL, to allow institutions to terminate or transfer the contracts or to request authorisation in Spain to operate as a Spanish or third-country institution [Article 19(3)] [see Banco de España (2019)].

20 The ECB has indicated that it will not accept "empty shells" in the banking union and that it will limit practices such as conferring dual responsibilities on managers or providing services to customers in the banking union through branches of banking union institutions in the United Kingdom.

21 The requirement included in CRD V that activities pursued in the European Union by large third-country banking groups be consolidated under EU intermediate parent undertakings (IPUs) is along these lines. This amendment has been welcomed by the ECB, which had however suggested that not only subsidiaries but also branches be included in the IPUs.

national frameworks for market access by third-country institutions, to limit regulatory arbitrage and guarantee the level playing field in the European Union.

3 Framework for the future relationship: enhanced equivalence?

According to the Political Declaration setting out the framework for the future relationship, after Brexit the provision of financial services will be governed by equivalence.

The wording of the Political Declaration envisages a relationship based on autonomous equivalence frameworks that, in short, preserve the respective regulatory and decision-making autonomy of the United Kingdom and the European Union in a setting of close cooperation on regulatory and supervisory matters. On this basis, both parties undertake to keep their equivalence frameworks under review and to cooperate in the process of granting and withdrawal of equivalence decisions that affect them (in a transparent manner and by means of consultation), and in regulatory and other issues of mutual interest (by means of information exchange and consultation).

The European Union and the United Kingdom also undertake to start assessing equivalence with respect to each other as soon as possible after the United Kingdom's withdrawal, endeavouring to conclude these assessments by the end of June 2020. Recognition of equivalence in areas where this is possible would facilitate the transition towards a new framework for the relationship.

The Declaration entails that, in the future, both parties will be free to maintain, extend or limit the activities that may be pursued under an equivalence regime, and ultimately to determine the level of access they wish to grant to third-country institutions. In this respect, there is no specific agreement between the United Kingdom and the European Union that seeks to allow broader access to their respective markets than that envisaged in the current frameworks. In addition, the Political Declaration implies that, in principle, the United Kingdom and the European Union will not grant each other special treatment in terms of access compared with the treatment they generally grant to third countries.

Nevertheless the outlines of the Political Declaration are flexible, so the future framework for relationships may to some extent go beyond the current undertakings. Thus, the United Kingdom and the European Union could eventually agree on a structured cooperation framework that would provide for a high level of financial market integration. In this respect, the undertaking included in the Political Declaration to keep their present equivalence frameworks under review could, in practice, permit consensual or parallel measures between the two parties.

In the end, the level of cooperation achieved will largely depend on the will of both parties to maintain the greatest possible level of access to their respective markets, although this will, in any event, be necessarily far removed from the benefits stemming from participation in the internal market.

Initially the United Kingdom had advocated a system of mutual recognition which, in short, would grant both British and European financial institutions broad and privileged access to their respective markets. More recently, it proposed an enhanced equivalence regime which, among other aspects, would cover a broader range of activities and provide for the implementation of common principles and formal cooperation mechanisms.[22]

Ultimately, from the EU standpoint, the limits lie in the need to preserve the integrity of the internal market. This, in short, is contrary to granting full access to EU markets to third-country financial institutions.

In any event a reflection on the equivalence regimes seems appropriate, in this new environment in which the United Kingdom – to date the European Union's main provider of financial services – will no longer be part of the Union.

Improvements are clearly needed in the process of adoption and withdrawal of equivalence decisions. Some of these improvements are not necessarily linked to Brexit [see European Commission (2017a)],[23] but others are particularly significant in this context. Specifically, insofar as this does not compromise financial stability, extending the scope of the equivalence regimes to new services could be considered. This would make for more uniform access to EU financial markets. Moreover, in a setting in which a significant portion of the demand for financial services is met from outside the Union, ensuring a level playing field for open and fair competition becomes especially important. To this end, equivalence should ensure that third countries' regulations on State aid, competition policy, taxation, environmental issues, labour protection and money laundering are taken sufficiently into account.

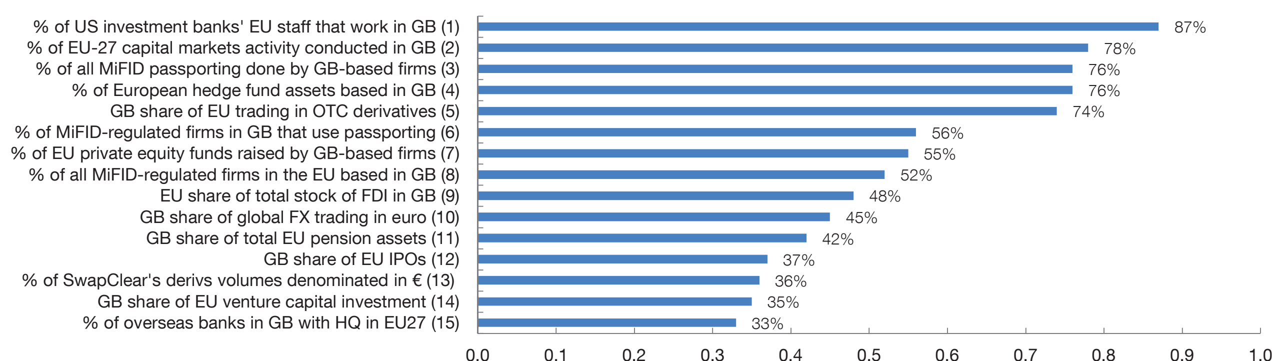
4 The future of EU financial markets - CMU

The United Kingdom's withdrawal from the European Union also prompts reflection on the model of financial market integration in the EU-27. There is no question of the influence the United Kingdom has had to date on the governance and functioning of

22 White paper on "The future relationship between the United Kingdom and the European Union".

23 For example, strengthening the role of the supervisory authorities, setting in place mechanisms to monitor ongoing compliance with the relevant regulatory and supervisory standards, or enhancing cooperation with third-country competent authorities.

Chart 1
INTERCONNECTION BETWEEN EU AND GB CAPITAL MARKETS (a)



SOURCES: (1) Bruegel; (2) Oliver Wyman; (3) EBA; (4) AIMA; (5) BIS; (6) Invest Europe; (7) EBA; (8) ONS; (9) BIS; (10) New Financial; (11) New Financial; (12) New Financial; (13) SwapClear; (14) New Financial; (15) Bank of England.

a Chart based on New Financial chart [see New Financial (2016)].

the financial markets. In the present setting, the CMU project becomes more important and delivery needs to be stepped up.

4.1 The CMU-27 project

The CMU is an EU initiative that was launched in 2015, aimed at deepening and integrating EU capital markets. The CMU Action Plan comprises a package of measures to be implemented between 2015 and 2019 [see European Commission (2015)].

Since the start there have been two contrasting views of the CMU model. The first holds that progress has to be gradual, avoiding politically sensitive issues in the short term and eschewing institutional change. From this viewpoint, there would be no need for competencies to be transferred to a single European supervisor, with coordination between national supervisors being upheld as the most practical option. The opposing view holds that deep reforms are needed from the start and should necessarily include some institutional change [see Ständer (2016)].

The outcome of the Brexit referendum had a major impact on the CMU project. The United Kingdom had been one of the main drivers of the CMU and had played a key role in the technical and ideological design of the programme. Jonathan Hill, the British Commissioner in charge of the initiative, resigned following the Leave vote and was replaced by Valdis Dombrovskis. Lord Hill shared the United Kingdom's position advocating gradual progress and opposing institutional change; with the arrival of the new Commissioner the priorities changed [see Quaglia (2017)] and

issues such as harmonisation of the insolvency frameworks, taxation and institutional matters gained protagonism [see Juncker (2016)].

Almost four years since the launch of the CMU progress has been made. This is reflected in how EU capital markets have evolved. For example, shares issued by non-financial corporations have risen as a proportion of EU GDP from 36% in 2014 to 41% in 2018, and debt securities from 8% to 10%. Moreover, the international distribution of investment funds with an EU label has also increased continuously [see European Commission (2019a)].

Yet from the very beginning progress has been slower than might have been expected and the project is far from complete. The European business sector is still highly reliant on bank finance and capital flows remain fragmented by country [see Hernández de Cos (2018)]. A new industry study reveals that recent headway has been limited. Despite the launch of initiatives in the framework of the CMU, in 2018 the ecosystem of the EU capital markets deteriorated and market integration improved only slightly [see AFME (2019)].

Clearly the Brexit vote has had an impact on the pace of capital market integration in the European Union. Since the referendum, European institutions have shifted their attention to the question of how to manage the future relationship with the United Kingdom. This has led to postponement of the approval of some components of the CMU initiative, awaiting the outcome of the negotiations[24] [see Wright, Benson and Hamre (2019)].

4.2 Relaunching the CMU after Brexit

The UK capital market is the largest in the European Union and has been a benefit to the Union overall. Free market participation currently means that the EU27's real economy can access a much higher volume and range of financial resources than are accessible in the EU27 itself.[25] After Brexit, this access to British capital markets could be lost. Figure 4 shows a selection of measures that reflect the high level of interdependence between the United Kingdom and the European Union.

24 This is the case, for instance, of Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation which was delayed significantly in its passage through parliament owing to its possible influence on the negotiations on the Withdrawal Agreement and the framework for the future relationship [see Brunsden and Hale (2017)].

25 On average, the depth of British capital markets relative to GDP is double that of the other EU markets. The depth of the EU27 bond markets is three quarters that of the UK market and that of the equity markets is approximately half that of the UK market [see Wright and Asimakopoulos (2018)].

Moreover, developed capital markets contribute to financial stability, as they weaken the sovereign-bank link and permit cross-border risk distribution. The recent crisis showed how underdeveloped capital markets, combined with a high level of reliance on bank finance, can multiply the negative effects of downturns. In addition, developing private risk-sharing channels can reduce the need to resort to public risk-sharing mechanisms such as fiscal transfers [see Cimadomo et al. (2018)]. Given the difficulties that are thwarting progress towards fiscal union in the euro area, the development of an alternative channel through which adverse shocks may be addressed becomes particularly important.

London is a leading global financial centre for which the EU27 has no clear substitute. In consequence, the business moving out of London since the referendum is not all heading to a single destination. This dispersion is resulting in greater fragmentation of the European financial market.

Against this backdrop it is essential that greater efforts be made to complete the CMU and to fill the role currently played by the British markets. The Commission has repeatedly stressed that the United Kingdom's withdrawal means that delivery of the CMU needs to be stepped up and requires that the work programme be modified [see European Commission (2017b), (2018d), (2019d) and (2019e)].

4.3 CMU model ex-UK

We are now at a key stage of the CMU project. The period for completing the measures envisaged in the 2015 Action Plan ends this year and the future direction the initiative should take must be considered.

It is a question not only of speeding up the pace of progress but also of restarting the project in more ambitious terms. A large portion of European capital market activity is currently supervised by a single body – the United Kingdom's Prudential Regulation Authority – since the bulk of this activity is concentrated in the United Kingdom. This business is now being moved to other parts of the EU27 without a sufficient degree of regulatory and supervisory harmonisation having been achieved [see Sapir et al. (2018)], with adverse consequences for regulatory and supervisory consistency.[26] This aspect is key to ensure that the EU capital market is attractive worldwide. It is vital, therefore, that progress be made in cooperation and coordination between national authorities and that the potential development of centralised supervisory

26 The recommendations suggested by the industry for the next phase of the CMU project include asking the European Union to continue to adopt incremental measures to improve supervisory practices and legal frameworks and achieve further convergence (especially as regards insolvency regimes and securities legislation). A further recommendation is that the European Union facilitate global regulatory convergence [see AFME (2019)].

arrangements for pan-European markets be considered. Possible institutional reform is clearly one of the issues that generates most controversy. An analysis of how the Single Supervisory Mechanism (SSM) has performed may be useful to assess the different options.

A genuine capital markets union will not be possible without headway being made on particularly sensitive political issues such as harmonisation of the insolvency frameworks, taxation or institutional reform. Here the approach must be ambitious, but it must also be realistic and pragmatic, to avoid political deadlock. The work of the Next CMU High-Level Group is a step forward in this respect.[27] The numerous measures proposed by the Group include moves to advance in these politically sensitive areas. Thus, for example, it advocates the harmonisation of insolvency regimes applicable to credit institutions, the implementation of a harmonised procedure for repayment of tax withholdings to investors, and the design of a supervisory framework for the different components of regulated capital markets according to their respective levels of integration [see The Next CMU High-Level Group (2019)].

In addition, practically coinciding with the publication of the conclusions of the above-mentioned Group, the European Commission has called for experts from different sectors to participate in a High-Level Forum on CMU. The Forum has been created to support the Commission in speeding up progress, preparing targeted recommendations.

These initiatives are welcome, but the question of which of the measures suggested are top priority will have to be addressed and those measures will have to be embodied in sufficiently ambitious specific legislative proposals.

It is also essential that capital market developments go hand in hand with advances in other initiatives. The CMU seeks not to replace but to complement bank finance. Accordingly, the project is closely connected and complementary to the banking union project, which is also still incomplete. So progress must continue, and especially in the development of a European Deposit Insurance Scheme (EDIS). Indeed progress is a priority in both initiatives, as they are both key elements for strengthening Economic and Monetary Union (EMU). The European Union's next institutional cycle will be essential to move forward in these two areas.

27 The Group, set up in May 2019 on a proposal from the German, French and Dutch finance ministers, is made up of experts from Germany, France, the Netherlands, Italy, Spain, Poland and Sweden with experience in the public and private sector and in academia. The conclusions were set out in a report published in October 2019.

5 Conclusions

The present third-country regimes and equivalence regime were not designed to handle relations with a country that decides to leave the European Union and with which there is extensive cross-border activity in financial services.

This prompts a reflection on the need for adjustments to be made, to achieve greater harmonisation of third-country regimes and enhanced equivalence. The limits lie in the need to preserve the integrity of the internal market, which is contrary to granting full access to EU markets to third-country financial institutions.

In a scenario of more fragmented financial services as a result of Brexit, the CMU opens up a window of opportunity to move towards greater integration of the EU27. Brexit should serve as an incentive to rethink the financial services model, and at the same time to fill the role currently being played by the British markets. Moreover, the CMU would appear to be the least controversial of the initiatives included in the package of reforms aimed at strengthening EMU.

Considering the uncertainty surrounding the future framework for financial services between the European Union and the United Kingdom, the CMU project should be a priority on the former’s political agenda and should be restarted on more ambitious terms.

REFERENCES

AFME (2019). *Capital Markets Union – Key Performance Indicators,* second edition.

Banco de España (2019). *Article 19 (Financial services) of Royal Decree-Law 5/2019 on contingency measures ahead of the withdrawal of the United Kingdom from the European Union without the agreement envisaged in Article 50 of the TEU.* Briefing note. April.

Brunsden, J., and T. Hale (2017). "Plan to boost EU securitisation market stalls over Brexit", *Financial Times.*

Cimadomo, J., S. Hauptmeier, A. A. Palazzo, and A. Popov (2018). "Risk sharing in the euro area", Issue 3/2018, *Economic Bulletin,* ECB.

De Guindos, L. (2018). *Promoting the stability and efficiency of EU financial markets beyond Brexit,* November.

European Commission (2015). *Communication from the Commission,* Action Plan on Building a Capital Markets Union (COM(2015) 468 final, 30.9.2015).

— (2016). *Communication from the Commission. Capital Markets Union - Accelerating Reform* (COM(2016) 601 final, 14.9.2016).

— (2017a). *EU equivalence decisions in financial services policy: an assessment,* Commission Staff Working Document. SWD(2017) 102 final.

— (2017b). *Communication from the Commission on the Mid-Term Review of the Capital Markets Union Action Plan* (COM(2017) 292 final, 8.6.2017).

— (2018a). *Communication from the Commission. Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019* (COM(2018) 556 final, 19.7.2018).

— (2018b). *Communication from the Commission. Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019: a Contingency Action Plan* (COM(2018) 880 final, 13.11.2018).

— (2018c). *Communication from the Commission. Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019: Implementing the Commission's Contingency Action Plan* (COM(2018) 890 final, 19.12.2018).

— (2018d). *Communication from the Commission. Completing the Capital Markets Union by 2019 — time to accelerate delivery* (COM(2018) 114 final, 8.3.2018).

— (2019a). *Communication from the Commission. Addressing the impact of a withdrawal of the United Kingdom from the Union without an agreement: the Union's coordinated approach* (COM(2019) 195 final, 10.4.2019).

— (2019b). *Communication from the Commission. State of play of preparations of contingency measures for the withdrawal of the United Kingdom from the European Union* (COM(2019) 276 final, 12.6.2019).

— (2019c). *Communication from the Commission. Finalising preparations for the withdrawal of the United Kingdom from the European Union on 1 November 2019* (COM(2019) 394 final, 4.9.2019).

— (2019d). *Communication from the Commission. Capital Markets Union: progress on building a single market for capital for a strong Economic and Monetary Union* (COM(2019) 136 final, 15.3.2019).

— (2019e). *Communication from the Commission to the European Parliament, the European Council, the Council and the European Central Bank. Deepening Europe's Economic Monetary Union: Taking stock four years after the Five Presidents' Report* (COM(2019) 279 final, 12.6.2019).

European Parliament (2017a). *Implications of Brexit on EU Financial Services,* Study for the ECON Committee.

— (2017b). *Understanding equivalence and the single passport in financial services. Third-country access to the single market,* Briefing, February.

— (2017c). *The UK's Potential Withdrawal from the EU and Single Market Access under EU Financial Services Legislation,* In depth analysis, January.

— (2019). *Third country equivalence in EU banking and financial regulation,* In depth analysis, March.

EY (2019). *EY Financial Services Brexit Tracker: Financial Services firms put contingency plans in action as asset and job relocation continues to increase,* March.

Hernández de Cos, P. (2018). “Monetary Union: the dangers of a work in progress”, *Euro Yearbook 2018,* Fundación de Estudios Financieros and Fundación ICO.

Hohlmeier, M., and C. Fahrholz (2018). “The Impact of Brexit on Financial Markets—Taking Stock”, *International Journal of Financial Studies,* 6(3), p. 65.

Juncker, J. C. (2016). *Complementary Mission Letter. Valdis Dombrovskis. Commissioner for Financial Stability, Financial Services and Capital Markets Union,* Letter dated 21 September 2016.

Lautenschläger, S. (2019). *A supervisory perspective on 2019 and beyond,* January.

Moghadam, R. (2017). “How a post-Brexit redesign can save the capital markets union”, *Financial Times.*

New Financial (2016). *Beyond Brexit: What next for European capital markets?*

— (2019). *The New Financial Brexitometer. Analysis of how the banking and finance industry has responded to Brexit – and who is moving what to where,* March.

Norton Rose Fulbright (2019). *Brexit: Doing business in the EU,* February.

PWC (2018). *Impact of loss of mutual market access in financial services across the EU27 and UK.*

Quaglia, L. (2017). “European Union Financial Regulation, Banking Union, Capital Markets Union and the UK”, *Diverging Capitalisms,* SPERI Paper No. 38, Palgrave Macmillan, pp. 99-123.

Sapir, A., N. Veron, and G. Wolff (2018). “Making a reality of Europe’s Capital Markets Union”, *Policy Contribution,* Bruegel.

Ständer, P. (2016). “What Will Happen with the Capital Markets Union After Brexit?”, *Jacques Delors Institut.*

Thecityuk (2018). “Key facts about the UK as an international financial centre”, October.

The Next CMU High-Level Group (2019). “Savings and Sustainable Investment Union”, October.

Wright, W. (2016). “Beyond Brexit: What next for European Capital Markets?”, *New Financial.*

Wright, W., and P. Asimakopoulos, P. (2018). “A decade of change in European capital markets”, *New Financial.*

Wright, W., C. Benson, and E. Hamre (2019). “Report: Brexit and the City – the impact so far”, *New Financial.*