5 December 2017

CAPITAL MARKETS UNION AND BREXIT

1 Introduction

- What are the prospects for Capital Markets Union (CMU)?
- How can the prospects for CMU be improved by strengthening the economic pillar of Economic and Monetary Union?
- How will the prospects for CMU be affected by Brexit, and what can be done about this?

2 EU Capital Markets Union

There are five main ways in which to make further progress towards CMU in the medium term:

- introducing 33 new measures, of which 20 had been introduced by the time of the Mid-Term Review;
- ensuring that existing measures are fit for purpose;
- achieving greater supervisory convergence across the EU;
- increasing financial stability in the EU by diversifying funding and sharing risks across national borders within the EU; and
- developing and integrating the EU financial market infrastructure.

3 CMU and euro area integration

The prospects for CMU would be improved by strengthening the economic pillar of Economic and Monetary Union in the euro area, through:

- closer economic convergence within the euro area;
- agreement on a path to fiscal integration, following elections this year;
- a settlement between the euro area and other EU countries.

In addition, there are two specific issues closely related to CMU to be resolved: the completion of Banking Union; and the search for a European safe asset.

4 Banking Union

- Banking Union and CMU are complementary parts of a Financial Union. More progress has been made on some steps to Banking Union than others:

- The Single Supervisory Mechanism should help to improve bank resilience through:
  - a fully consistent approach to bank supervision in the euro area;
  - reducing the interdependence between some banks and their governments;
  - reducing the overhang of non-performing loans.

- The Single Resolution Board is intended to ensure that failing banks are resolved without recourse to the taxpayer. But:
  - the Single Resolution Fund requires a credible fiscal backstop; and
  - the arrangements for bail-in have been put to the test this year in the Spanish and Italian cases.

- A European Deposit Insurance Scheme is needed in place of national schemes.

5 A European safe asset: option (i)

German Bunds are treated in the market as the "safest" national asset. There are two main options for a European safe asset to act as a euro benchmark:

Option (i): Joint and several guarantees on new issuance of government debt in the euro area:

- This would reduce the cost of funding for some, but might increase it for others.
- It could weaken financial discipline among less creditworthy euro area governments, though a central treasury might charge differential pricing.
- There would be political resistance (eg in Germany) to the provision of taxpayer guarantees.
- A change in the EU Treaty would also be required.

6 A European safe asset: option (ii)

Option (ii): Sovereign bond-backed securities (SBBS), with several but not joint guarantees:

- SBBS would be designed to promote risk sharing and reduce interdependence between banks and their own sovereigns.
- But there is a high correlation between most euro-area sovereign risks.
- The resilience of banks which buy SBBS would not increase unless the underlying sovereign assets are split into a senior (“safe”) and junior (“less safe”) tranche.
- Would SBBS be treated as securitised products or sovereign assets for regulatory purposes?
- Will the current regulatory treatment of sovereign exposures be changed?

7 CMU and Brexit

- Brexit makes CMU more important, as capital markets are less developed in many parts of the EU27 than in the UK.

- But the scope of CMU will be reduced as a result of the withdrawal of the UK.

- The costs for end-users may rise if capital market firms have to operate in two financial centres rather than one.

- CMU is designed to encourage capital market integration. The question is whether this is only of benefit to the EU27 *internally* within the EU, or whether open and competitive markets would benefit the EU27 *internationally* as well.

8 Background on Brexit: (i) the UK Government's approach

Following the UK Referendum on 23 June 2016, the UK Government said that:

- Its objectives were to control EU immigration to the UK and end the jurisdiction in the UK of the European Court of Justice.
- It therefore proposed to leave the Single Market and Customs Union when it left the EU, as remaining would have been inconsistent with its objectives.
- It also rejected joining the EEA, for the same reasons.

The UK Government triggered Article 50 on 29 March 2017, leaving two years for negotiations with the EU27, but in practice less than this, given the need for approvals.

9 Background on Brexit: (ii) the December European Council

Following the negotiations to date, the European Council on 14/15 December is scheduled to decide:

- whether or not sufficient progress has been made on a withdrawal agreement: ie the UK divorce bill, the Irish border and the rights of EU27 nationals in the UK and vice versa;

- if so, negotiations can begin on the framework of a future trade deal with the UK and on a transition period to take place after Brexit until a future trade deal is reached.

10 Background on Brexit: (iii) options for the UK

- The UK Government's preferred option is a withdrawal agreement with the EU27 which will win the support of the House of Commons by the Article 50 deadline of 29 March 2019. It is not yet clear whether this will be achieved.

- There is a risk that the UK could leave the EU without an agreement, either because agreement cannot be reached between the UK Government and the EU27 or because the agreement is not supported in the House of Commons.

- The Article 50 deadline of 29 March 2019 could be extended (though this would require unanimity among all EU28); or the UK might be able to leave the EU and join the EEA, if EEA members agreed (though the UK has ruled this out so far).

- It is even possible that the UK decides in the end to remain in the EU rather than leave if the UK Government's intentions change (though this would depend on whether Article 50 can be revoked; it would also be likely to require a second EU referendum in the UK, or at least another General Election).

11 Capital market preparations for Brexit: (i) time to prepare

- There are long lead-times for capital market firms in the UK and the EU27 in preparing for Brexit.

- To avoid the risk of a "cliff edge" on Brexit, agreement on a transition period needs to be reached by the UK and the EU27 as early as possible before Brexit to cover the period after Brexit until a free trade agreement is reached.

- Capital market firms will also want to be confident that they will need to make changes only once, and that they have a clear idea of the changes required.

- The UK Government has asked for an "implementation" – ie a transition – period of "around two years" on a "standstill" basis. But it is not clear whether, when and on what basis the EU27 will agree.

- CETA took seven years to agree, and does not fully cover financial services.

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12 Capital market preparations for Brexit: (ii) legal certainty

- It is important to avoid the risk of uncertainty about the continuity of cross-border financial contracts between market participants in the UK and the EU27, if passporting ends when Brexit takes place.

- The UK and EU27 authorities need to reassure the market by announcing as soon as possible that existing cross-border financial contracts outstanding when Brexit takes place will be "grandfathered".

- The Bank of England has proposed that the UK and the EU27 should make provision for the continuity of cross-border financial contracts (eg in the UK/EU27 withdrawal agreement).

13 Capital market operations after Brexit

There are two main options for capital market firms operating in the UK and the EU27:

- One is to rely on mutual recognition of each other's regulatory regime (ie regulatory equivalence). But this is currently a patchwork.

- The other is to be authorised, capitalised and staffed in both the UK and the EU27. This would increase costs for firms and could complicate the task for supervisors.

14 Location, supervision and systemic risk

- EU27 supervisors may decide to set conditions for providing authorisation.
- The question is whether – and to what extent – EU27 supervisors will insist on relocation of capital market activities and the market infrastructure (eg CCPs) from the UK to the EU27.
- The grounds for doing so would be that location within the EU27 is necessary to ensure financial stability.
- A possible alternative could be an agreed form of coordination between UK and EU27 supervisors.

15 Capital market regulation after Brexit

- When Brexit takes place, capital market regulation in the UK and EU27 will be the same.

- So there should be an opportunity for the UK and the EU27 to negotiate a free trade agreement.

- This could provide mutual recognition of each other's regulatory regime by filling in the gaps in the current regulatory patchwork.

- If so, regulatory provisions in the UK and the EU27 would need to continue to be comparable in future after Brexit. Provisions would also be needed for enforcement and for settling disputes.

- If, instead, UK regulation was to diverge from regulation in the EU27 after Brexit, that could have implications for the terms of UK access to the EU Single Market.

16 Conclusions

- There are several ways to make further progress towards CMU.

- The prospects for CMU would be improved by strengthening the economic pillar of Economic and Monetary Union.

- There are two specific issues closely related to CMU to be resolved: the completion of Banking Union; and the search for a European safe asset.

- CMU is designed to encourage capital market integration. The question is whether this would only be of benefit to the EU27 internally, or whether open and competitive markets would benefit the EU27 internationally as well.

- Brexit raises a number of risks for capital markets, relating to: the need for time to prepare; the need to avoid uncertainty about continuity of cross-border contracts; mutual recognition of – or deference to – each other's regulatory regime; location, supervision and systemic risk.

Note

This presentation is based on the Quarterly Assessment on *Capital Markets Union and Brexit* in the ICMA Quarterly Report for the Fourth Quarter 2017:

Capital Markets Union and Brexit October 2017

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