Part II Brexit, 5 Some Aspects of the Impact of Brexit in the Field of Financial Services

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(p. 81) 5 Some Aspects of the Impact of Brexit in the Field of Financial Services

I. Introduction

5.01 The impact of Brexit on different segments of economic, social, and personal life is likely to be very considerable. In this limited contribution, we intend to outline a few aspects that are of particular importance for financial services activity.

II. Access

5.02 A first issue relates to the conditions for EU banks and investment firms to obtain access to each others markets. Today, firms from both sides enjoy passporting rights: they are entitled to establish themselves throughout the Union without any additional authorization, remaining subject to their home regulation and supervision, the latter being largely harmonized. The same applies to most products or services: they can be offered in all Member States, sometimes with some minor additions.[1] After Brexit, free access will not be the rule anymore: UK firms, products, and services will be governed by the 'third country' regime, calling for authorizations or additional requirements.

5.03 Post-Brexit, access by financial institutions from the UK to the European markets is being discussed extensively. It is feared that institutions will have to relocate to the Continent and some seem to have already decided to do so. Ireland, Luxembourg, and Frankfurt are the most cited destinations.

5.04 To obtain access, several avenues are possible, the situation being different depending on whether the UK bank or investment firm owns a subsidiary on the Continent, has been active by way of a branch, or only offered services to European clients. Moreover, further differentiation has to be made by products: a UK firm may not be able to offer UK products on the Continent.

5.05 Location by way of a *subsidiary* allows the foreign group to take advantage of the European freedom of establishment of that subsidiary, as the latter is considered a separate legal entity based in the EU, irrespective of its shareholders. It will fully enjoy the Treaty freedoms and (p. 82) will be able to access all EU markets. The authorization of the subsidiary normally relates to a wide range of products or services and that should not change as far as products or services developed by the subsidiary are concerned. The subsidiary should normally have access to the central bank, and for the euro area banks, to the European Central Bank (ECB) liquidity, the local securities trading mechanism, the local financial mechanisms such as the interbank market, the clearing and settlement functions, deposit guarantee systems, etc.

5.06 Some banks may have been considering establishing a subsidiary as a mere front desk, with transactions being registered at the subsidiary but offset by back-to-back transactions with the UK head office. The ECB has made it clear that it would not take a favourable position on these large intragroup positions and would ensure that no prudential concerns are raised. The subsidiary should also be organized in terms of staff, infrastructure, etc. as a fully valid financial institution. But the ECB added that there would not be an outright rejection as the position and the nature of the transactions will be monitored, and that these will be a factor in recovery and resolution appreciation. The need for cooperation will be the more underlined.[2]

5.07 The subsidiary solution is quite simple. However, it comes with a cost in terms of relocation of staff, providing the funding adapted to EU operations, and building the subsidiary into a fully fledged institution. Banks are not very keen to block a considerable amount of capital in subsidiaries where its utilization would remain lower than on a group wide basis as on a solo basis, separate entities will need more capital than required on a consolidated basis. As to staff, there may be further considerations to be borne in mind, such as taxation, housing facilities, language barriers, education, etc. which will make this solution more difficult. Some places would be less attractive: those with a cap on remuneration would be objectionable to high earning staff.[3] At present, national supervisors can be seen to be competing to attract part of the activity emigrating from the UK—decidedly a newly discovered commercial activity.

5.08 Most UK banks own one or several subsidiaries on the Continent. Those who do not could still create one before the end of the two-year transition period according to the EU regime. They should not fear discretionary measures leading to a refusal of access. But the easiest way may be to buy an existing bank in one of the EU jurisdictions, in which case no new authorization would be required, although local supervisors will scrutinize whether the shareholder and the directors are 'fit and proper', and the bank will have to explain its future business plan.[4] This may be the case particularly with respect to capital requirements which would (p. 83) no longer be calculated on a consolidated basis, and hence would be calculated on a single entity basis.[5] For the larger entities, the ECB would be the supervisory body, assisted by the authority of the state where the bank is located. The authorization procedure will be commenced with the local supervisor, the ECB taking the final decision.[6] As to recovery and resolution, the bank located in the euro area would be subject to the Single Resolution and Recovery regime, and have to file its recovery plan with the Single Resolution Board. In both cases coordination with the parent supervisor will be needed.

5.09 The second approach is the establishment as *a branch*. As long as the UK remains a member of the EU, branches enjoy freedom of establishment: they can exercise all activities of the bank throughout the EU. They do not need an authorization for the branch, nor do they require endowment capital,[7] separate legal structure, separate own funds, separate boards, and accounting-wise could be integrated in the group. They remain subject to their home state supervisor which will coordinate with the host state supervisor.[8] Branches are more cost effective, flexible, and do not give rise to some of the handicaps mentioned with respect to subsidiaries. However, this regime is reserved to institutions originating from other EU Member States, and would therefore come to an end upon the UK leaving the Union.

5.10 After Brexit, branches of non-EU banks would lose their status and would have to be recognized as 'third country' branches. Their access to the EU markets would be governed by a nationally administered regime, which is largely based on a finding of equivalence between the national Member State regime and that of the third country. Also, their activity is restricted to the state where the branch is established.[9] Therefore, firms often prefer the subsidiary status.

5.11 Under the Capital Requirements Directive IV (CRD IV) branches of third country banks should be subject to rules which are analogous in all Member States, or which should not be more favourable.[10] Agreements should be concluded with the supervisors in these third countries. But their regime is a largely laid down in national legislation. Access to other EU Member States would be restricted.

5.12 The prudential banking regulation contains no general equivalence clauses for third country banks: these will in principle have to follow the locally applicable banking law provisions. There are no passport-like provisions even for wholesale banking. The Capital Requirements Regulation (CRR)/CRD IV only refer to equivalence notions relating to exposures by the (p. 84) third country institution with respect to several aspects of own funds requirements, under the condition that the third country supervisor follows prudential and supervisory requirements comparable or 'at least equivalent' to those applicable in the EU.[11]

5.13 The regime applicable to investment firms is comparable: subsidiaries will enjoy the full passport; branches will be limited to the Member States of location except for offering securities under the private placement regime.[12]

III. The Equivalence of Third Country Regulations or Standards

5.14 The concept of 'equivalence' has a long history in European financial regulation. Originally it was developed in banking regulation to allow a bank from another EU state to become active as a branch in a host state. A major step was undertaken in the 1989 Directive, laying down some core common principles (minimum capital, know your shareholders[13]), while eliminating the restrictions on the creation of branches (no authorization nor 'endowment capital') and introducing home state supervision.[14] Third country banks or branches were subject to close scrutiny.[15] From there on, and on the basis of the Treaty's freedom, the passport regime was developed which is still followed by today's CRD IV.[16] In the context of EU internal establishment of credit institutions and investment firms, equivalence does not play a direct role: it is assumed that the supervisory system of all EU states is equivalent, and hence no questions should be asked. If there are different realities, these should give rise to Commission action.[17]

5.15 For third country subsidiary banks, the regime is one of 'converse' equivalence: local law will apply and—once established—these banks are governed by local law and could avail themselves of all the benefits of freedom of establishment—creating branches and engaging in offering services in all Member States. The only caveat is that the Member States should not grant more favourable treatment to branches of third country institutions, making it clear that equivalence should be viewed and analysed from the European angle, and not in terms of equal treatment. The subject is partly relegated to international agreements with a view to 'granting identical treatment throughout the Union'[18] and allowing for supervision on a consolidated basis. Upon Brexit, this regime is unlikely to be changed for applications of third country banks.

(p. 85) **5.16** Equivalence has many forms, and often is formulated differently depending on the EU instruments where it is used.[19] Basically, an equivalence finding is the result of the comparison between the host regulatory system and that of the home state. Although in the early years, the Commission required 'line-by-line' equivalence, this approach has now been abandoned in favour of equivalence of 'outcomes', which is in fact the only workable approach.[20]

5.17 In the older legal instruments, the equivalence requirement is formulated in general terms and is applied by the supervisory authority in charge of specific subjects—such as the approval of the prospectus—to be appreciated by the supervisor in the host state. In the prospectus case, the equivalence refers to 'international standards'—including IOSCO disclosure standards—or to the 'requirements of the directive'.[21] In other cases, the reference is to the 'equivalent rule having the same regulatory purpose and offering the same level of protection'.[22] The field of action of the approving or disapproving authority is wide, but its direction is clearly defined in the regulation to be applied, and should be respected. In these cases, the equivalence appreciation is part of the supervisory process and no explicit decision on equivalence is needed.

5.18 In the more recent legal instruments, the subject of equivalence is split into two parts: the general decision to declare a specific foreign regime equivalent is based on a detailed and in-depth assessment of that legal system[23] based on an analysis in which the European Supervisory Authorities (ESAs) are heavily involved. Finally the conditions for equivalence are approved by the Commission, which lays down its conclusions in a formal decision, usually an implementing act in the sense of Article 292 TFEU, or in a decision applicable to an individual third country. The latter decision is open to judicial review.

5.19 The general equivalence decision analyses a number of criteria which are formulated in the enabling regulation. Among these, one usually finds elements such as the effectiveness of the regulatory or supervisory regime in the other state and its enforcement,[24] cooperation agreements, or the protection of investors, but in some cases, more detailed criteria are put forward, such as an explicit reference to compliance with money laundering rules or the OECD tax codes.[25] One can expect cyber security matters to be added to this list at least in (p. 86) fields such as Central Counterparties (CCPs) and Central Securities Depositories (CSDs) which are particularly exposed. This part of the equivalence process is eminently political as the EU evaluates the quality of a regulatory and supervisory system of another jurisdiction, in some cases coming across weaknesses or deficiencies. Equivalence can then be refused, or at least postponed, until a solution is found, even leading to a change if the regulation of the third country is found not to be equivalent. The process has sometimes led to considerable tension, and reflects political options sometimes outside the limited technical comparison of the two legal systems concerned.[26] Whether the equivalence process allows for political decisions or only for a technical assessment of the third country's legal provisions is controversial. The political nature of the Commission decision is expressed in the regulation by referring to the optional character of the Commission initiative, the regulation stating that the Commission 'may' undertake action. In other provisions, where it mentions that the Commission 'shall' take an equivalence initiative, this would indicate an obligation, but it is not clear whether this is always followed up. One of the strongest examples was the 2016 agreement between the Commission and the Commodity Futures Trading Commission (CFTC) about reciprocal access to the derivatives markets,[27] a very controversial subject that necessitated about three years of negotiation.

5.20 The individual decision by the national supervisor to recognize equivalence of a third country legal regime would then result in the application of the EU regulation as read against the background of the Commission's decision. In the specific case of the 2016 agreement with the US, the regulation mainly states that specific US rules will be considered equivalent under the conditions expressed in the regulation. No national supervisor may adopt a different position.

5.21 To what extent may equivalence decisions and their specific applications be challenged in court? Although their political nature has been mentioned, once the Commission goes down the route of a decision, this should meet the criteria laid down in the regulation enabling the Commission to act. Most of the time the criteria are so vague that any judicial action seems largely theoretical. General objectives like investor protection or financial stability may however constitute the basis for an action for judicial review.

5.22 Another aspect of the equivalence matter is its validity over time: after equivalence has initially been accepted or applied, how long will it remain valid and can it be withdrawn over time? In some regulations, a withdrawal of the decision is expressly provided for, for example when the provision is no longer used.[28] If the circumstances under which the initial equivalence was granted no longer apply, for example when the regulation in the (p. 87) third country has been changed, the equivalence decision will lapse. Normally this would be the result of a negotiation between the two jurisdictions involved, resulting in a formal decision of non-equivalence. But it could also intervene outside that hypothesis, when the objective of the EU regulation is not further pursued by the third country, for example as a consequence of a change in policy. In some decisions, equivalence is granted for a limited period of time, allowing the third country to adapt its regulation.

5.23 In a more developed equivalence regime most of these elements are made explicit: the equivalence is established by the supervisor in charge of the registration or delivering the authorization. The decision is adopted on the basis of a set of further criteria, provided in the regulation or to be established by the EU Commission in the context of a delegated regulation.[29]

5.24 The rules to be followed for equivalence depend on each individual regulation: in some fields, there is no equivalence regime. This is the case for UCITS, as only EU registered UCITS are admitted to the EU markets. Hence UK UCITS will have to be set up in the Union, in which case they can be marketed all over the EU. This does not mean that they could not be managed in the UK, as the management function can be delegated to an asset manager outside the EU to which equivalence requirements will apply.[30]

5.25 The equivalence debate may become one of the core elements of the post-Brexit era, as it will govern the establishment of UK firms and their offer of products and services in the EU. Upon Brexit, the situation will be quite paradoxical: the UK will be presumed to have been compliant with all EU regulations, but the day after it will lose this status having become a third country.

5.26 In order to clarify the position, it is useful to distinguish between formal, regulatory equivalence and substantive equivalence.

5.27 The latter flows from the pre-Brexit status of UK law: with respect to directives one can presume that these have been fully transposed, while in the case of regulations they will have been part of the applicable UK legal system before Brexit. Post Brexit, the UK law transposing the directive will remain applicable. But regulations, in particular here the equivalence regulation, will lose their legal force and decisions adopted on that basis, for example mutual recognition, will not further apply. Market institutions such as trading platforms, or CCPs[31] that have been authorized under the EU regulation would not further qualify for that status. As a consequence, a considerable gap would be created in the UK financial system.

(p. 88) **5.28** The UK government has announced that it will table a Great Repeal Act—later renamed the European Union (Withdrawal) Bill—allowing all pre-Brexit EU regulations to remain in place as UK legal instruments until further changes. This Act is indispensable for the continuity of the internal UK legal system, but does not modify the position with respect to the EU Member States. Although in substance nothing will have changed, the legal position will be significantly different.

5.29 The extent to which the existing equivalence decisions will be under threat deserves some further analysis. Equivalence decisions adopted by national supervisors based on their own judgment—including on equivalence with the foreign legal regime—will continue to stand as being based on the sole analysis by supervisors or the judge where applicable: here substantive equivalence will prevail. This would not be the case if the decision required a formal Commission equivalence decision to be taken into account. The number of domains in which no equivalence regulations have been adopted is probably quite high.[32]

5.30 Upon Brexit, equivalence will be lost for all fields where the EU equivalence requirement applied before: some will argue that nothing has changed in the substance of the applicable regulations. However, the legal position will be different as equivalence will flow not from EU membership but from the third country regime and the Commission equivalence decision. Moreover, the legal protection flowing from the CJEU's jurisdictions will no longer apply.

5.31 Starting from the assumption that UK regulation has conformed to EU requirements on the day before Brexit, the legal function of regulation from the EU point of view could be extended by the EU adopting a decision declaring that, as a provisional measure, the EU regulation(s) be declared equivalent and would continue to apply. A general equivalence decision of this type ensures continuity in the legal status of many aspects of the financial system where both the EU and the UK are involved. In order to avoid a standstill in regulatory developments, appropriate agreements should be made dealing with subsequent changes to regulation both on the EU and the UK side. In many cases this might result in the UK further applying the EU rules, until one of the parties modifies its regulation. Finally, the ECJ's jurisdiction should also be included or at least discussed with a view to establishing a binding legal interpretation in case of differences of opinion.

5.32 Usually, equivalence decisions address a specific jurisdiction, so the equivalence technique could be used as the basis for a post-Brexit individual equivalence decision.[33] The equivalence process is considered by the Commission to be a political one, which will be of considerable importance in Brexit discussions. However, the Commission's equivalence decision is based on the finding that the legal and supervisory regime of a third country is equivalent, e.g. for investor protection or financial stability purposes. In these cases the Commission power should be restricted to these objectives, and its assessment is subject to court review. In the case of the UK, once the Commission has adopted the decision to proceed to establish equivalence, the complex and time-consuming assessment procedure (p. 89) will usually not cause an additional delay, the UK regulations having remained substantially identical.

IV. Euro Derivatives Clearing

5.33 A point of controversy which has received a lot of attention relates to the euro-denominated clearing for derivatives.[34] The ECB, as the euro-area monetary authority, and representatives of several Member States have required clearing of these derivatives to be located in the euro area, although the market is now essentially concentrated in London. The discussion between the UK and the ECB has been going one for several years now, but Brexit is likely to put this matter in a different perspective.

5.34 A first spat took place in 2013 when the ECB published its 'Standards for the Use of Central Counterparties in Eurosystem Foreign Reserve Management Operations of the ECB'[35] which would have led to a location requirement for CCPs clearing in euros. The ECB argued that the measure was needed to allow it to maintain control of this important activity in euros, oversee its evolution, and more specifically the liquidity needs in case of emergency, especially as developments in this market are closely related to monetary policy and to the payment system.[36] The UK strongly objected to the ECB's Standards which would have had very negative consequences for the London-based derivatives market. By splitting the market in two parts, it would not further be possible to offset margins, leading to additional capital requirements and other costs. The matter was submitted to the ECJ. Obviously, parties reached an agreement as the pending cases were removed from the Court's register.[37]

5.35 Later on, the ECB and the Bank of England agreed on enhanced arrangements for information exchange regarding UK CCPs with euro-denominated activity. They agreed to facilitate the provision of liquidity support by both central banks to these CCPs and this both in the UK and in the euro area, by extending the existing swap facilities in several currencies.[38]

5.36 At present clearing of over-the-counter (OTC) derivatives—mainly interest rate swaps and credit default swaps—has been concentrated in London, where a daily nominal (p. 90) figure of EUR 930 billion derivatives is reported to be cleared.[39] LCH-Swapclaer and Intercontinental Exchange are the two main clearing institutions in the UK.

5.37 Upon Brexit, according to some EU institutions, euro-denominated clearing should no longer take place in London outside the jurisdiction of the EU but should be organized through an institution located in the euro area. The idea remains very controversial, firmly defended by some European leaders and institutions, equally strongly dismissed by the UK —and also the US—financial institutions.

5.38 From the European side several arguments have been advanced. European governments and the ECB have argued that the monetary authority should have full control of its core monetary infrastructure, the amounts involved being liable to create major systemic risks.

5.39 As derivatives clearing is based on EMIR,[40] after Brexit clearing could only take place on CCPs recognized by ESMA, and subject to an equivalent legal regime. In the absence of these, clearing would be based on an unstable legal foundation as the European regulation and the authority of the ECJ would not further apply.[41] The ECB has added that this very important financial activity should not take place in financial institutions over which it has no control and which are not subject to EU rules. In the future, it can be added that these intermediaries are not protected under the future infrastructure recovery and resolution scheme which is now under discussion in the Parliament.[42]

5.40 High principles such as the 'integrity of Union Law' or dangers to 'legal certainty and continuity' were mentioned in the European Parliament, while the application of UK contract law—mostly through the ISDA standard agreement—might also reduce the EU's control of the instruments so traded.

5.41 The UK position has understandably been to oppose any form of delocalization, pointing to the hurdles for EU banks to access liquid trading and clearing pools and the risks of fragmentation, leading to inefficiencies. The markets would be split in two parts, leading to additional capital requirements and other costs[43] and preventing the offset of margins. All users of derivatives will be confronted with higher costs. Euro denominated assets, for example government bonds, are traded in many markets and may face similar reactions. (p. 91) Arrangements which will secure flexible access are to be preferred. The spectre of emigration to New York is also raised. Negative reactions have already been registered from the American CFTC[44] and other American sources and have shown no support for the EU position. On the other hand, attention has been drawn to the fear of regulatory competition: UK regulation should stay as close as possible to EU rules.[45][46]

5.42 The Commission has taken an open stand stating that it remains committed to integrated financial markets and the need to avoid fragmentation. It considers that specific arrangements based on objective criteria could be developed to ensure that for CCPs that are systemic and 'would impact financial stability and monetary policy, safeguards should be provided: these would, when necessary include enhanced supervision at EU level and/or location requirements'.[47] The existing structures could remain in place provided the level of supervision and oversight gives the ECB sufficient guarantees also with respect to UK clearing houses.[48]

5.43 In June 2016, the Commission published a proposal that reflects this idea of enhanced supervision.[49] The proposal distinguishes two classes of CCPs: CCPs representing a low to medium risk profile, called Tier 1 CCPs, will remain under the previous regime, essentially based on the action of the national supervisors and coordination by ESMA; and tier 2 CCPs, which incorporate high intensity systemic risks. The classification will be made and regularly reviewed by ESMA. Tier 2 CCPS would be subject to a double regime of supervision, one in the state where they are located, on top of which EU-based supervision would be exercised by the EU supervisory body, newly organized within ESMA, verifying equivalence of the third country regime. It would exercise additional supervision on the third country CCP on the basis of the (p. 92) EU authorization, supervision, and enforcement powers. In addition to ESMA as a market supervisor, the role of the central banks of issue, that is the bank whose currency is involved, would also be strengthened, both as part of the supervisory structure of ESMA and in their own right, as central banks, exercising separate supervisory powers.[50] ESMA will ensure and monitor full and effective supervision in full compliance with the regulation's applicable provisions, including on the additional requirements as formulated by the Commission, and strive towards 'comparable' compliance by EU and third country CCPs. Changes to models and parameters for example have to be approved by ESMA. To what extent this dual layer of supervision will be acceptable to the home state supervisor is open for discussion, but it seems already to have been accepted for other third country supervisors, e.g. the US. More difficult are the objections stemming from systemic concerns and risk of contagion.

V. Brexit and the EBA

5.44 Brexit will render the relocation of the EBA inevitable.[51] Up to now, it seems that the issue has mainly been approached from the 'small' side, that is how and to where the Authority will be relocated. There seems to be little public discussion about what would be the optimal situation in terms of efficiency, and even less about what the overall structure of the three ESAs should be. It is therefore the right moment to launch a few ideas.

1. Relocation

5.45 Looking at the issue from the simple relocation angle, one must first define the core functions of the EBA and see where these can be exercised in the most efficient way. The Banking Authority is mainly active in the field of regulation of banking, offering valuable support to the Commission in its regulatory endeavours, while adopting its own non-regulatory but nevertheless authoritative standards; to be mentioned especially are the recommendations and guidelines, which are binding on national supervisors on a 'comply-or-explain' basis, but also the Q and A's, opinions, and other statements. The EBA has proved to be efficient and effective in this field.

5.46 It is essential that the different categories of normative instruments be adjusted to each other, which is not always the case today. The number and complexity has become very considerable and many researchers and even expert practitioners lose their way.[52] The EBA has made efforts to realize its 'Single Rulebook', an objective frequently mentioned in EU documents, but equally rare in practice. In addition, EBA exercises supporting functions in the supervisory process, in the context of the supervisory colleges or in undertaking and coordinating stress testing. Unlike ESMA, no direct supervisory powers, that is to address supervisory decisions directly to individual firms, have been assigned to the EBA.[53] Its (p. 93) activity has been concentrated in the regulatory field, in the direction of both the European legislator, and secondary regulation. The sheer number of instruments indicates that this has been productive.

5.47 This analysis should be the starting point of the relocation decision: the regulatory activity of the EBA is based on the one hand on the cooperation and coordination by the national banking supervisors, and on the other on the coordination with the other parts of the EU regulatory system, especially the acts of the Commission and Parliament. In terms of efficiency, proximity with these bodies would be an undeniable advantage. It would save considerable time and expenses, while allowing a more efficient, timely, and flexible exchange of views among the different agents of these complex regulatory processes, and allowing for earlier agreements. It might also contribute to making the entire system more transparent and user friendly. A location in each others neighbourhood would contribute to realize these objectives.

2. EBA and ECB

5.48 The present structure of the SSM is the product of history and of decisions taken in the midst of the crisis. The overall situation is somewhat odd: supervision of the banking sector is exercised for the most important banks by the ECB (nineteen out of twenty-seven Member States using the euro as their currency) but regulation is developed by the EBA, representing twenty-seven Member States and also involved in some aspects of supervision. The EBA has been conceived on the template of the previous committees which were essentially cooperation mechanisms between the national supervisors: hence the cooperative governance mechanism with its preponderance of the Board of Supervisors or the absence of voting rights for the chairman.[54] The ECB was later added to the Board of Supervisors as a non-voting member.

5.49 Strictly speaking, the ECB has no general regulatory authority, except within the limits of the application of the SSM regulation[55] and of national banking laws. If needed it can ask the EBA to take an initiative, including in the case where the subject matter has to be addressed by the European Commission.[56] Also, its position in the ESA structure is not clear: it does not take part in the Boards of Supervisors of EIOPA and ESMA, as if their decisions were of no importance to its supervisory action, while in the EBA it is present as a member, alongside the two other ESAs and the Commission. Over time this state of affairs is likely to evolve.

5.50 A possible scheme could consist of confirming the role of the EBA in the development of generally applicable regulations. This would include support to the Commission in the development of delegated regulation, of developing regulatory technical or implementing standards, and other generally applicable instruments or decisions for which a political backing—from Parliament and Council—is desirable. The preparation and coordination of international agreements—for example in the field of equivalence, or similar matters of coordinated action—should also belong to the EBA line. Its competences in the field of securing the application of EU law by the Member States,[57] and some coordinating action in emergency (p. 94) situations have strong characteristics of political decisions. Finally, one may consider the possibility of the EBA organizing a first instance administrative review of the national banking supervisors or of the ECB, making reviews more transparent and independent.

5.51 The position of the EBA in the field of supervision should be extended to the non-participating eight Member States. It is evident that this should not lead to their inclusion in the SSM, but may aim at developing information and non-binding coordination thereby enhancing the coordination of supervisory action and create a useful interface, especially with respect to those Member States where the banking system is essentially composed of banking groups which are included in the SSM regime. Support of the colleges of supervisors might also be included in this business line. Alternatives to the unsuccessful regime of the 'non-participating states' could usefully be tested.

5.52 By more clearly separating the supervisory from the regulatory line, one could achieve a scheme that is similar to the one being developed in the securities field and is also being considered for insurance.

5.53 The final question will then become: should banking supervision remain within the ECB, or be exercised by an independent European supervisor?

3. Reform of the three ESAs

5.54 Now that one of the three ESA pillars is coming up for change, a more fundamental reflection should be developed relating to the overall structure of this part of the regulatory framework.

5.55 According to their annual reports, the three ESAs dedicate most of their means to developing the regulatory system, including supporting the supervisory functions exercised by the national supervisors.[58] In the future, these regulatory tasks will likely continue to absorb most of their attention. However, as the regulatory system is progressively put in place, attention is likely to shift from regulation to supervision, as this is already the case for ESMA. Support of supervisory functions and outright supervision on specific issues are likely to occupy a more prominent place in the future. At present, the ESAs—ESMA excepted—are not well prepared for a shift from regulation to supervision.

5.56 This change will call for the identification of new topics which, due to their strong multistate character, will best be dealt with on an integrated basis: multistate securities transactions (issuance,[59] listings, takeover bids), integration of reporting requirement irrespective of transactions, offerings of investment funds all over the Union, more widely applicable mutual recognition, supervision of infrastructure, creation of a European derivatives market, supervision of CCPs, data reporting, and processing are a few examples. A recent Commission statement indicated that the supervision on CCPs is likely to be entrusted to ESMA.[60] CSDs and other market infrastructure may be the next in line.

(p. 95) **5.57** Pooling the three sectors of financial activity might avoid some of the drawbacks of the present fragmented approach: although pursuing the same general objectives, and notwithstanding the evident relationship between their respective fields, the three groups of supervisors each supervise financial activity from the angle of the regulation of which they are in charge. Often deficiencies, for example from the angle of investor protection, may be known to the banking supervisor, but remain unknown to the securities supervisor. CCPs are subject to securities regulation although they generate macro risks. Only with great efforts has a joint approach been reached in cases involving the offering of investment products affecting both the securities and the insurance field.[61] This status only changes when the breaches reach a level of higher risk: the phenomenon was very visible in the financial crisis where the risks in certain products—Collateralized Debt Obligations (CDOs), Credit Default Swaps (CDS) or other derivatives, but also Credit Rating Agency (CRAs)—led to considerable losses for investors but were not addressed except when the aggregate risk put the banks in danger, or threatened financial stability. The investors in some of these products—e.g. CDOs—had to fight for their individual protection. Coordination—or even stronger: integration—might have led to early recognition, and avoided macro and micro risks.

5.58 Centralization of supervisory tasks takes other forms than institutional centralization: it may be achieved by declaring one of the ESAs in charge of a certain field of supervision, but also by designating one of the national supervisors to deal with a subject concerning several jurisdictions. This is already the case for the public offering prospectuses, or for some aspects of take-over bids. In its strongest form, overcoming conflicting national competences would consist of putting an ESA in charge of supervision Europe wide, or even stronger, reforming the ESAs into one single European board of financial markets supervisors.

5.59 The April 2017 Commission consultation touches upon these issues: it invites the markets to comment on the arguments for or against a single supervisory regime, or a twin peaks approach, while mentioning that many participants in the markets consider changing the current structure to be premature.

5.60 Integration in this field means first and foremost centralized decision-making, overcoming national positions which are still prevalent not only where directives apply, but even in fields covered by regulations, where actual practice sometimes leads to different interpretations or practices, resulting in detrimental regulatory competition. It implies that the differences in the national regulatory regimes would gradually be eliminated. Integration would allow dealing with supervisory management in an efficient way: choosing integrated IT developments, for example for dealing with Big Data or cyber risk, which should not be developed by each ESA separately. Interconnecting the data from the different fields could allow effective cross-sectoral analysis based on common expertise. The same consideration applies to inspection teams, developing cross-sectoral methodologies on risk, on market evolutions, on governance. A very simple example: there is a clear need for having for example a common layout of the websites, allowing for easier searching of the numerous documents posted. There are considerable efficiency gains—but also cost savings—to (p. 96) be realized by developing a central support functions which at present are often dupli- or even triplicated.

5.61 The change to more centralized functioning would imply a considerable change in management style, staffing, instruments, and overall needs. It would probably imply relying more on own staff rather than on the coordinated efforts of the national authorities. New and different profiles will be needed: inspectors, investigators, data analysts, IT developers, financial research assistants will play a core role in the supervisory activity and could be acting for all sectors of financial activity. Reliance on national data and analysis will increasingly be replaced by integrated Europe-wide data bases and analysis, focusing on the interaction of the markets and on the financial system as a whole. Decision-making for a regulator is also quite different from that expected from a supervisor: here information, swiftness, knowledge of the markets, but also attention to the legal underpinning of decisions will become more important.

5.62 The Commission consultation document also mentions the centralization of the seat of the three ESAs which would allow the realization of the economies of scale mentioned. As the ESAs will continue to be deeply involved in regulatory matters, it would make sense to locate them in one place close to the other parts of the regulatory system, that is the Commission, Council, and Parliament. At present, not only is much time lost in travel, but the added benefits of proximity and direct contacts should not be underestimated. Centralization would also avoid cross-sectoral issues remaining hidden.

5.63 Centralization of the ESAs is of course very controversial and will be strongly opposed by the Member States which house one of the present ESAs. A reflection on the future structure should be launched.

5.64 In terms of governance, this could result in a two-tier structure whereby general policy guidelines are adopted by a common policy board, clearly identifying the common issues and arbitrating the items of divergence, or implementing regulatory or supervisory initiatives if significant gaps or distortions in the level playing field should appear. The actual implementing regulation would be entrusted to three technical committees reporting their products back to the policy board. The specificity of the regulation would be respected, while allowing for synergies in both regulation and supervision, and the avoidance of conflicts. It would also enhance expertise and contribute to costs savings. Better coordination and stronger convergence would be achieved, ultimately leading to 'better regulation'.

Footnotes:

[1] These are the ‘public good’ based additional requirements, imposed especially for investor protection and prudential reasons.

[2] See Sabine Lautenschläger, ‘Caution Should Be the Life of Banking’ ECB Speech (22 March 2017) <https://www.ecb.europa.eu/press/key/date/2017/html/sp170322.en.html> accessed 1 August 2017; also: introductory remarks: ‘Technical workshop for banks considering relocation in the context of Brexit’ (Frankfurt am Main, 4 May 2017) <https://www.bankingsupervision.europa.eu/banking/relocating/html/index.en.html> accessed 1 August 2017. Also: a similar position was published by ESMA, ‘ESMA Issues Principles on Supervisory Approach to Relocations from the UK’ ESMA71-99-469 (31 May 2017).

[3] Based on the 100 per cent bonus cap introduced by the CRD IV, Art 94(1)(g), some Member States have adopted stricter regulations, such as a 20 per cent cap in the Netherlands, a 50 per cent cap in Belgium, PwC Financial Services Regulatory Practice, ‘EU Bonus Cap: Restrictions Nearly Final for Asset Managers’ (March 2014) <http://pwc.to/1iLsRjq> accessed 1 August 2017. The UK Central Bank has announced that it will abandon the cap on remuneration.

[4] Dealing especially with the different types of risks mentioned in the CRD IV, the relevant internal ratings-based approach (IRB) models, and the internal governance structure.

[5] However, for the purposes of the Bank Recovery and Resolution Directive (BRRD) or the Single Resolution Mechanism (SRM), the consolidated position will have to be considered: see eg Art 45(8) BRRD; Art 12(6) Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (SRM Regulation).

[6] Article 14(3) Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (SSM Regulation). The ECB decision is rendered on a no-objection basis.

[7] See Art 17 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (CRD IV), referring to the previous practice ie to require a substitute capital.

[8] See Art 35 e.s. CRD IV.

[9] Unless the EU agrees differently with the third state: Art 47(3).

[10] See Preamble 23 and Art 47 CRD IV.

[11] See inter alia Art 107(3) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (CRR); see European Parliament, ‘Third-country Equivalence in EU Banking Legislation’ (12 July 2017) <http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/587369/IPOL_BRI(2016)587369_EN.pdf> accessed 1 August 2017.

[12] Article 46 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 (MiFIR).

[13] Article 3 First Council Directive 77/780/EEC of 12 December 1977 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institution.

[14] Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC.

[15] See also Art 3 Directive 77/780, mainly relating to own funds requirements and two-headed management.

[16] Article 35 and following.

[17] Article 258 TFEU.

[18] See Art 47 CRD IV.

[19] For an overview, see ISRG, 'The EU's Third Country Regimes and Alternatives to Passporting' (23 January 2017) <https://www.irsg.co.uk/assets/IRSG-Full-report-The-EUs-third-country-regimes-and-alternatives-to-passporting.pdf> accessed 1 August 2017.

[20] This is not mentioned in several regulations, eg Recital 41 MiFIR.

[21] See eg 20(1) Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to bepublished when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (Prospectus Directive). The directive will be replaced by Regulation 2017/1129, starting 21 July 2019.

[22] Article 37 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 (AIFMD).

[23] Not only formal laws of the home state of the branch, but also legally binding prudential and business conduct requirements may be taken into account: see Art 47 MiFIR.

[24] See eg Art 25(9). 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 (CSDR).

[25] See eg Art 35 AIFMD.

[26] See for an overview of the discussion points see Mark D. Young, Maureen A. Donley, and Patrick Brandt, 'Reconciling Regulatory Requirements in Cross-border Derivatives takes Center Stage' (January 2015) <https://www.skadden.com/insights/publications/2015/01/reconciling-regulatory-requirements-in-crossborder> accessed 1 August 2017.

[27] European Commission and the United States Commodity Futures Commission, 'Common approach for transatlantic CCPs' Press release (10 February 2016); 'European Commission Adopts Equivalence Decision for CCPs in USA' (Brussels, 15 March 2016) <http://europa.eu/rapid/press-release_IP-16-807_en.htm> accessed 1 August 2017; Commission Implementing Decision (EU) 2016/377 of 15 March 2016, on the equivalence of the regulatory framework of the United States of America for central counterparties that are authorised and supervised by the Commodity Futures Trading Commission to the requirements of Regulation (EU) No 648/2012 of the European Parliament and of the Council. This decision is based on Art 25(6) EMIR, allowing the Commission to adopt an equivalence decision ('may').

[28] Article 47(4) MiFIR.

29 Commission Staff Working Document, ‘EU Equivalence Decisions in Financial Services Policy: An Assessment’ SWD (2017) 102 final (27 February 2017) <https://ec.europa.eu/info/sites/info/files/eu-equivalence-decisions-assessment-27022017_en.pdf> accessed 1 August 2017.

30 Article 13 Directive 2009/65/EC of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). The ESMA Principles (n 2) should be observed. This issue has become hotly debated, as delegation may leadto ‘letter box’ entities and firms without consistence norresponsibility. The European Supervisory Authorities and the ECB have published their approach towards these developments.

31 See Arts 14 and 17(4) Regulation (EU) 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (EMIR): ‘The competent authority shall grant authorisation only where it is fully satisfied that the applicant CCP complies with all the requirements laid down in this Regulation and that the CCP is notified as a system pursuant to Directive 98/26/EC’.

32 See Commission Staff Working Document (n 29). For example in the field of prospectuses, the Commission does not list any implementing or delegated act dealing with third country equivalence, equivalence was based on the decision by the national supervisors see <https://ec.europa.eu/info/law/prospectus-directive-2003-71-ec/amending-and-supplementary-acts/implementing-and-delegated-acts_en> accessed 1 August 2017.

33 See the Commission Staff Working Document (n 29).

34 See for a clear, general overview: Brueghel, ‘Brexit and the UK’s Euro-denominated Market: The Role of Clearing Houses’ <http://bruegel.org/2016/06/brexit-and-the-uks-euro-denominated-market-the-role-of-clearing-houses/> accessed 1 August 2017.

35 See ECB, ‘Standards for the Use of Central Counterparties in Eurosystem Foreign Reserve Management Operations’ (November 2011) <https://www.ecb.europa.eu/pub/pdf/other/standards201111en.pdf?043b83a252124a5b9c839a8ad1c683e6> accessed 1 August 2017.

36 For an analysis, see Graham Bishop, ‘The UK and its Cases Against the European Central Bank’ (October 2014) <http://esharp.eu/debates/the-future-of-the-euro/the-uk-and-its-cases-against-the-european-central-bank> accessed 1 August 2017.

37 <http://www.bankofengland.co.uk/financialstability/Documents/securitisation/ecbboeresponse.pdf> accessed 1 August 2017. The two cases are known as T-45/12 (United Kingdom v ECB) CJEU 8 May 2015 and T-93/13 (United Kingdom v ECB) CJEU 8 May 2015 and the second case was removed from the Court’s register, <http://www.bankofengland.co.uk/financialstability/Documents/securitisation/ecbboeresponse.pdf> accessed 1 August 2017.

38 ECB and Bank of England, ‘European Central Bank and Bank of England Announce Measures to Enhance Financial Stability in Relation to Centrally Cleared Markets in the EU’ (29 March 2015) <http://www.bankofengland.co.uk/financialstability/Documents/securitisation/ecbboeresponse.pdf> accessed 1 August 2017.

39 However, these figures relate to the nominal amount, not to the market value of the derivatives, being the amount that is at risk: see Milken Institute, ‘$700 Trillion in Global OTC Derivatives? Behind the Number’ (31 March 2014) <http://www.milkeninstitute.org/blog/view/580> accessed 1 August 2017.

40 EMIR provides that OTC derivatives have to be centrally cleared through CCPs. Euro denominated margins have to be constituted to reduce risk.

41 See on this topic, the interview by Benoit Coeuré to CNBC (20 January 2017) <https://www.ecb.europa.eu/press/inter/date/2017/html/sp170120_1.en.html> accessed 1 August 2017. As to the historical position see Eurosystem, 'Policy Line with Regard to Consolidation in Central Counterparty Clearing' <https://www.ecb.europa.eu/pub/pdf/other/centralcounterpartyclearingen.pdf?d6cf75a1d08e42ecd348dbac855f6109> accessed 1 August 2017.

The position was confirmed in the Council formal guidelines for the Brexit negotiations: see David A. Green, 'Brexit Timetable, Evolution of the EU's Position, Part 1' *Financial Times* (25 April 2017) <https://www.ft.com/content/74e5fe4b-b1e4-3f9c-9e9b-73316872e144> accessed 1 August 2017.

42 See Commission proposal for a Regulation on a framework for the recovery and resolution of central counterparties and amending Regulations (EU) 1095/2010, (EU) 648/2012, and (EU) 2015/2365 COM (2016) 856 final; as to the European Parliament, see Legislation in Progress, **<**http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/599345/EPRS_BRI(2017)599345_EN.pdf> accessed 1 August 2017.

43 See A Barker and J Brundsden, 'Brussels readies rule change to target UK euro clearing' *Financial Times* (16 December 2016). The UK press mentions an additional margin requirement of $ 77 billion. Eighty-three thousand jobs would be in danger: Ph. Stafford in *Financial Times* (14 November 2016).

44 Christopher Giancarlo, as reported by Philip Stafford, Head of US derivatives regulator warns of impact of euro clearing decision <https://www.ft.com/content/83422248-3582-36f1-888d-07cc2c23d9ee> accessed 1 August 2017.

45 Alexander Weber, 'EU Has to Control Euro Clearing After Brexit, Lawmakers Say', Bloomberg Markets (9 March 2017) <https://www.bloomberg.com/news/articles/2017-03-09/eu-needs-to-control-euro-clearing-after-brexit-lawmakers-say> accessed 1 August 2017.

46 See the Memo approved by the EU Council on 29 April 2017. European Council (Art 50) Guidelines for Brexit negotiations <http://www.consilium.europa.eu/en/press/press-releases/2017/04/29-euco-brexit-guidelines/> accessed 1 August 2017.

47 See Commission Communication to the Parliament, the Council and the ECB, Responding to challenges for critical financial market infrastructures and further developing the Capital Markets Union, COM (2017) 225 final (4 May 2017) <http://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-225-F1-EN-MAIN-PART-1.PDF> accessed 1 August 2017.

48 See Jim Brundsen, 'ECB Steps Up Warning on UK Euro Clearing' *Financial Times* (22 January 2017) <https://www.ft.com/content/51a68c6e-e094-11e6-9645-c9357a75844a>; Gavin Finch and John Detrixhe, 'Banks Said to Plan for Loss of Euro Clearing after Brexit' Bloomberg (22 September 2016) <https://www.bloomberg.com/news/articles/2016-09-21/global-banks-said-to-plan-for-loss-of-euro-clearing-after-brexit> accessed 1 August 2017; see also: Peter Leahy, 'The EU's Attempts to Drive Euro Derivatives Clearing out of London Post-Brexit are Doomed to Fail' (27 January 2017) <http://brexitcentral.com/eus-attempts-euro-clearing-london-brexit-doomed-fail/> accessed 1 August 2017; Chris Arnold, 'The Post-Brexit Future of Euro Clearing in London' (13 February 2017) <https://www.law360.com/articles/891342/the-post-brexit-future-of-euro-clearing-in-london> accessed 1 August 2017. London clears about three-quarters of all euro denominated derivatives for IRS. See Josie Cox and Rob Merrick, 'Brexit: EU Prepares for Power Grab on London's Euro-Clearing Market' *Independent* (3 May 2017) <http://www.independent.co.uk/news/business/news/

brexit-eu-clearing-houses-euro-brussels-commission-regulation-transactions-a7716276.html> accessed 1 August 2017.

49 Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorization of CCPs and requirements for the recognition of third-country CCPs, COM (2017) 331 final 2017/0136 (COD) (13 June 2017).

50 For payment and settlement related matters: (21) The central bank would be consulted on matters that may impact its monetary policy. It may also formulate additional requirements for being imposed by ESMA, eg collateral held in a CCP, segregation requirements, liquidity arrangements. ibid.

51 This analysis predates the EBA relocation decisions.

52 See about this subject Eddy Wymeersch, ‘European Financial Regulation: how to make it more workable’ <https://ssrn.com/abstract=2821135> accessed 1 August 2017.

53 The ESA can address instructions to individual firms in case the negotiations of individual authorities have not been able to reach an agreement: see Art 19(4) Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (EBA Regulation); a comparable case relates to emergency measures: see Art 18(3) EBA Regulation.

54 These are two aspects the Commission consultation puts on the agenda.

55 Article 6(5) and 23(2) SSM Regulation.

56 See Art 4(3) SSM Regulation as advisor to EBA.

57 Present Art 17 ‘breach of Union Law’.

58 See eg the action in support of the colleges of supervisors, or the activity undertaken by the EBA in the field of stress testing.

59 See for prospectuses see eg Arts 13(5) and 17 of Directive 2003/71 of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC allowing the prospectus to be approved by one authority to be valid in other Member States as well. See also Art 6(3) of the Directive 2004/25 of 21 April 2004 on takeover bids.

60 See Communication from the Commission, ‘Responding to challenges for critical financial market infrastructures and further developing the Capital Markets Union’ COM (2017) 225 final (4 May 2017).

61 Already in 2007, the 3L3 Committee of the three ESAs put this topic on its agenda under the name ‘competing products’: ESMA: CESR Archive, CESR press release 322 (November 2007).