BrieFin

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#1 - BREXIT

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity."

The opening lines of "A Tale of Two Cities" by Charles Dickens form one of the most recognizable pieces in the history of literature, capable of capturing the uncertainty of an epoch where too many momentous things were happening, and the unease of not knowing what the future would hold. Elevating such restlessness to a form of art was something only Dickens could do, but the work of the English author also holds lessons that others less gifted than him can follow, such as the power of simple words, language and conversation as vehicles to tackle the most complicated topics and seek human understanding.

BrieFin is thus born as a means to facilitate conversation. The European Banking Institute (EBI) was born as an effort to promote path-breaking research on banking and financial law. Yet, the ultimate goal of such endeavour is to enhance the quality of institutions through an improvement in their understanding. Our hope is to render such understanding easier by facilitating/creating/promoting a platform where relevant voices from practice and academia, senior and junior can be heard. The idea is to provide brief and synthetic pieces, unlike a traditional academic publication, but to offer reflective and insightful remarks to differentiate it from a Newsletter, or news clip. Most importantly, we wish to offer diversity in perspective.

And thus, we are thrilled to present BrieFin's first number. True to the idea that no topic is too complex or volatile to be addressed in an honest conversation, this number provides the EBI Community with critical insights on *Brexit*, from senior academics, industry representatives and young researchers. The varying nature of the contributions reflects the EBI's compromise to accomplish interdisciplinary, focused, and relevant research on banking and financial regulation. It also places a special emphasis on the aim to stimulate critical debate amongst different constituents and disseminating cutting-edge research on these topics. On Brexit the uncertainty at both legal and political levels is the main challenge. However, the idea of combining such diverse perspectives is not to provide the reader with definitive answers, but with a sufficiently comprehensive view to initiate, not end, a conversation, and hopefully find such answers as the events unfold. We do hope you enjoy this first BrieFin number!

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1. The Comprehensive View

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Brexit is coming closer

At less than 30 days before the final date set for Brexit, it is hazardous to write anything on the consequences of this momentous change in the European landscape. One can only give some indications of possible consequences of a Brexit without agreed transitional provisions. While the outcome of negotiations is still unpredictable given the daily changes in the positions adopted by the UK side, the overall political landscape seems to be quite well established: The Member States of the European Union have adopted a common position and have resisted attempts to be divided notwithstanding the UK's attempts. In the UK, however, a major political battle is raging. On one side there are supporters of a "hard Brexit" (that is, without a transition regime), to those pleading for a decision in principle –the UK leaving the EU – both with some flexibility as to the consequences. The other side of the spectrum pleads for a continuity of EU membership, possibly linked to a new referendum. The government's position is further weakened as the Conservatives are dependent on the Northern Ireland's DUP support, which is conditioned on finding an acceptable solution to the Northern Ireland border with the UK, which has become one of the core issues in the debate. This deep division has made negotiations almost impossible, inciting EU member states to adopt a stricter position, while stating that they want further good relations with the post-Brexit UK. It has also been difficult to determine whether the UK negotiators are well prepared and grasp the dimension of the potential consequences of a hard Brexit: almost on a weekly basis, new issues are popping up, and stricter EU positions lead to more damaging consequences for the UK. Recently, there was a report that UK airlines could not obtain access to EU airports, as they will be considered third country airlines and therefore have to meet stricter conditions, unless the majority of their capital was owned by EU-entities. British Airways seemingly has not adopted safeguards in this respect, neither has Ryanair. Also, customs controls are being prepared by the UK, although it is doubted whether the existing customs and other controls will be able to cope with the very momentous cross-Channel traffic, obliging UK firms are stockpiling medicines, foodstuff etc At the same time, without a transitional regime, the outcome of a hard Brexit is likely to be very disruptive in many fields, and these will affect many sectors of the UK economy, but of the EU as well.

Some will state that in negotiations as these, agreements are reached in the last five minutes. This may be a solution for the Brexit case, in the sense that parties would agree to accept that the UK leaves the EU, as a matter of principle, while opening a negotiations period until the end of 2020 for settling the individual issues. This may seem realistic, were it not that there remains a hard point of hard principle, being "the Irish Border", or more precisely the border between Northern Ireland, part of the UK, and the Republic of Ireland, part of the EU. In the past this border has been the source of very serious incidents, so that all parties want to avoid a repetition there. A solution has to be worked out: include Northern Ireland into the EU free zone may be a solution, but is rejected by the Northern Ireland government, which offers its support to a weak Conservative government in London. Technical logistical solutions were put forward, but in the absence of concrete proposals these are considered unrealistic. As a consequence, the border question may well be the breaking point resulting in a hard Brexit.

The effect of Brexit on the financial sector has not been in the middle of the political debate in the UK. This may seem quite extraordinary as the financial industry is one of the most important employers in the UK, concentrated in some large cities, with a very significant contribution to UK GDP. But it is unclear how much Brexit will actually affect the industry, as the services provided – e.g. in asset management – cover products offered in the entire world. For political reasons, also considering their position in the post-Brexit world, large financial institutions adopted a low profile on Brexit issues, preferring not to adopt an official position which might have been politically controversial, while at the same time analysing the ways to reduce their risk. Moreover, the financial services industry is mainly concentrated in London and in some regional centres (e.g., Glasgow, Manchester, Edinburg) where in the referendum Brexit support was lower than in rural areas.

A legal analysis of the consequences of Brexit therefore should be based on a hard Brexit hypothesis. It consists of terminating UK membership without any transitional regime, the UK becoming from one day to the other a third country and losing all privileges of EU membership. The following analysis will be limited to financial services, but dramatic examples have been mentioned in many other fields.

Membership of the EU confers important privileges: free access to the other member states and their financial markets is a core feature of the European Union. This applies to natural persons, who can freely travel between EU states, without even minimal formalities and no visa requirements. Between certain member states – the so-called Schengen states – border controls have been abolished and driving across the order is the same as continuing to drive on the same motorway. Even Switzerland and

Norway apply this open border policy. Companies can establish themselves in other states, opening a branch or creating a local subsidiary: they will be subject to the same rules as applicable to the nationals. This also applies to banks or financial services firms: if they establish a subsidiary, this will be a local bank and subject to the banking rules in the host state, while being entitled to offer its services throughout the EU. Also, subsidiaries of third country groups enjoy the same regime: they are local entities identical to local banks. For branches, a somewhat more restrictive regime applies: in most states they have to limit their activity to the state where the branch is established. Once the UK leaves the EU, this regime will cease to apply. This would not mean that UK banks would be totally excluded from accessing the single market: their - pre-existing or newly established - subsidiaries are considered EU legal entities and therefore they can continue to be active as EU banks all over the Union. In fact, most large banking groups have already followed that route, and will be able to activate the essential banking functions at the level of their often specialised subsidiary which was active in the main EU financial centres. Branches would be confronted to a limitation of their activity to their state of establishment, and in many cases will therefore convert into subsidiaries.

Would this regime bar access to EU markets for other operators? Not entirely. Several limitations would allow third country service providers to access the EU markets and investors. One which has been provided expressly in Article 34 of MiFID II, stating that if the service is solicited by the investor, the authorisation requirement would not apply ("reverse solicitation"). The directive states that the service has to be provided at the "exclusive initiative" of the investor: the notion is vague and might allow continuous contact once the initial contact was established. Another way to reduce the impact of the third country regime is the delegation technique: especially in asset management, the actual portfolio management is delegated to the parent or an affiliate company. This practice is recognised in the regulation but should not result in the EU located entity becoming an empty box, a mere contact centre with no internal financial functions. Similar to this is the technique whereby banks set off their loans to EU clients with a back-to-back transaction with the non-EU parent. The ECB has, however, warned that the bank should maintain an effective presence in the EU, with the main functions, such as risk management, being exercised there. These examples illustrate that even today the EU markets are not separated from the financial markets in the rest of the world.

In some cases, access will be rendered more difficult due to the structure of EU regulation: this is the case for UK investment funds, created in accordance with the UCITS directives. These cannot be provided in future as the UCITS regime is strictly reserved to EU established funds, a regulatory strategy aiming at protecting the UCITS brand. Therefore, UK funds would have to adopt the AIF format, leading to quite substantial differences in the applicable regulatory regime. In fact, however, the problem is less severe as it seems since most UK fund houses act through funds established in the EU, especially in Ireland and Luxembourg.

In many fields, access to EU markets will be subject to the requirement that the third country regulatory regime is "equivalent" to that of the EU, meaning that is based on the same principles as those applicable in the EU, leading to an equivalent level of protection of investors and to ensuring financial stability. In some provisions, there is the explicit requirement that the regulation is adequately supervised and that rules are effectively enforced. Equivalence is established by the European Commission, on the basis of a delegation in a level 1 regulation. It usually is the outcome of a complex exercise in which the third country regulator and in some cases the competent ESA are exchanging information on their respective regulatory regime, sometimes adapting it in order to achieve access. Whether "equivalence" is a purely technical term, as mentioned above, or would also include political considerations is controversial: The Commission has confirmed the latter approach, although in legal terms this seems controversial. An example is the decision to declare the Swiss stock exchange equivalent; the Commission granted equivalence but only until the end of 2018: the decision was clearly political being conditional on the ground that sufficient progress would have been achieved on a common institutional framework relating to the Swiss-EU bilateral relations.

As the Brexit date approaches, what are the alternatives? As discussions now stand, it does not seem impossible that a last-minute deal would be struck, the Irish question receiving a solution by keeping the UK into a provisional arrangement of further participation in the EU. This would avoid a hard Brexit and open the door to further negotiations and planning for practical arrangements. There is quite some discussion in the UK about the date at which the transitional period will end, as some fear that this may become the definitive situation. But even then, will it be possible to find an acceptable deal for each of the numerous topics? The "hard Brexit" will remain on the table. This would be very damaging for both the UK and for the EU. Partial and temporary solutions could be found under the equivalence mechanism, whereby the EU would adopt equivalence decisions for certain matters, allowing to defer the final decision until a later date. The time limitation would not be applicable, but each of the parties could put an end to the equivalence and hence to its consequences in terms of access in case it modifies some of the conditions of equivalence or revises its assessment. This technique could be used for declaring the market infrastructures equivalent, including the legal position of derivatives clearing through the UK CCPs, while allowing ongoing businesses or transactions to be pursued. It would not be perfect, but the least detrimental to financial markets in both jurisdictions. One can only hope that political leaders will be able to agree to a better construction, safeguarding the future of our economies on both sides of the border.

2. The Practice View

Wim Mijs, Chief Executive Officer of the European Banking Federation

Wanted: answers to the many questions triggered by Brexit

At the European Banking Federation, we much appreciate the mission of the European Banking Institute to establish a platform for dialogue between academia, regulators, supervisors and the industry. The coming withdrawal of the United Kingdom from the European Union has important implications for the financial sector and the wider economy.

We appreciate the role of the EBI as a platform for academic insights and answers to questions emerging in the challenging European landscape for banks. The very prospect of Brexit exacerbates the need for finding these answers and solutions. In this article I want to reflect on this and identify further questions which need to be addressed, also considering the differentiation and fragmentation in the European banking landscape. Through these questions I hope to inspire academic researchers in the EBI community and invite them to think about how to address the challenges at hand. We much value the academic contribution to this dialogue.

At the time of writing this article – just over a month before the 29 March Brexit-date – it is still unclear as to how exactly the UK's departure will play out. I sincerely hope that when you are reading this article a solution already has been found to prevent a no-deal cliff-edge scenario. Like many others, I regret that the prospect of a no-deal-Brexit, at this time, has become a real option. But it's an option we do need to consider in the absence – at least at this moment – of realistic alternatives. Much will depend on courageous political leadership in the coming weeks.

Since the results of the referendum were announced two years ago, banks across Europe and in the United Kingdom – like many other businesses - have prepared and implemented Brexit contingency plans. A considerable number of financial institutions changed their footprint in Europe and relocated their European headquarters into the eurozone and obtained a banking licence in an EU member state.

Some specific dossiers – such as London-based clearing of derivatives transactions – have been addressed, to varying degrees, by the European Union and/or through national measures taken by the respective national governments. Of special importance is the EU's contingency action plan, which includes a temporary and conditional equivalence decision for 12 months to allow UK-based clearing houses to temporarily serve EU 27 customers from their home base.

At the EBF we analysed which areas of the bank business deserve most attention from lawmakers, and the clearing of derivatives and the access to clearing houses is certainly one of the most important aspects. Secondly, Brexit poses questions around the continuity of contracts. This is also of significant relevance for the derivatives business because some contracts have a very long duration.

One specific additional measure we would like the European Commission to take is to recognise trading venues in the UK. This is important as EU banks might need to limit derivatives trading in the UK due to clearing threshold for third countries under EMIR. As soon as the UK leaves the EU without a deal exchange traded derivatives will be considered off-exchange OTC derivatives to which this limitation applies. This means a limitation for derivatives trading, typically used for risk-reduction purposes, by EU banks and companies unless the trading venues are recognised by the Commission.

What's more, the free movement of data is a vital component of the Digital Single Market specifically, as well as supporting the Single Market in general. It has become an everyday necessity for firms in a wide range of industries to perform everyday tasks. It is therefore necessary for our industry to ensure that data can flow freely from the EEA to the UK, and similarly from the UK to the EEA while still maintaining strong data protection rules for European citizens.

Furthermore, the UK's withdrawal from the EU may result in EU banks finding themselves in breach of their so-called Minimum Requirement for own funds and Eligible Liabilities, or MREL, as liabilities issued under English law, in good faith, may no longer be MREL-eligible. We appreciate the SRB's statement to recognise contractual bail-in clauses and to assess each bank's situation on a case-by-case basis, which may entail an extension of transitional periods for MREL shortfalls as a consequence of the ineligibility of UK law issuances.

With the looming prospect of a no-deal and the incomplete coverage of the contingency measures, there are still a considerable number of operational uncertainties when it comes to Brexit and financial services. Uncertainty is perhaps most significant when it comes to the future relationship. Only when UK Prime Minister Theresa May reached her agreement with the European Union in November 2018 did the door to discussions about the future relationship open. And in the absence of an agreement on the deal in the British parliament, the talks about the future relations between the EU and the UK have come to a standstill.

Still, we can be optimistic that at some point in the future a way forward will be found. And a certain number of mutually agreed principles seem to emerge in this area – as well as important questions that will need to be discussed.

First, when it comes to financial services, both the UK and the EU agree to commit to preserving financial stability, market integrity, investor and consumer protection and fair competition, while respecting their regulatory and decision-making autonomy, and their ability to take equivalence decisions in their own interest. And they agree to engage in close cooperation on regulatory and supervisory matters in international bodies.

Such a commitment naturally deserves praise. But we will need constructive discussions on how this commitment is to be implemented.

A related topic is the cooperation on regulation and supervision. Under the proposed political declaration, the EU and UK want to jointly agree that close and structured cooperation on regulatory and supervisory matters is in their mutual interest. This cooperation should be grounded in the economic partnership and based on the principles of regulatory autonomy, transparency and stability. It should include transparency and appropriate consultation in the process of adoption, suspension and withdrawal of equivalence decisions, information exchange and

consultation on regulatory initiatives and other issues of mutual interest, at both political and technical levels.

Banking supervision in the European Union has matured significantly over the course of the last decade. Europe can take great pride in having developed a truly European supervisory structure for its banking sector in only a few years under Banking Union, which also includes the Single Resolution Board and the Single Rulebook.

While we all know that Banking Union remains to be completed with the fourth pillar – a single European deposit guarantee system – it is clear that this European project has successfully contributed to the stability of the European financial system, thanks also to the solid engagement of the European Banking Authority and the European Central Bank. One potential question for academics to consider is: how do we safeguard these major achievements in European banking supervision in the post-Brexit era?

From Banking Union, it is only a small step towards the Capital Markets Union. Here, it has been clear for some time that the European Commission has not delivered. Brexit led to the departure of my good friend and UK Commissioner Jonathan Hill. His departure effectively meant the end of CMU in the Juncker Commission. CMU was supposed to facilitate further integration of the EU capital markets.

Given that roughly a quarter of Europe's financial markets is anchored in London, the EU's next steps on CMU – expected after this year's EU elections - will be crucial for the economy and for the role that banks play in financing businesses and households across Europe. I'm convinced that those in Brussels working on the CMU update would highly value fresh academic insights before the next steps take shape.

In the absence of a final agreement between the EU and the UK, it is too early to talk about the need for political will to address the important aspects of financial services. What's more, financial stability may be tested in the coming months due to the economic impact of Brexit. No one doubts that Brexit will have economic consequences, but it remains to be seen in practice how the economies of the United Kingdom and its trade partners will be affected.

Not only banks but companies from various sectors face risks as they need to prepare for a post-Brexit world, not knowing what it may look like. This leads to burdensome and costly preparations, such as keeping extra stock, adjusting supply chains and production facilities as well as considerations to relocate and adjust staffing. These effects are particularly painful for small and medium-sized companies. Uncertainty has an economic cost when companies cut capital expenditure and lay off people to preserve cash. The banking sector continues to implement contingency measures to prepare for Brexit, including a hard Brexit scenario. But as the political and economic situation is extremely complex, it is simply not possible to circumvent all potential difficulties.

Finally, there is another aspect to consider when looking at the challenges for the European banking sector as a whole: fragmentation. Europe's banking sector is amazingly diverse. The banking landscape in Europe is home to more than 6,000 banks. Large and small, commercial, retail and cooperative, public and private. For cultural and historic reasons, this is how banking in Europe looks. Significant differences exist among financial institutions in Europe. Some of the largest of banks hold total assets of more than 1 trillion Euro on their balance sheet, while many smaller banks have assets of less than 1 billion Euro. That still is significant, but it means some of the biggest banks are more than 1000 times bigger than the smallest ones.

And at the same time, the one hundred biggest banks in the Eurozone – the ones that are directly supervised at the European level by the ECB through the Single Supervisory Mechanism – account for approximately 80 percent of the total assets held by the European banking sector. These dimensions will not alter significantly as a result of Brexit.

Policymakers in Europe know that the EBF has pleaded for a proportional application of regulation and supervision in the European banking sector as whole and asked for a smart and coherent approach to proportionality. But does the EU really have a well-designed and coherent approach? Does the current approach foster the diversity we want to maintain? How does Brexit affect the discussion around proportionality in European banking regulation?

And how can we make sure that there is a level playing field for European banks so that they can continue to serve businesses and consumers in Europe in a post-Brexit world? And how can European banks be competitive in a post-Brexit environment? Are there alternative academic ideas and concepts that are not yet part of this debate? Again, insights and analysis from the EBI community are much valued to support an intelligent discussion.

Brexit has important implications for the financial services sector because of London's position in global financial markets. European banks take preparations for Brexit very seriously, and their teams in the UK and on the continent are coordinating their efforts. Of course, an agreement between the EU and the UK including a transition period would be the most favourable outcome because it would give all market participants more time to finish their preparations. It would also improve the chances that the future relationship might be known in advance by the time the UK leaves the Single Market. We are aware that a transition period can only address some but not all of the problems associated with a cliff edge. Therefore, any outstanding issues that may result in cliff effects would still need to be identified and satisfactorily addressed before the end of any transition period.

Despite recent political setbacks we remain hopeful that a withdrawal deal can be agreed. This would also open the door for discussion about the future relationship between the EU and the UK and trigger new thinking around the EU equivalence regime and the possibility for updating the framework, particularly addressing questions around scope and process.

I know that I can count on you, with your academic powers and insights, to find answers to all these questions, from a European perspective.

3. The Professors' View

Professor Rosa M. Lastra, Sir John Lubbock Professor in Banking Law

Brexit and financial services: what next?

As Brexit D day – 29 March 2019 – gets closer, the prospect of a no deal is now a distinct possibility. There is limited hope and little time left to bring the EU-UK negotiations on the terms of Britain's departure from the EU to a workable agreement.

While before the referendum there was no real understanding of what model a potential Brexit should follow, after the referendum the UK's red lines (the Irish border, free movement of people and the jurisdiction of the European Court of Justice) have limited the room for manoeuvre.

The EU's own stance, namely the strongly held view amongst EU negotiators that States that leave the block cannot get better treatment outside the block than the Member States that remain has not facilitated the success of the negotiations. The EU has reaffirmed its commitment to the integrity of the four basic freedoms and its own view of the Irish issue, rejecting further Europe *à la carte*.

The Irish border issue shows yet once again that politics matters more than economics. Financial services after all are not as 'important' as the future of the country, the integrity of the United Kingdom and the desire for peaceful coexistence amongst its citizens. Like with German reunification or the preparations for the Euro, it is the political will that determines the success of the integration process.

If transitional period is agreed, the current status quo of unrestricted, reliable and generic single passport in the provision of financial services in the UK will be replaced by a new untested system likely to rely on the principle of equivalence, whose efficacy is yet to be proven. Since such a regime is likely to lead to different results across the various sectors of the financial industry, the future of financial services provision in the UK in its relationships with EU member states is shrouded with uncertainty.

Though risk always presents opportunities, financial markets dislike uncertainty and exhibit trends – the Minsky moment – that make them 'psychologically fragile' against pressures and external shocks. Pragmatism and a utilitarian approach, so deeply entrenched in the British legal and business tradition, appear at times to have become replaced by an ideological zeal.

The unlikely alliance between the most conservative sectors of the Tory party - who support free trade – and many disaffected Labour supporters – who wish protection rather than free trade – is an interesting phenomenon at the root of some of the populist responses to the economic and social tenets of a liberal tradition that will be surely be debated for years.

It is worth reflecting upon what is on offer in each of the models that have been considered over the last two years as a solution to Britain's relationship with the EU post Brexit, namely, the Norway model (or Norway plus), the Swiss model, the Canada model, the Turkey model and the Singapore model.[1]

The 'Norway model' refers to membership in the European Free Trade Association (EFTA) and the European Economic Area (EEA). Norway, along with Lichtenstein and Iceland, is a member of both. While the EEA gives full access to single market, it obliges members to make a financial contribution and to accept EU laws and free movement. EFTA is made up of Norway, Lichtenstein, Iceland and Switzerland. The group's members trade between themselves and the group as a whole has signed free trade deals with numerous non-EU countries, Canada, Mexico and others. Norway plus would also include a customs union.

The Swiss model is characterised by a series of bilateral agreements that govern access to the EU market in some but not all areas of trade. Switzerland makes a financial contribution to the EU but smaller than Norway's, does not have a general duty to apply EU law though it must implement some EU regulations to enable trade, and allows free movement of people. After a referendum on 9 February 2014 in which Swiss citizens voted in favour of restricting the number of workers arriving from the EU, Brussels retaliated swiftly, stalling agreements and freezing participation in education projects.

The Turkey model is a tailored-made custom union with the EU, with no tariffs (taxes or duties on imports and exports) or quotas on the industrial goods it sends to EU countries. However, the customs union does not apply to agricultural goods, nor to services.

The Canada or CETA (Comprehensive Economic and Trade Agreement) model refers to an agreement which had been in the making for several years and which entered into force provisionally on 21 September 2017, meaning most of the agreement now applies. However, national parliaments in EU countries – and in some cases regional ones too – will need to approve CETA before it can take full effect.[2] CETA gives Canada preferential access to the EU single market without all the obligations that Norway and Switzerland face, and eliminating most trade tariffs. However, not all items are covered. Furthermore, Canadian exporters will also have to prove that their goods are entirely 'made in Canada', which imposes extra costs, to prevent imports entering the EU through a 'back door'. The services sector, which is of fundamental importance to the UK, is only partially covered by CETA.

The Singapore model presents a unilateral free trade approach (it does not impose import or export tariffs) coupled with low taxation in order to attract business. While this approach may appeal to those Brexiteers whose ideology favours no trade restrictions, it would be less welcome by Labour Brexit voters and left-wing critics of the EU.

Much has changed since the days after the non-binding referendum on 23 June 2016 when a soft Brexit was still on the table. We are heading towards a hard Brexit. And a no deal would signify reliance on WTO rules alone

[1] https://www.bbc.co.uk/news/uk-politics-eu-referendum-36639261

[2] http://ec.europa.eu/trade/policy/in-focus/ceta/index_en.htm

4. Young Researchers' Reflections

Ioannis G. Asimakopoulos, EBI YRG Member

PhD Fellow; University of Luxembourg, Faculty of Law, Economics and Finance.

Post-Brexit regulatory arbitrage: Basic instincts never change

Regulatory arbitrage is not a new phenomenon. Financial institutions have always tried to structure their activities in order to minimize the impact of regulation on their activities. Cross-jurisdiction arbitrage, as a subcategory of arbitrage, is not new either; financial institutions have always tried to exploit the fact that rules differ across jurisdictions, by structuring their operations in such a way that would allow them to benefit from less strict rules. Needless to say, when over time, more and more businesses shift to countries with more lenient regulatory standards, financial stability risks arise –not in one country, but in all countries – whilst countries start competing in an endless race to the bottom in order to attract businesses.

In principle, mitigating arbitrage requires a robust substantive and procedural regulatory framework. In terms of substance, making rules clear and granular is important. However, financial institutions are sophisticated enough to be ahead of the game, by identifying and exploiting loopholes in the system. Therefore, since undertakings will always find a way to circumvent rules, there are clear limits to a rules-based regulation, and a strong case in considering that principles-based regulation should be the preferred approach. A principles-based regulation is capable of dealing with such issues, but it requires a powerful supervisor to enforce it, capable of acting swiftly whenever arbitrage strategies are being identified.

In the EU, regulatory arbitrage is not new either, and mitigating it has been particularly challenging given the EU's multi-level regulatory architecture. Apart from certain areas, which are regulated through Regulations, vital components of the EU financial regulation are based on Directives. Decisively, Directives such as the CRD IV or MiFID II have been transposed in different ways in each Member State, so as to reflect local specificities. In the CRD IV there are approximately 150 national options and discretions built-in, while MiFID's enforcement presents significant divergences amongst Member States. Moreover, in terms of enforcement, improvements have been made as regards the role of the European Central Bank as the supervisor of systemic banks within the Single Supervisory Mechanism (SSM), and as regards the European Securities and Markets Authority (ESMA) as a sui-generis European regulator for the EU financial markets. However, neither is the governance structure of the SSM truly unified, nor is ESMA equipped with enough powers to harmonize enforcement in financial markets.

Enter Brexit. The problem of regulatory arbitrage has reached the surface again due to Brexit. As financial institutions are deciding to relocate in different jurisdictions to benefit from passporting, the structure of the European financial market is changing. From London, where the largest part of financial activity was being concentrated for decades, financial institutions are relocating across the EU. Meanwhile, Member States engage in a race to attract as many financial institutions as possible by using their national options and discretions; Dublin, Frankfurt, Luxembourg, Paris, and Madrid are the main examples to point out. Consequently, the regulation of financial markets is shifting from one regulator (Financial Conduct Authority) to multiple regulators, while having the largest European financial center as a third country, which thus will not be governed by EU rules any longer.

That being said, there are two opposite dynamics in EU financial regulation; one pushing towards further harmonization and one pushing towards regulatory arbitrage. Overall, there is definitely pressure towards further harmonization and towards reinforcing the role of the ESMA as the European financial markets' regulator within a European capital markets union. Since early 2017, ESMA has issued several opinions in order to make sure that Member States will not compete on the basis of different levels of enforcement of the single rulebook. At the moment, the ESMA and National Competent Authorities (NCAs) are coordinating on relocation issues within a special forum for this purpose, the Supervisory Coordination Network. One recent example has been the ESMA's briefing on 'back-branching', which aims at helping NCAs on matters of authorization and supervision of institutions which intend to establish or have established a branch in a non-EU jurisdiction, such as the UK post-Brexit. In the same context, a peer review of supervisory practices on Brexit relocations will take place towards the end of 2019.

However, more needs to be done, especially with regards to supervision and overall enforcement of the single rulebook. In this vein, the ongoing ESA's review is particularly topical (for a brief overview, see Demarigny and Lannoo, 2018). Under the Commission's plan, the ESMA would, among others, expand its powers on monitoring prospectus, have direct supervision on investment funds, such as venture capital and European Long-Term Investment Funds, while national supervisors would be monitored by an independent watchdog. The Parliament was particularly supportive in that regard, also making a proposal to equip ESMA with certain powers to issue so-called no-action letters. These are letters commonly used by US markets regulators, which give participants temporary respite from compliance with complex rules in view of new developments in financial markets. Nevertheless, the final framework which was agreed to be negotiated is significantly watered-down. Smaller EU States had tried to completely block the reform, fearing it would reduce their power to attract foreign financial firms; but under pressure from larger States, led by France, Spain and Luxembourg, a compromise was reached by the EU finance ministers gathered in Brussels in February 2019 (Reuters, 12 February 2019). For example, Member States blocked the reform having ESMA directly supervise investment funds; the monitoring of national supervisors will also remain largely in the hands of a board of national authorities. Overall, even though regulatory arbitrage is not unknown to the EU, Brexit makes it even more important to have a harmonized substantive framework and supervisory convergence to deal with this issue. And, indeed, a lot has been done already; the work conducted by the SSM and ESMA is already helping mitigate such concerns. However, it seems that Member States are very much trying to protect their own national options and discretions, in order to attract the largest possible number of financial institutions leaving London.

Katarzyna Parchimowicz, EBI YRG Member
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Parent undertaking requirement – Another headache for the UK financial markets

The Global Financial Crisis taught regulators that finding a golden middle between banking globalization and mitigating systemic risk is crucial both for financial stability and the real economy. A relatively new concept aimed at achieving this balance is the parent undertaking requirement[3] – a solution introduced in the US in 2014 and proposed in the EU[4] two years later. It obliges internationally active banking institutions of a certain size to move their subsidiaries established in the foreign country[5] under one roof – a parent undertaking incorporated in this host jurisdiction. Its main objective is to avoid capital withdrawals in cases of cross-border resolution, and thus to maintain control over financial entities active in a given area and prevent an economic crisis from spreading. In this way, the financial stability of the whole system should be enhanced and home depositors protected. However, this standard has been controversial from the very beginning, when the original American initiative was called 'inglorious isolation' and 'discriminatory', and the subsequent European proposal has been seen as 'retaliation'. Adding to the controversy, the EU proposal is considered retaliatory not only towards the US but also towards the UK in light of Brexit. In this short piece I will signal the main weaknesses of the parent undertaking requirement and explain briefly how the EU solution would harm UK financial market.

The seemingly justified and logical parent undertaking system has considerable flaws. Apart from some structural inconsistencies of these requirements (e.g. the arbitrary hurdle in the US and EU for asset size qualifying institution as obliged to set up IHC/EPU, question of branch assets not being counted towards this requirement, IHC/ EPU constituting not much of help in the MPOE resolution environment existing in the EU), there are also ponderable side effects that could have been omitted by the regulators. The financial and administrative burden is already visible for example with Deutsche Bank's US unit failing in the second round of 2018 stress tests – in relation to capital planning controls, a duty of US-incorporated companies. Entities within one banking group will simply have to comply with even more legal regimes than before. Also, the regulators introducing this law in a given country (or region when it comes to the EU) do not take into consideration legal provisions binding the respective entity in its motherland, thus theoretically the institution could be driven out from the market by simply being asked to infringe the law of its home country. We have witnessed that in the case of the US when the Volcker Rule was not compliant with the initial EU proposal of pooling subsidiaries, and only after strong criticism did EU authorities decide to change that.

Additionally, in the face of Brexit, parent undertaking standards introduced in the EU could put both British banking institutions and other non-EU institutions with their EU headquarters in the UK, in an uncomfortable situation. Big British banks wanting to operate on the continent would be forced to create a parent entity there. Barclays has already started moving, as it has rented offices and set up a subsidiary in Dublin. Additionally, non-EU banks with headquarters in the UK would face a dilemma – either to leave one hub in Great Britain and establish another one for EU-operations purposes, or to give up on the costly entity in the UK that is able to serve mainly the British market and to set up a new European headquarters in Germany, for instance. The exodus of the third-country banking institutions has already begun. Bank of America is moving to Dublin and Morgan Stanley to Frankfurt. Goldman Sachs is an example of wanting to have both – the institution intends to maintain its London headquarters and open EU hubs in Frankfurt and Paris. There are also fears that in this 'IHC/EPU retaliatory game' domino effect scenario seems quite possible. Namely, British regulators could impose their own similar requirement to complicate European (maybe slightly less for American) banks.

Given the high level of uncertainty surrounding Brexit and the future of banking institutions having access to the EU market from the UK, the parent undertaking requirement does not seem to vastly contribute to the stability of the EU financial system. It fragments the financial landscape and could be read as a sign of opting more for isolation than cooperation both in the US and the EU.

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[3] In the EU, the term European Parent Undertaking (EPU) is used, and a more or less analogous solution in the US is dubbed Intermediate Holding Company (IHC).
[4] Recently, on the 15th of February 2019 it was endorsed by the Council. See https://www.consilium.europa.eu/en/press/press-releases/2019/02/15/banking-union-eu-ambassadors-endorse-full-package-of-risk-reduction-measures/.
[5] In the US or in the EU.

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