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Brexit and financial services reforms: where do we stand and what way forward?

CFA (Chartered Financial Analyst) Institute
Polish Supervisory Architecture Event
2nd of February 2018, Warsaw

Before 2008 crisis the European Single Market of the financial services practically did not exist. The sector was largely fragmented but cross border groups were growing in importance. Both global crisis and risk related to fragmentation have triggered a change of heart which led to a huge regulatory effort in this area. Since then more than 40 directives and regulations have been adopted, accompanied by more than 100 delegated and implementing acts. At global level, through FSB, Basel Committee, IOSCO etc standards have been negotiated and gradually incorporated into the EU body of law. Gradually, the logic has been adopted of influencing the emerging global standards instead of struggling at the end to depart from them. Today, the EU financial services market is deeply integrated, highly regulated and strictly supervised. It is, however, still an unfinished business. The work is ongoing, more reforms will come in next years. Some of these reforms have been with us for a while, remain, nevertheless, for a variety of reasons, an unfinished business. I am thinking here about the Banking Union and the Capital Markets Union, both hopefully soon to become a European Financial Union.

It goes without saying that the EU has to continue reforms of financial sector with or without the Brits. Brexit as such requires, however, serious adjustment to avoid risks to financial stability but also to ensure in the EU a long term sustainable financial sector development.

We have to prepare as well to a Brexit no deal scenario with a view to have full capacity at both public actors and private firms level to mitigate risks that might emerge. The EU will also have to adapt its system to the future bilateral relationship, whatever it will be.

Let me start with a few comments on the Capital Markets Union. This project has been launched some years ago, in 2015, by the European Commission. Its beginning goes therefore to the period before the UK decided to leave the EU. At its outset it was seen as a vehicle to expanding the access to non-bank financing for SMEs and diversifying the sources of funding away from a disproportionately bank-based model. This was a project that was actually spearheaded by the Brits.

Since 2015, timid steps have been taken in order to build a Capital Markets Union. It started with the adoption of the regulation on simple, transparent and standardised securitisation, with a lighter regime for prospectus issuance and with a new regulation on venture capital funds. We are also now starting the discussions in the European Parliament on a Pan European Pension Product (PEPP).

But, of course, we need to do more if we take seriously the goal of diversifying our sources of funding, allocate investments more efficiently and keep pace with the innovations we are seeing on financial markets. The need to change the traditional European banking oriented financial culture is a big challenge across the EU.

We have new entrants on markets, Fintechs that are providing services similar to banks but are not regulated like banks. In this perspective, we have to make sure that the same rules are applied to entities that create the same risks or challenges. But we have to do this without discouraging innovation. We have to make sure our regulation, both in terms of the incentives it provides and of the limits it sets, is looking forward and not backward, that it provides a response to the challenges of the future and not to the crises of the past. Maybe, indeed, we should pause for a moment and reflect on what we want for the future and what regulation we need for this future. This sounds very ambitious, but this is what we should try to achieve as legislators, with the assistance of researchers and think tanks.

One very concrete issue that we could look at now is making sure that the relevant legislation, such as the Capital Requirements Directive and the Markets in Financial Instruments Directive, allows companies to recruit people with those skills and talents that are needed for the financial services sector of the future. I think here mostly about people possessing expertise in IT, engineering, algorithm designing, so not what we traditionally imagine as a banker skills. It is important that the recruitment of those people is not penalised if we want our companies to benefit from their knowledge and remain competitive. There is a need to see that financial services sector does not lose its competitive edge in the labour market.

We might have to adapt many other pieces of legislation in light of new developments. Probably in a world where we can have robots providing financial advice, we need to re-think investor protection, and here again some people tell us that some rights of the investor should be safeguarded.
Finally, let me say that we know that the CMU, in particular in countries such as Poland, is also about cultural change, about making savers more familiar with financial markets and less reluctant to invest. Financial education is key

in bringing this change, as well as good, independent and sound financial advice. And this is a task for the industry but, I believe, also for the education sector.

Let me now talk shortly about the second main project that has been ongoing for some time at the level of the EU and which is the Banking Union. I would like to begin by stressing that the CMU and the Banking Union are complementary and interactive. It was not by accident that the five presidents' report of 2015 grouped them under the name of "financial union".

They are complementary because the guiding principle for the completion of banking union is that risk-sharing and risk reduction should go hand in hand. And capital markets are a channel for private risk-sharing: through them, investors in one Member State can provide funding to support a company in another Member State, without any system needing to be designed to organise the sharing of risk.

Private risk sharing is crucial to determine the capacity of an economy to resist shocks. To give you an order of magnitude, it has been studied (there are papers from CEPS about that) that, in the US, over half of the effect of an asymmetric shock is absorbed through private risk sharing mechanisms. So moving ahead with the CMU will help us move towards the completion of the Banking Union.

However, developing private risk sharing does not mean that private insurance system mechanism would justify stopping our work on the completion of the Banking Union. We need to strengthen the Banking Union in order to make the European financial system more resilient to shocks.

We are in my view more than halfway through with the Banking Union, with one pillar operational, the second, though lacking some elements, started last year to be tested in coping with real cases. Actually, now, we have all proposals we need on the table in order to complete the Banking Union. We have a proposal for a third pillar, the European Deposit Insurance Scheme (EDIS), whatever its final shape. We have a proposal for a fiscal backstop for the Single Resolution Fund that will be provided by the European Stability Mechanism, integrated, hopefully, into the EU framework and renamed European Monetary Fund.

We need to start working swiftly on those proposals and, since they establish mechanisms to share risk, we also need to keep trying, in parallel, through the work on the banking package and on other aspects of EU financial services legislation, to reduce risks in the banking sector.

As we are in Poland, let me say a few words on how joining the Banking Union could be beneficial also for countries that do not intend in the nearest future to adopt the euro. Joining the Banking Union is an open possibility for those economies. The participation in the SSM and the SRM is opened to Member States that do not have the euro as their currency. It so happens that the countries which are out of the euro area appear to be precisely these which need an EU-wide solution to supervision and resolution the most.

In the Central and Eastern Europe, the banking sector is characterised by a large share of assets held by foreign banks and by the significant presence of large cross border groups. It is precisely those cross border groups, complex to supervise and resolve because of their international nature, for which the Banking Union was designed.

Moreover, it so happens that the assets held by foreign banks are not held by third country banks but mostly by banks headquartered in the Banking Union area. For instance, in Czech Republic, it is estimated that 88% of assets are held cross-border, that is, by branches and subsidiaries of foreign banks and 78% are held by banks coming from the Banking Union area. In Bulgaria, 77% of assets are held cross-border and 71% are held by banks coming from the Banking Union area. Here in Poland, 66% of assets are held cross border and 58% are held by branches and subsidiaries of banks from the Banking Union area.

We, Poland, are a host country. Therefore, joining the Banking Union would give us an opportunity to be involved in the process of supervision and resolution of our banks instead of having to pay for the mistakes made elsewhere and having to fight uncertain fights to obtain carve outs and special provisions for host countries in the legislation.

We know that Denmark and Sweden are considering joining the Banking Union, and the case of Nordea relocating from Sweden to Finland in order to benefit from the Banking Union has shown that membership in the Banking Union could make a difference. So why do we not consider doing the same in Poland?
So, these are issues that are on the table and that we need to address, with or without the Brits.

But of course Brexit is now confronting us with wholly new challenges. In general, with Brexit, there will be a loss of integration, a risk of fragmentation, a tendency to go for the creation of regional hubs, hopefully with a global mind set. Following Brexit, some loss of the integration between the EU and the UK is obvious. With Brexit and the likely rise of continental hubs comes the risk of going back toward the way of national thinking and making choices. We will have to avoid it. The Union has the chance to ensure its seat at the global table and we must have our mind set on this goal.

Since the 2008 crisis we have been investing heavily in reducing fragmentation, not only within the EU but also across the Atlantic and globally. In the years to come we can assume that the EU will continue moving in this direction, minimising fragmentation and seeing the benefits of European solutions. We have to accelerate the investment in financial markets integrity, harmonization of rules, enforcement of rules and consistent supervision without, at the same time, increasing too much bureaucratic requirements that might have devastating impact on capital markets.

Brexit creates risks that we need to address. The most important of these risks is in the area of clearing. A CCP such as LCH, which is clearing over 98% of interest rates derivatives denominated in euros, might overnight lose access to the EU market and not be able to serve clients and members in the Union any more. This would result in major disruptions on financial markets. The same goes true with UK trading venues that will no longer be able to serve EU clients.

And we also have a significant, horizontal risk of long-term contracts. An example here can be derivative contracts or insurance contracts that have been lawfully concluded under the passporting regime. There is a risk after Brexit that their validity will be questioned, and time will be too short to look at the contracts one by one. A solution has to be found.

I know EIOPA is examining this issue and the Commission is also looking at what can be done to address it. The best outcome in an ideal world would be to find a horizontal solution that will deal with those contracts once and for all, may be through some kind of grandfathering or mutual recognition. Another solution is to work by category of contracts and transfer outstanding contracts, category per category, to a subsidiary established in the EU 27. It seems in any case that, to some extent, it will be for firms to look into their contracts and address the issue. But there is no simple solution.

As you know we have moved recently to the second phase of Brexit negotiations when the withdrawal and transition agreement will have to be agreed and finalized and the discussion on the future framework for the EU - UK bilateral agreement should lead to an agreement on its general framework. We should finish these tasks by October this year.

We also have to reflect seriously and, actually, have a contingency plan for a no deal scenario. In the withdrawal agreement there will rather be nothing on the financial sector which will move to the transition period on the grounds of status quo. UK will maintain all the rights and obligations of the member state without the right to participate in the institutional frameworks and decision making process.

I said before that financial services are heavily depending on regulation, and the EU market is very integrated. It is also strictly supervised. This regulatory and prudential dimensions of financial services put clear limits to what can be achieved in this area through a Free Trade Agreement.

On financial services, what we will need is a form of regulatory cooperation, concerning the design of the rules and regulations, and supervisory cooperation, concerning the application of the rules.

And we have no example of sufficiently far reaching provisions on regulatory cooperation in Free Trade Agreements. In CETA, we have provisions only on establishment, not on market access. In TTIP, we discussed regulatory dialogue but at no moment we could go any further.

So, it seems that we will have to try to work first and foremost on the basis of equivalence and third country provisions in existing EU legislation. The problem is that those provisions have never been designed for a situation where such a significant share of activities that are and will be important for the financial stability of the Union will be done outside the Union.
Equivalence is unilateral, revocable at any time, so does not offer certainty from the UK perspective. From the Union perspective, the equivalence regime is also, in cases such as this of CCPs, too reliant on third country supervisors to ensure the financial stability of the Union. Equivalence is also made on a case-by-case basis, for each piece of legislation, and then recognition decisions are made at the firm level, while with Brexit it will be the whole financial system of a whole country that will have to be assessed.

Also, usually the monitoring and enforcement of the ongoing compliance with the conditions for equivalence is rather limited. This characteristic again appears to make equivalence not a perfect fit for the Brexit situation. With Brexit we will have a case where the frameworks will be identical at the point of departure and might diverge thereafter. So equivalence as a mechanism will need to be strengthened. This means that, although equivalence is a better starting point than a Free Trade Agreement, if we take equivalence as a basis for our future cooperation framework, equivalence provisions in all pieces of legislation have to be reviewed on a case-by-case basis and be either clarified or amended.

This work has started. It has two facets: clarification of the existing legislation and review of critical pieces of legislation. The Commission and all European supervisory authorities have already worked on clarifying existing legislation in light of Brexit, for instance as regards the treatment of third country branches and the ways of avoiding the creation of empty shells. ESMA and EBA have been issuing guidance on the application of legislation relating to banking and asset management, such as MiFiD, the Alternative Investment Funds Directive, or the Undertakings for Collective Investments in

Transferable Securities (UCITS). The Commission will shortly be issuing a series of notices on the application of rules concerning bankers, insurers, asset managers and credit rating agencies. I would like to encourage you to follow the Commission website in this context.

Then, another challenge and need is an overhaul of equivalence provisions in relevant legislation. Very clearly the priority for the Commission has been to address the risks related to an improper supervision of CCPs. The new Commission proposal issued in June last year proposes a two-tier framework in which ESMA would enjoy over those third country CCPs that are systemic for the Union the same powers it has over trade repositories and credit rating agencies. This would ensure a better monitoring of those institutions.

The review of the European Market Infrastructure Regulation will also provide an insurance mechanism in case of a disruptive Brexit or wide divergences of the regulatory framework. It will give the possibility to the Commission, working on the basis of an assessment by ESMA and by the relevant central bank, to adopt an implementing act denying recognition to a third country CCP that would be too systemic for the Union financial markets and requiring the CCP to register directly in the Union in order to provide clearing services.

Another area where the Commission is currently proposing to review the third country framework is this of investment firms, since these firms are mostly based in the UK and, without being regulated like banks in the EU-27, are conducting bank-like activities and taking risks similar to banks. The Commission has issued in December a new proposal carving out the investment firms from the Capital Requirements Regulation applying to banks and creating a bespoke regime that will include third country provisions.

On the rest of financial services legislation, the Commission seems to be still in an assessment mode. One cannot exclude in the future a review of the MiFiD third country provisions once more experience with the application of the legislation has been gained. Actually I cannot see anything else as a priority.

I mentioned the challenge concerning specific contingency planning and preparedness for Brexit. I thought here about the responsibility to adapt which lies with the firms. There are contingency plans that are required from firms by supervisors. In this regard, not all firms are at the same level of preparedness, with large US firms being the best prepared and small firms in general lagging behind.

What we can expect is that this contingency planning will involve decisions on relocation of activities, application for new licences or for the extension of existing licences, adjustment of booking models, transformation of EU branches into third country branches.

And, as regard preparedness it is crucial to say that any transition period should be used to the fullest extent. Transition will be useless if it is seen as two more years left for firms to do nothing.

And the last point I would like to mention in relation to Brexit is the risk, for countries like Poland that do not share the euro as their currency, of marginalisation. The UK was the leader of the non-euro group. Without the UK, euro area member represent an overwhelming majority of EU GDP, around 85%. Non-euros are a group of small or medium-sized economies, with little unity as there are very large differences between the Scandinavian countries and those from Central and Eastern Europe that do not yet meet the convergence criteria. In some of them there are euro sceptical political elites at power that do not understand the risks of staying outside.

But to conclude about Brexit, I would like to emphasize that it should not distract us from completing the CMU and the Banking Union. One can look at Brexit as an opportunity for the EU 27 to speed up the development of its financial markets and also improve its resilience to shocks. The CMU is in essence a single market project, about facilitation of cross border investment and bringing down of barriers. Therefore, if we embrace it, this could be a beneficial project for countries in this part of Europe, from which we would all stand to gain.

As a last point, let me touch on the issue of the future of financial supervision in the Union. The current process of review of the ESAs is very clearly related to Brexit as the role of the ESAs will be crucial during and after Brexit. Strong ESAs are indispensable to prevent and mitigate the risks to financial stability in the context of Brexit.

The role of the ESAs will be, as they have already started to do, to deliver their Brexit opinions, to act to prevent fragmentation and regulatory race to the bottom after Brexit. There will be a very strong pressure for regulatory arbitrage and for countries to change their frameworks in order to attract activity after Brexit and incentives to cooperate might weaken. So strong ESAs will be important.

They will have to perform the ongoing assessment and enforcement of compliance with the conditions for equivalence that we currently miss and that we will need after Brexit. The ESAs can also help design harmonised templates for memoranda of understanding so that national authorities do not feel overwhelmed by their UK partners.

We also need to have strong authorities in order to dialogue with the UK supervisor on an equal footing and, more generally, we need the ESAs to be credible at the global level and help push EU priorities.

Today the ESAs are doing a very good job, but their governance is complex, with a lot of consensus required. As a result, ESAs have a hard time coping with powers of the national authorities. We need a much better balance, with a stronger European dimension of the system without losing too much of the expertise of local regulators. We need a stronger governance of each ESA. We need more staff and funding for the ESAs and in particular we need a stable and larger funding base for the ESAs since the budget will be reduced after the departure of the UK.

Let me, however, stress here that a review of the European system for financial supervision was due for this year anyway. So reflection on the future of the ESAs was bound to have taken place in any case, even if it is now taking place in a different context and with challenges different than those we would have imagined. With the review of EMIR as regards the supervision of CCPs, and now with the review of the ESAs, we are looking into all essential elements of the system established after the 2009 crisis.

The Commission proposal of the review of the structure of the three institutions established after the crisis: ESMA for securities markets, EBA for banks and EIOPA for insurance and pensions goes in the direction of more centralisation and more effective governance arrangements. It proposes a stronger coordination of supervision across the EU by the ESAs. The ESAs would set EU-wide supervisory priorities, check the consistency of the work programmes of individual supervisory authorities with EU priorities and review their implementation. They will monitor authorities' practices in allowing market players - such as banks, fund managers and investment firms - to delegate and outsource business functions to non-EU countries, to ensure that risks are properly managed and to prevent circumventions of the rules. In addition, EIOPA will have a stronger role in promoting convergence in the validation of the internal models that some large insurance companies use to calculate requirements on solvency capital. This will help overcome fragmentation and ensure better supervision of the large cross-border insurance groups. Finally, the functioning of the ESRB will be made more efficient in order to strengthen its oversight of risks for the financial system as a whole.

Moreover, ESMA will become also a direct supervisor over certain sectors of capital markets across the EU such as capital market data providers, benchmark administrators, certain investment funds. It would also have a stronger role in prospectus approvals and market abuse investigations.

As regards the governance and funding of the ESAs, the intention is to make the ESAs governance more effective, with newly-created Executive Boards with permanent members that will replace the management boards and lead to quicker, more streamlined and EU-oriented decisions. Moreover, interested parties will be able to ask the Commission to intervene if the majority consider that the ESAs have exceeded their competences when issuing guidelines or recommendations. The reform will also make the funding of the ESAs more independent from national supervisors in order to guarantee that the ESAs have improved autonomy and independence. While the EU budget will continue to contribute a share of the ESAs' funding, the rest will be funded by contributions from the financial sector.

Finally, the ESAs will be required to look better into environmental issues and financial innovation, so into what we can assume be developments relevant to the future. The proposal will make the promotion of sustainable finance part of the mandate of the ESAs, asking them to take account of environmental, social and governance-related factors and risks in all the tasks they perform. The ESAs will prioritise FinTech and will coordinate national initiatives to promote innovation and strengthen cybersecurity. They will take account of technological innovation in all the tasks they perform.

In the European Parliament, discussions have just begun. The two co-rapporteurs, have released a working document, with a long list of questions they plan to address, and we have held a first debate on the ESAs review last week. The intention seems to be to finalise the report before the end of the legislature.

In the Council, talks have begun, to my knowledge, and what we feel from Member States as well as from the industry is that there is a sort of backlash against the pro-European approach taken by the Commission. The complaint is that the impact assessment of the proposal is not clear enough and that the need for moving supervision to the EU level is not sufficiently justified because there is no proof that the current system does not work. And here we are only discussing the centralisation of new powers given to national authorities on the occasion of recently passed pieces of legislation such as the benchmarks regulation, MiFiD II or the prospectus regulation. We are not discussing the centralisation of powers that national authorities have had for longer periods of time.

So I can say that debates on the ESAs review are going to be difficult, to say the least, and be with us for some time.
I will conclude by saying that a more integrated supervisory framework is the way to go, as far as possible, and finding the appropriate level of decision-making will be key.

I would like to conclude by a small warning in this respect: when trying to achieve this delicate balance between the EU and the national level, we should be mindful of not introducing too much complexity.