BREXIT IMPACTS AND GLOBAL REGULATORY COORDINATION

Are the contours of the of future EU-UK financial services trade relationship in sight?

1. The remaining options for EU-UK financial services relations post-Brexit

1.1. The UK proposals of the July 2018 White Paper

An official noted that there has been a shift in some of the UK proposals in July 2018. The UK had previously proposed having an arrangement of mutual recognition with the EU for financial services, which it considered to be the most stable and predictable way to manage the UK-EU relationship. By July it had become clear that the UK did not have enough EU support for it to be in a negotiating position that would move sufficiently swiftly. The UK White Paper published in July states that the UK will provide an arrangement that recognises the sovereign processes for the assessment of equivalence that would exist in each jurisdiction after its departure from the EU. In the EU, there are existing processes for equivalence decisions and the UK will have to develop its own sovereign decision-making process on equivalence. This approach will provide the UK and the EU with access to each other's jurisdictions in a way that is sound and transparent and that addresses financial stability concerns as well as the scale of the exposure between the two jurisdictions.

The reason why the UK thinks that it can live with this shift in its position is that the other components of the proposal have not changed, the official underlined. The UK continues to advocate a deep and developed regulatory dialogue between itself and the EU, which is still part of the proposition. Supervisory cooperation allowing e.g. the sharing of information appropriately and cooperation if a crisis arises is indeed essential with the scale of business happening between the EU and the UK, because regulations alone cannot determine an appropriate outcome for both jurisdictions. The EU already has successful dialogues up and running with other major jurisdictions and the same will need to be fixed with the UK, possibly with greater intensity.

For equivalence to work, clarity is also needed for market participants regarding the way equivalence decisions are made and how they may be withdrawn. The predictability of the process is indeed an important factor for ensuring that equivalence can support a substantial quantity of business. Autonomy is also a very important point. The UK does not envisage any supranational authority that would arbitrate decisions in the event of disagreement between the EU and the UK. Appeals about these decisions would be made within each regime i.e. the Supreme Court in the UK and the European Court of Justice in Europe. Thought is needed in addition about the scope of the equivalence regimes, which do not exist for all EU financial regulations since they were never intended for a relationship as developed as the one between the UK and the EU.

Regarding possible other options, the official explained that the White Paper is the only remaining proposal on the table on the UK side, the alternative being a hard Brexit. A hard Brexit in financial services is absolutely not the UK's preferred scenario but it is essential to prepare for it, given its potential impacts on the UK and global markets. In order to ensure continuity in regulatory requirements the UK is on shoring the entire EU acquis into UK law so that there are no differences in the requirements and the compliance of firms between March 29th and April 1st in the UK.

An industry representative felt that although significant progress has been made in the discussions about Brexit, the existing EU equivalence regime would not work for the private sector as it will provide insufficient certainty. Not all EU directives are drafted with equivalence regimes and those that are were not drafted for this purpose. The most important problem is that equivalence can be withdrawn at short notice. The EU should keep the right to withdraw equivalence, but this should not be possible without a notice period because removing this certainty overnight could make the situation worse and this issue is not addressed in the directives. The official emphasized that the predictability provided by existing equivalence arrangements is largely untested and agreed that serious thought is needed about how to ensure this. The use of equivalence arrangements will have major impacts on the business models of UK-based financial institutions because of the scale of the business involved between the UK and the EU and these impacts need to be appropriately anticipated and addressed.

1.2. The EU's position on future EU-UK financial services relations post-Brexit

A policy-maker stated that the EU has been quite clear as to how it sees EU-UK relations going forward. It does not see mutual recognition as the way forward; instead, there would be three components in the relationship. Firstly, there would be a free-trade agreement component, similar to the one the EU has with other countries such as Canada and Japan. The second component is regulatory dialogue, with the likelihood that a more intensive dialogue will be needed with the UK than those that already exist with other third-countries. And thirdly, the EU has a preference for using equivalence as the tool with which to handle interactions with third countries. The UK will have its own equivalence regime following the White Paper proposition, so how the EU and UK regimes fit together will need to be assessed.

There are many areas of convergence between the EU approach and the White Paper, the policy-maker remarked. Equivalence is the basis in both cases and there is an agreement on both sides to keep autonomy in rule-making and decision-making. There is also an agreement to pursue a full and intense regulatory dialogue and to put in place the structures needed for this to happen.

Where there is more reluctance on the EU side concerns the suggestions made by the UK to add certain formalistic elements to equivalence, such as a specified timeline for withdrawal. Abrupt decisions concerning equivalence will be highly costly, so there is a type of "auto control" on this that would prevent unecessary sudden withdrawal. Many of the other enhancements to equivalence which are being suggested in the White Paper cannot be accepted by the EU either. The EU is not convinced that binding dispute-settlement processes are necessary for example. The current EU equivalence system is successfully used with other third countries such as Japan or the US and should therefore be workable for the UK. The policy-maker added that the EU is now at the end of its proposal phase for this particular cycle and has to prepare for the European elections. It is therefore difficult to see further proposals about enhancing equivalence in this mandate, beyond what has already been proposed in EMIR 2.2. Another issue is that if further proposals were made, their implications for all other third-country equivalence partners would have to be examined, since these changes cannot be made specifically for the UK or related to Brexit.

A market observer believed that the main implication of Brexit for the EU27 in the financial area is the need to ensure financial stability over time and the only way to achieve this is the current equivalence regime. The EU regulatory and supervisory framework is closely integrated with common rulebooks, the European supervisory authorities (EBA, ESMA, EIOPA, and the ESRB) and the role played by the ECJ. For the euro area the Banking Union has moreover been created, but part of the euro market is in London and outside the jurisdiction of the ECB. Before Brexit the EU felt it could live with that situation because the UK was part of the EU framework in place, but a new approach will be needed post-Brexit. Procedures and commitments proposed in the White Paper that may challenge the autonomy of EU decisions are problematic in this regard because if there is an abrupt financial stability problem threatening the EU, then immediate action is needed to change, reduce the scope or discontinue equivalence. Equivalence must remain unilateral, not only in principle but also in practice and the EU authorities cannot be tied by any commitments with regard to these agreements. This does not mean that predictability and transparency cannot be improved, for instance with a better monitoring over time of the evolution of the regulatory frameworks of third countries after they have been considered equivalent. This would help to anticipate and mitigate possible issues and avoid abrupt changes, unless they are absolutely necessary for unforeseen financial stability reasons, but this requires a monitoring framework that does not exist at present.

An official considered that there is potential to increase the transparency of the equivalence processes regarding prerequisites, impediments, potential consequences and decision timelines. Regarding the status of the EU legislative process, there are still more than 30 open dossiers that need processing. However, if equivalence is retained as the basis of the future EU-UK relationship, it is likely that further proposals will be made to enhance it. Examining the detail of the EMIR 2.2 proposal can give a first idea of the nature of those additional elements.

1.3. The need for close supervisory cooperation

An official stated that the EU-UK relationship should remain as close as possible. Detailed assessments of financial stability risks are needed, as well as regular supervisory interactions to ensure effective compliance with regulatory requirements and to avoid divergence over time, which is neither in the interests of the UK nor of the EU. This calls for close supervisory cooperation after a positive equivalence decision has been made and more formal agreements concluded on this between supervisors.

A market observer considered that the framework to implement close supervisory cooperation already exists to a large extent. Supervisory and regulatory cooperation has been considerably strengthened at the global level since the crisis with institutions such as the Financial Stability Board (FSB) and the Basel Committee for Banking Supervision (BCBS). Supervisory colleges also work on a global basis and should be extended to all institutions that need one.

An industry representative concurred with the need for transparent supervisory cooperation. Before and since the crisis there has been close cooperation between the UK PRA and FCA and the Fed and this cooperation should also include other European and domestic supervisory authorities such as the ACPR, BaFin and ECB.

A policy-maker agreed with previous speakers that equivalence agreements should be monitored more closely over time. Equivalence decisions are made in the expectation that rules will remain convergent or become more convergent under G20 arrangements. The fact that private companies are so concerned about predictability suggests however that the sector is expecting and preparing for divergence. In that perspective, Europe will want to maintain its decision making autonomy. The possible financial stability risks associated with the post-Brexit situation with or without a deal also need to be further evaluated, which should be easier now that there is an agreement that equivalence is the only option available. An industry representative pointed out that the private sector is not looking for divergence, because many financial institutions operating in the capital markets are doing so on a global scale and this cannot be done if rules diverge too much. What the private sector is looking for is more certainty and on the contrary the least divergence possible, because that is what is needed to make the financial market operable.

2. Approach for framing and implementing a possible EU-UK agreement

2.1. Approach for framing the agreement legally

An official stated that the obvious legislative vehicle for framing the future EU-UK relationship is the withdrawal agreement, which is about closing out the UK's EU membership. The UK would have within the related treaty an association agreement, a free-trade agreement, or a collection of agreements with the EU that determine the end-state relationship. Indeed, one cannot solely determine the relationship on financial services through the EU acquis and the UK sovereign legislation. What is needed is a structure that draws it together into a framework to ensure coherence and to establish principles and common goals that provide some form of predictability in terms of what the EU and UK are collectively aiming to achieve.

Another official stressed that although there has been a significant shift in the positions to show convergence on the basic option of equivalence for the future state of financial services, the progress on the overall withdrawal agreement is much slower and there is still a risk of having no overall agreement.

An industry representative emphasized that implementation is also a key question and so is how everything will "join together" so that post-Brexit scenarios are actionable. There will be a large amount of work to do after March, but a timetable of different workstreams is needed on which people can agree, sign up to, and implement.

2.2. The need for a transition and implementation period

An official underlined that however prepared the public authorities and private sectors are for a hard exit, it remains a difficult outcome to live with, which is why achieving a withdrawal agreement, getting an implementation period and using that implementation period effectively are essential. In terms of delays, wishful thinking about the Brexit process should be avoided on both sides, because deadlines are not extensible. It is now a matter of UK law to leave the EU on 29 March 2019 and there will be no UK MEPs in the future Parliament.

An industry speaker emphasized that clarity about the transition and implementation periods is essential for the industry. Another industry representative suggested that in terms of implementation a two-step approach is necessary. After reaching a detailed agreement, an implementation period is needed, because the current transition period of one year and nine months looks more like a negotiation period to reach a more detailed framework.

3. Main short and medium-term challenges raised by Brexit in the financial services sector

3.1. Contract continuity issues

An official underlined that in December 2017 the UK had announced that it would establish temporary-permission regimes for its regulators to enable them to help firms over a cliff-edge and allow them to continue to operate smoothly in the UK. Some issues cannot be entirely unilaterally managed however, such as contract continuity in cleared and uncleared derivative markets, insurance, and data, for which there is a need for a bilateral and cooperative solution. A working group between the ECB and the Bank of England has been established to discuss and map out pending contract continuity issues, but it is essential to move now to discussing the solutions that can be achieved between the UK and the EU, to ensure that they work and that unintended consequences are identified and to help clients to plan for these solutions.

A policy-maker stated that the problems associated with a no-deal scenario need to be mapped out before coming forward with solutions and this is currently being done. Solutions should indeed be commensurate with the actual problems that need addressing. When the continuity of contracts was initially examined it looked like a major problem. Further assessments however showed that derivative contracts can be serviced post-Brexit, except for certain events or changes in those contracts. In addition within the 70 million insurance contracts that are potentially concerned by contract continuity issues, a very large number are very short-term.

Despite this, an industry representative was extremely concerned about the enormous level of complexity that has to be handled in a limited timeframe. Although the number of insurance contracts concerned by continuity issues will not be as high as 70 million, these will be the most complex wholesale ones related to the aviation market in particular. These issues potentially impact businesses and households and resolving them will take a great deal of time.

A market observer stated that if a transition period cannot be agreed there will be many operational issues and risks related to contract continuity and repapering in particular. The European Commission must be prepared to enact unilateral equivalence legislation in this case, as the UK has done.

3.2. Liquidity fragmentation and market disruption concerns

An industry representative claimed that their biggest worry in the short-term is fragmentation of liquidity. The largest banks are working on this but the industry as a whole is only as good as its weakest link. It is necessary in particular to ensure that Financial Market Infrastructures (FMIs) have an appropriate Brexit plan in place and that the system is being tested end-to-end. The problem is that there is no one making sure that the whole end-to-end process will work post-Brexit. Entities are making their own adjustments and everybody is hoping that the process will be joined up at the end, but that is unlikely. The priorities before March 2019 are to clarify how liquidity and risk will move post-Brexit, and if the flow between the UK and the EU will be optimal. Arguably many clients of financial institutions are not ready and if an institution is ready but its clients are not, then the appropriate changes to the business will not be made. The key question is what the "forcing function" is to get European corporates to prepare for a hard Brexit.

Another industry representative added that many customers are worrying about market disruption in case of no deal. Some have already taken pre emptive action without knowing the final outcome but it is not clear if they have made the right choices. There are warnings to prepare for a no-deal situation, but for businesses more clarity is needed on what the outcome may be. If the EU and the UK split up and there is regulatory fragmentation, it will increase operational costs for third-country banks and their customers in particular without increasing profitability. Therefore, while Brexit negotiations are bilateral and sovereign between the UK and EU, the cliff-edge and related issues will harm the attractiveness and competitiveness of the whole European market and also impact third country entities. The EU will nevertheless remain a very important market notably for Japan and it is encouraging that an agreement on an economic partnership has been reached between the two. This includes a very strong framework for a financial regulatory dialogue mechanism and it will become bilateral between Japan and the EU27 in the case of a no-deal Brexit.

A market expert noted there will be unavoidable extra costs from Brexit, but hopefully these will be relatively transitory. The level of concentration of the European capital market in London is fairly recent and is the result of the addition of the single market rules and of the euro. This was not the case 25 or 30 years ago, when there were several financial centres in Europe. In the US the landscape is also more decentralised with Chicago and other cities than New York playing a significant role. In recent decades there has also been a large development of markets. If Europe can make a more decentralised market work, there could be a very efficient and open European capital market in 20 years' time despite Brexit.

3.3. Connection with the CMU initiative

Some panellists highlighted the link between the future relationship between the EU and the UK and the Capital Markets Union (CMU) initiative, which is a major objective and challenge for the EU going forward. So far, London has been Europe's main capital market centre, an industry representative underlined, therefore maintaining a close relation between the EU and UK is essential for the CMU. The question going forward however is whether Europe wants a closed and regional European capital market or an open, global market. That will determine the nature of Europe's relationship with areas such as the UK, Asia and the US. The depth of liquidity that Europe will get may be insufficient in a closed market for the purposes of fuelling the European economy given the limited share represented by pension funds in particular. In France and Germany, pension assets are less than 15% of GDP, compared to over

120% of GDP in the US and UK. All major capital markets have developed by being open, and while the private sector wants to contribute developing these markets in the EU, it needs to understand what the plan is.

Another industry representative claimed that an open Europe is needed. Their company has a global booking model which is understood by the main regulators and other European regulators are gradually incorporating this into their thinking.

A policy-maker stated that the CMU will be open, not closed. Openness is possible, as long as Europe can manage financial stability risks in a way that is effective and accountable. An official agreed that the objective should be to achieve an open global market so long as sufficient financial stability safeguards can be put in place.

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Tackling the short-term operational and practical challenges of Brexit

1. Progress made over the last 6 months

1.1. Overall progress made in the preparation for Brexit

An official stated that there has been some progress in areas that can be dealt with unilaterally and in the understanding of the issues at stake. But major risks remain in some key areas such as cleared and uncleared derivatives, insurance and data where further progress has been hindered so far by the underlying politics. The UK government has committed to put in place temporary-permission regimes to ensure that, if there is no transition period and authorisations cannot occur in time, EU firms will be able to continue to operate in the UK under this temporary regime until authorisations can be completed. Those statutory instruments have been laid in Parliament already. Quite soon, the UK will also unilaterally lay statutory instruments on contract continuity to ensure that contracts can continue and EU firms can perform on contracts with UK counterparties, and vice versa. Secondly, there is now a better collective appreciation of the scale and impact of the issues that need tackling. Brexit is something new for the financial sector. Given the size and complexity of the sector in the UK the impacts have been analysed in depth by the UK authorities and market participants also have a better understanding of the implications. In some areas, the public sector will need to take action, the official believed, because the private sector cannot solve all of these issues.

Another official stated that there is a fair degree of convergence about the list of issues that need to be dealt with, including contract continuity, access to CCPs and data-sharing. These issues however have to be analysed with more granularity. The problems are not the same across all financial activities and the most critical ones relate to some insurance and derivative contracts. Further analysis is needed to identify precisely the problems that need addressing as a priority and what is at stake exactly. Detailed assessments on contract continuity in particular are still being conducted by lawyers.

A third official stated that 12 months ago, most questions were about the approach of EU supervisors to authorising firms that were going to come to their country. Cooperation between central banks, the ECB and the ESAs has helped to address the main issues in this respect. Progress is also being made on the assessment of contract continuity issues in the group set up by the Bank of England and ECB. This gives hope that these very complex issues can be appropriately tackled.

An industry representative felt that the main issues that need addressing in the context of a hard Brexit are well identified. The financial industry learned from the crisis that it is incumbent upon them to be well-prepared to serve clients in this context and many discussions are taking place with the public authorities about the types of actions that need to be carried out. The issue however that gives the speaker pause is that, with the persistent uncertainty about the final Brexit scenario, the closer any decision comes to the 29 March the more likely a negative outcome is. The financial industry needs to manage this situation in order to accommodate that uncertainty, but the short amount of time remaining is a major concern.

1.2. Current level of preparation of market participants

An official was concerned about the general speed of adaptations to Brexit in the market. Although progress has been made by the larger financial institutions, other players are on average less advanced. Another official confirmed that the larger firms have made ‘huge’ efforts to prepare for Brexit and should be able to continue providing services with no disruption to their clients whatever the scenario. That will be more challenging in the case of a ‘no deal’ for smaller financial firms or those that provide cross-border services without an establishment on either side of the Channel. However, even if the outcome on 29 March is a ‘no deal’, that would not be the end state. Temporary permissions can be granted and supervisors will be monitoring how the situation is evolving over time. Yet, more needs to be done by certain players. Another official also saw a high level of engagement of insurance firms in the preparation for Brexit, whether they are third-country branches or subsidiaries. This involves an enormous amount of management and operational tasks, but supervisors are concerned that there is still a lack of detail about some of the steps that firms are going to take, particularly in terms of trigger points, dates for decisions and time needed to conduct these actions.

An industry representative stated that, from a private-sector perspective, the issues that need to be tackled in the perspective of Brexit are relatively simple and could easily be resolved if they were dealt with one at a time; the difficulty is that all is coming at once, which causes a significant resource challenge and risks are increasing as time goes by. The speaker’s firm is in the process of obtaining approval for a new subsidiary in Frankfurt that will regroup the business of five existing branches. This process takes more than 6 months and many tasks that need to be undertaken to prepare for Brexit (more than 40%) can only be started once regulatory approval has been obtained for this subsidiary. This includes for example obtaining access to market infrastructures (e.g. SWIFT, BIC, payment systems…). By the time the authorisation has been obtained, less than 6 months will remain to finalize all these actions in case of a no-deal Brexit. But such transfers are complex, involving multiple issues (asset transfers, customer consents, local filings, etc.). In addition, specific delays are fixed in some cases e.g. regarding authorisations to access market infrastructures or the hiring of local staff when people have to respect notice periods. Some special arrangements will need to be put in place by the public authorities for dealing with the remaining issues that cannot be tackled in time by the financial industry, the industry speaker believed, addressing both some technical details and some broader issues. However, such measures should only be temporary.

Another industry representative saw a great deal of 'movement' happening, but was frustrated by the difficulty of actually finalising these changes due to the multiplicity of actions that need performing and the current uncertainty about the final Brexit outcome, which increase the level of risk.

The speaker's firm started its Brexit planning one year ago based on the assumption that there would be a hard Brexit, at a time when that was not the most widely-shared option. Their objective when starting this planning was to ensure that clients could be serviced seamlessly, wherever they are based. This led to planning some specific organisational changes to handle this situation, which are now being put in place. The first one is to create an EU-based bank through the merger and transfer of existing entities, which requires an application process and court procedures that are underway and should be completed by December 2018. The second change is to establish a new investment firm to conduct the activities that cannot be performed within the bank and an application process is also underway for that entity. When considering the amount of work that is required for setting up what is in effect a new bank and a new investment firm, there is a cumulative effect that builds up, which further increases the level of risk. Besides the licensing process, a great deal of ancillary activities are needed that are costly and lengthy to implement: i.e. setting up the systems and the operational capabilities of the entities; repapering clients; connecting to the different market infrastructures; facilities work to renovate and expand offices. There is also a significant HR dimension in the project that is often overlooked, with people that need transferring and responsibilities that need redefining.

1.3. Level of preparation of end-customers

An industry representative stated that most customers have not yet really started their operational preparation for Brexit because the evolution scenario is still uncertain and financial institutions cannot provide definitive answers on the choices that need to be made. In addition, some institutions are still in the process of setting up a subsidiary in the EU, which is the starting point. This uncertainty may have detrimental effects for clients, with some of them wanting to start transferring certain assets for the sake of safety, which might turn out not be the most appropriate ones, thus risking to create further disruption in the market.

Another industry representative added that meetings about Brexit preparations often only address the issues that financial institutions are facing, but rarely what clients need to do in this context. Financial institutions such as the speaker's institution are striving to set up new entities in the EU as quickly as possible and are discussing with their clients the implications of these changes for them. The objective is to repaper clients into new EU entities as soon as they are licensed and set up. Clients have not moved much so far, the speaker confirmed, but they will probably do so when the Brexit date comes closer, which is why moving as fast as possible to create EU entities is essential, as well as monitoring the situation very closely.

A regulator underlined that the major industry players are counting on their banks to help them in the transition process towards Brexit. The problem however is that they are often reticent to make the changes needed for repapering until the Brexit outcome is clearer and banks cannot carry this out without them. This is not an excuse however for the financial industry not to prepare these changes and supervisors are highly mobilised and putting a great deal of pressure on them to do that. More clarity on the Brexit scenario and on a possible transition would greatly facilitate this process but that goes beyond the powers of supervisors.

2. Short-term operational issues and implications for the financial industry and the public authorities

2.1. Contract continuity issues

An official stated that Brexit raises significant issues concerning derivative contracts that may have financial stability implications and for which public-sector action may be needed.

Firstly, there is a notional value of £29 trillion of uncleared derivative contracts between UK and EU firms. It is believed that these contracts will still be executable after Brexit but there is a great degree of uncertainty about whether lifecycle events such as portfolio compression, the rolling of open positions or some types of unwinding can still be performed when they concern EU27 counterparties and involve regulated activities, and what the relevant rules will be. This is a major issue because lifecycle events are essential operations used by firms on a daily basis to manage the risk of their portfolios, adjusting positions and dealing with hedges. Some counterparties have up to 10,000 lifecycle events a month for the totality of their derivative contracts and these concern all types of contracts. In addition, some of these actions are compulsory, such as compression, which is required by law in many jurisdictions and if an option in a contract cannot be exercised, then the position ends up being unhedged. Solutions need to be found, the speaker claimed, because there is no sign of these contracts being novated to any large degree and their size appears to be increasing. Also novation is a complex, contentious and time consuming process, because everybody has to agree.

Secondly, there is a £67 trillion value of cleared derivatives between UK CCPs and EU clearing members that is still growing slightly, a notional £38 trillion of which will continue after the Brexit date. If no public-sector action is taken and if UK CCPs are not recognized as equivalent, the EU clearing members of these CCPs will not be able to fulfil some of their obligations under EMIR post-Brexit (e.g. margin payments related to products that are mandated to be centrally cleared such as interest-rate swaps) and they will face much higher capital charges for that business. If a UK-based CCP sees that a sizeable number of its members may not be able to legally perform their obligations and if the board of that CCP believes it faces sanctions if it continues to offer clearing services in the EU when it has not been recognized to do so, then it will not take those risks anymore. The answer will be to 'off load' EU clients, even if this is not simple and takes time, because a non-EU firm must be found to take over the contract and the amount of time left for those changes is diminishing. Reacting to a remark made by another speaker that a 'deeper' analysis of contract continuity issues is needed in order to identify the real risks at stake and better evaluate their scale, the official stated that while analysis is necessary, it needs to stop at some point because time is running out and solutions need to be found in the next couple of months.

Answering a question from the Chair about the compared level of criticality in the case of a hard Brexit of derivative contracts for which there is a clearing obligation and those for which central clearing is not mandatory, another official confirmed that a distinction needs to be made. Concerning the second category of contracts, for which clearing is not mandated, UK-based CCPs would at least temporarily lose their qualification to clear these contracts with EU counterparties, but they can still be accessed indirectly, possibly in a more costly way. This is not the case of contracts with a clearing obligation, for which the only option will be to conduct the clearing in the EU; relocating these activities is however challenging from an operational point of view particularly if time is limited, despite the existence of a sufficient capacity on the continent to handle them.

A regulator added that there are some fall-back options for uncleared derivatives, including national-level temporary permission regimes, contrary to those for which central clearing is mandatory, which are governed by EMIR and for which domestic regulators have no discretion. The regulator however felt that cleared and uncleared derivative contracts need to be tackled with the same degree of urgency for the sake of simplicity, because the time is too short to handle different classifications. The key issue is not the nature of the contract, but the ability of the counterparties, the CCP or other stakeholders to continue servicing them and the numerous lifecycle events that need to be performed in the course of a contract. Rather than a 'contract-continuity' issue, this is a 'contract-servicing-capability-continuity' challenge. Two extra years or so would be needed to solve the problems related to these contracts, which require a general transitional exemption, the regulator believed. Indeed, nobody would want to employ 'blunt' forbearance which is the only other alternative. The first official added that forbearance is not only undesirable but it would not work, because there is no provision in the EU for no-action letters such as those that exist in the US, therefore market participants would not be provided with a sufficient degree of certainty.

A third official agreed that certain temporary solutions might be necessary, but they should not be seen as an excuse for industry participants not to fulfil their responsibilities in terms of preparation.

An industry representative underlined that the practical approach to Brexit for financial institutions is to transfer assets to the EU. This cannot wait for measures to be taken by the public authorities, because ensuring continuity of service for customers is essential. At present the transfers that are envisaged are limited to derivative portfolios, which is manageable. However, other financial products may be concerned, such as loans and deposits. If such conventional contracts are also exposed to contract continuity uncertainties, the workload will be five or six times greater.

2.2. Other short-term operational issues

An industry representative stressed that data issues in the context of Brexit are significant and need to be fixed, because it is very hard for the private sector to deal with a situation where it cannot share data with a third country. Another industry representative explained that the UK will be compliant with EU data protection law on the date of Brexit, but its status as a third-country may jeopardise cross-border data flows from the EU27 (e.g. used for KYC processes). To ensure that data can be transferred to the UK seamlessly, cooperation is needed between banks and the authorities. An official agreed that data is a matter for concern. This problem needs to be solved horizontally, because it applies to a wide range of issues.

Another official suggested that some other issues need addressing, such as differences across Member States in the way the MiFID third-country regime and the related processes are implemented.

3. Role of the public authorities and actions expected from the financial industry

3.1. Role of domestic supervisors

A regulator stated that supervisors are called upon to take action on three levels in the Brexit context.

The first is operational supervision, which includes interacting with individual financial institutions that want to relocate to the EU to secure passporting rights. Discussions were initially mostly about principles and intentions, but as the deadline is approaching and the probability of a no-deal scenario is increasing, they are moving into much more practical areas such as the necessary headcount in risk management departments in particular subsidiaries. There is no existing 'text-book' approach to deal with these issues. This requires creating new standards and using a more iterative and flexible approach than the traditional supervisory processes, which is a challenge for supervisors. The second level is defining how to approach broader questions such as contract continuity and data transfer from a supervisory standpoint. This notably requires memoranda of understanding (MOUs) to be drafted or amended in order to ensure on-going operational co-operation between UK and EU supervisors, because whatever the status of the UK going forward, supervisors will need to liaise on these questions. Clearing and contract continuity are two issues that cannot be solved unilaterally; they require collective action, preferably European action to provide the degree of legal certainty and stability needed, as there is an obvious potential financial stability threat in this space that needs to be tackled. The three ESAs have a very important role to play in establishing a framework for MOUs on a multilateral basis in particular. The third, and most political, level is the advisory role regarding the broader legal framework going forward. Anticipating the possible impacts of an EU-UK agreement based on equivalence or another concept is very difficult. A transitional agreement would give the industry more time to plan ahead, but it is not the role of regulators to define this and putting forward solutions such as permanent contract continuity would circumvent Brexit, which was a democratic decision. The role of regulators is to mitigate financial stability risk in the immediate vicinity of a cliff-edge situation and the role of the financial industry and its clients is to prepare for this situation.

An official agreed that it is not the job of regulators, but of governments, to 'fix' the Brexit negotiations. Regulators have to deal with the transition, whatever it is, or with the implications and risks of having no transition. Secondly, anything that can be solved unilaterally by the UK already has been. Some problems could be solved by joint unilateral action, rather than bilateral action in a treaty. If there is no deal and no transition, there will need to be MOUs and co-operation agreements between the EU and the UK. Such a sharing of confidential information already exists with jurisdictions such as the US, Switzerland, Japan and China for deciding what the split of supervisory functions should be in relation both to branches and subsidiaries and what may happen in resolution. These arrangements are normal co-operation arrangements between third countries on the supervision of cross-border firms. However, the way this would be approached in the Brexit context has not yet been discussed because it is not yet known whether possible MOUs would be part of an overall deal between the EU and the UK or whether they would just be ordinary supervisory cooperation arrangements between third countries such as those mentioned previously. In any case such arrangements are needed to handle a worst-case scenario, because otherwise it would be very difficult even to allow EU firms to operate in the UK. This is a matter of normal best practice that needs to be dealt with quickly.

Another official stressed that there is much focus of the public authorities and the industry on what may happen at the moment of Brexit and how to mitigate risks and issues related to that, but what might happen afterwards also needs anticipating and there should be no complacency about that.

3.2. Further actions expected from market participants

An official stated that given the uncertainty, elaborating detailed contingency plans is essential. At present the best guess is either that a transition will be granted in the context of a hard Brexit or that there will be no agreement. In the second case it is very difficult to anticipate the outcome and the EU authorities have said that they would not intervene proactively to solve possible contract continuity issues. Everything should therefore be done to identify precisely in the contingency plans what needs to be put in place in case of a no-deal situation. Discussions over the past weeks indicate that financial intermediaries have started on-boarding clients to their EU-based entities. This is a critical step that needs to be addressed now.

A regulator added that uncertainty is not a reason to 'wait and see'; on the contrary, if market participants are hoping for a contribution from the public sector, then the best way to make their case is first to solve as many issues as possible themselves. That means that the contingency plans that they are working on have to be amplified and executed to the largest extent. There is a question of resources and of timing. Given the challenge this represents, it is essential that all the necessary resources are mobilised in order to react as quickly as possible. This is what supervisors are doing and the same is expected from the private sector.

Another official emphasised that a hope or expectation that public authorities will step in is no excuse for firms not to do everything that they need to do, with the required level of detail. The public authorities are conscious of the potential issues raised by a no-deal outcome and also of their responsibilities in relation to financial stability. However, financial firms remain responsible for taking their contingency plans forward, making sure that these are defined with a sufficient level of detail and granularity, and that they are not just focused on the date of Brexit, but also consider subsequent issues.

An industry representative agreed that the industry needs to commit whatever resources are necessary to address these problems. While there are other key regulatory issues to address for banks such as the impacts on their capital requirements, the main concern at this point is the systemic and cliff-edge risk that might be generated if something goes wrong in the Brexit context.

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Addressing increasing financial fragmentation at the global level

Following the 2008 crisis, global cooperation on financial regulation has become increasingly important over the last decade to achieve a resilient financial system. In 2009, the G20 launched a comprehensive programme of reforms, coordinated through the Financial Stability Board (FSB), to increase the resilience of the global financial system while preserving its open and integrated structure. Timely and consistent implementation of these reforms is essential to achieve sustainable growth.

However, global regulatory cooperation is declining and financial fragmentation is worsening in some areas at a time when emerging risks (e.g. cyber risk, crypto assets) require a continued need for global consistent standards. In this context, ways forward were proposed for improving the consistent implementation of global standards.

1. Global activity is slowing down and financial fragmentation is worsening in some areas

1.1. There are good and bad reasons for the slowdown in global regulatory activity

A regulator emphasised that global regulatory activity is naturally slowing down because a great deal has now been addressed, for example in relation to Basel III, which is seen as a significant milestone. However, activity is also slowing down because the world has become, geopolitically, a much more complicated place for regulators over the last few years. There is a feeling that the world is no longer post-crisis but instead pre-crisis, and that it is probably closer to the next crisis than it is to the last. The regulatory engine is sputtering and, as such, the importance of supervision as opposed to regulation is rising dramatically. Even if it is the case that regulation will help with the next crisis, regulators are having trouble keeping the global engine running.

There are therefore both good and bad reasons for the slowdown in activity. Some of the reasons are perceived as being very frustrating in terms of politics interfering as never before in the structure of financial markets. It may be the case that everything in life is political but it can be difficult to understand why technical equivalence should be explicitly politically decided and why regulators seem to have built an incredibly 'baroque' piece of architecture around equivalence. A simpler approach to the global regulatory architecture may be required, particularly because re-nationalising market systems and pools of liquidity processes will leave the world in a poorer place and will not help in preventing and managing the next crisis. After that crisis occurs, politicians will ask the regulators what they were doing and they cannot afford to say that they had stopped trying. It is the regulators' job to keep trying because, as long as there is still a global financial system, it is their job to protect it and keep it safe.

1.2. The Basel Committee on Banking Supervision (BCBS) agenda

An official stated that very little is currently on the BCBS policy agenda. Currently, the main topics are market risk and the fundamental review of the trading book. There is a great deal of incentive to finish with those topics by the end of the year, and they are moving in the right direction.

A very minor, but important, remaining policy issue is the leverage ratio and whether it should recognise client initial margin for banks that provide client clearing services. This is a cross-sectoral issue and the BCBS has worked closely with the International Organization of Securities Commissions (IOSCO) and the Committee on Payments and Market Infrastructures (CPMI), as well as with the Commodity Futures Trading Commission (CFTC) where the leadership shown by Chairman J Christopher Giancarlo's staff has been recognised. The BCBS appreciates that there is more to regulation than banking, and it does take into account payment systems, securities market regulation and insurance.

The BCBS also understands the mandate of the other standard setters and hopes that there is a true appreciation for its own mandate. A great deal of work has gone somewhat unnoticed in the past, for example around the margin requirements that the BCBS worked on with IOSCO, formulating the capital rules for bank exposure to central counterparties (CCPs) and minimum amounts of capital banks are required to maintain against such exposures. This cross-sectoral work is important in any discussion relating to fragmentation.

Promoting full, timely and consistent implementation of the Basel Committee's post-crisis reforms; evaluating the effectiveness and impact of its post-crisis reforms, as they are implemented; and monitoring the emerging risks are three key areas which are high on the BCBS' agenda:

- The first is the full, timely and consistent implementation of the rules, without which the rules themselves are useless. The BCBS has a very formal process to follow up on implementation to see if jurisdictions are indeed implementing the global standards in a full, timely and consistent basis. There seems to have been some deceleration in that regard. In particular, in a few large jurisdictions the net stable funding ratio (NSFR) is not in place nor is the standardised approach for counterparty credit risk. This is because the rules are complex and there is a bandwidth problem for some jurisdictions making it difficult for the national regulators to transpose the rules into national law, rules and regulations. The complexity of the rules means that there are difficulties in ensuring that the standards that the BCBS produce are understandable and operational. Standards, in some cases, sound good from a technical perspective but it is then difficult to put them in place at the operational level. Forward momentum in this regard needs to be maintained.
- The second element is to look at the new standards once the rules are in place, including the leverage ratio, the liquidity coverage ratio, the net stable funding ratio, buffers and a revamped large exposure framework, and to ask what the original objective was, what risks were to be addressed and whether that objective has been met and whether those risks have been addressed. This has to be done from a position of analysis and of data. The concern is that a significant portion of the Basel III framework has still not been implemented. There is concern that there will be significant regulatory rollback. This may not come to pass, but there is also a concern as to whether or not countries will put the rules in place as and when agreed. The BCBS continues to pay close attention to this. This does not mean that everything will be reopened for discussion but rather that the impact of the rules will be assessed once in place.
- The third area is the monitoring of emerging risks. The BCBS is paying very close attention to cyber risk, fintech and to cryptoassets, though they are more supervisory as opposed to regulatory issues. The distinction between regulation and supervision is a critical one. Not everything needs to be regulated and often the better response is a supervisory one.

There is a question as to what the landscape for the banks will look like with these new standards and what behavioural changes will emerge as a result. If banks are not meeting the letter and the spirit and the intent of the rules, consideration would need to be given as to whether a regulatory response is required. Such a response is often difficult and painstaking, such that a supervisory response may be preferable. One particular issue that is being looked at is the window dressing of the leverage ratio and how best to respond to it.

1.3. Some pieces of the regulatory agenda have promoted fragmentation

An industry speaker stated that some pieces of the reform agenda have actually promoted fragmentation such as the complex of rules around recovery and resolution, which have led to ring-fencing, trapped capital and mandates on entity structure. This is understandable because of the concern of firms operating globally but dying locally and the burden that that puts on national authorities and national central banks, but it has naturally led to a set of rules that now inhibit globalisation and that have created fragmentation. An optimistic perspective is that the dialogue that has emerged from the new complex of rules, particularly between the Federal Deposit Insurance Corporation (FDIC) and the Bank of England, is contributing towards more of a supervisory approach rather than a hard rules-based approach.

Another industry speaker highlighted issues around the Intermediate EU Parent Undertaking (IPU) proposal, which requires banks to establish intermediate holding companies and to consolidate all of the EU entities under one holding company. The speaker felt that this proposal does not take into consideration existing ownership or governance structures. The European Commission explains that this will allow for enhanced supervision of non-EU globally systemically important banks (G-SIBs) and for strengthened resolution planning of EU operations of the non-EU G-SIBs. Though these policy rationales are appreciated, it is believed that this proposal will inevitably create fragmentation of capital and liquidity and will lead to reduced operational efficiency. Furthermore, in the context of financial stability, the IPU would undermine the recovery and resolution planning of non-EU G-SIBs. Breaking up the global value chain into regional pieces will not maximise a bank's franchise value but rather create sub-scale non-self-contained operations in a crisis situation. It is also believed that it will undermine global efforts of the cross-border resolution under single point of entry strategies. Ultimately, the IPU could result in reduced efficiency and reduced flexibility in resolution planning. Therefore, global co-ordination is required in this area.

In response to the above concern, a policy-maker stressed that the Commission is not proposing the IPU to be 'nasty' to other jurisdictions. Instead, it was predicated on the belief that it will enhance prudential supervision in the EU and enhance and facilitate resolution. Having said that, the Commission has listened very carefully to what different countries have said throughout the legislative process and progress has been made on a number of issues around legal constraints for banks that have limited footprints in the EU. The Commission believes that, through the co-decision process, there is now a broad consensus on the way forward.

An industry speaker outlined two opposing schools of thought in relation to the fragmentation that the sector is facing. The first is that international standard setting bodies like the BCBS have been working intensely to harmonise rules and regulations for internationally active banks and that there should be appreciation for the fact that many of the key standards in prudential and resolution areas are based on a single internationally aligned framework. The opposing view is that, while key jurisdictions have agreed to international standards, those standards are tweaked in the course of local implementations, resulting in regulatory and market fragmentations. Policy-makers may not be intentionally creating fragmentation but rather that fragmentation occurs as an unintended consequence.

1.4. Financial fragmentation is increasing in the Banking Union

An industry speaker stressed that fragmentation is not only painful for banks but is also inefficient for clients and for the economy at large. In some cases, such as in the new spaces like cyber, it may also be dangerous. While the Eurozone should not necessarily be treated as one jurisdiction, there is concern that the global rules that have been discussed at the Basel table and at the European Commission and that were decided to be implemented are still being implemented at the solo level within each European jurisdiction. Indeed the EU prudential framework does not recognize trans-national groups at the consolidated level but as a sum of separate subsidiaries ("solo approach"). This approach maintains a domestic focus in the way prudential requirements (capital, liquidity leverage, MRELs) are imposed on banking subsidiaries across the Eurozone which is inconsistent with the notion of a banking union.

A policy-maker concurred that there is indeed still a significant amount of fragmentation within the EU and even within the Eurozone in spite of the Banking Union. The Commission deplores this situation and is doing its best to change it. Progress is being made, albeit slowly. A particular obstacle is that Member States have national policy objectives that may run counter to the Commission's efforts to promote integration, for example in relation to consumer protection or the question of who foots the bill in case of a crisis. It should be recognised that many politicians and regulators have been traumatised by the crisis and that that paradigm still remains, even more so at the international level. Regulators need to be realistic in terms of what can be achieved with regards to open markets at the international level. Ultimately, the Commission believes in open markets.

1.5. The global trade repository system is also fragmented, which hinders the transparency in the market pace

An industry speaker highlighted that there has been a recent increase in the number of trade repositories in the world, from 29 to at least 33 or 34. A promise that came out of G20 Pittsburgh was transparency in the marketplace by way of global trade repositories in each asset class reporting to each of the regulators so that they could see where the risks are and how the risks are moving across the globe. This, however, has not happened. Local trade repositories are still being built based upon local rules. The speaker's firm is working with the global standard setters, including the Financial Stability Board (FSB), IOSCO, the Commission, the European Securities and Markets Authority (ESMA) and the CFTC, to come up with a set of standards and clear ideas as to what data would be necessary to identify systemic risk. There is some promise there but there is still some way to go.

As such, it is unclear where the next crisis will come from. Without transparency into the marketplace, regulators cannot identify risk building up in a particular area in the markets. It can be identified on the local level and local market regulators do receive fairly good information from the trade repositories but there is no clarity on systemic risk issues.

An industry speaker highlighted the importance of finding a positive way forward. Transparency is very useful, as is engagement with the industry. It is also important that the objectives be kept in mind. Often, regulations are made without a clear view as to what the end state is. Clarity allows for a prioritisation of objectives. Countries prioritising their national policy objectives will hinder harmonisation. However sharing a common objective can lead to movement in the right direction and trust being built between jurisdictions.

Another industry speaker noted the vulnerabilities existing in regulation and that the sector may already be in a pre-crisis situation, and believed that this should be dealt with by focusing on the implementation of existing standards as opposed to creating a new set of standards.

1.6. Brexit is a significant factor in fragmentation

An industry speaker underlined that Brexit is a significant factor in fragmentation. Two extraordinarily important markets are in the midst of deciding whether their future is one of a global market or a fragmented market. One side forced the issue and the other side has to respond. There are policy principles that the Europeans are understandably protecting and defending but, ultimately, the decision that they have to make together in the discussions with the UK is whether their future is a fragmented one or not a fragmented one. Chairman Giancarlo mentioned this in his speech in terms of experience with equivalence determinations on one model of recognition ultimately creating confidence with one national regulator that the regulator in the other market can be allowed to do what they do without second-guessing them and without the extraterritorial imposition of national laws. Ultimately, Brexit will be a significant statement about whether fragmentation is the path that two important markets want to take in terms of very important parts of the global economy.

2. Emerging regulatory issues require a continued need for global consistent standards

2.1. The benefits of global financial markets

Open and integrated markets in financial services, freedom of location of activity and free trade support economic activity and employment.

An industry speaker stressed that the benefits of global co-ordination and standards should be centred around investors, borrowers and consumers and allowing the flow of capital in a way that is reasonably safe and sound. All of those constituents have the right to expect safe and sound banks, markets and resiliency across jurisdictions. This essentially means that money flows from countries that have it to countries that need it. It allows for wealth generation opportunities and it allows for the ability to manage concentration risks and to diversify risk.

2.2. Global regulation is fundamental for emerging issues such as cybersecurity and financial technology

An industry speaker warned that there are a number of emerging issues on the horizon, such as cybersecurity and financial technology, where global co-ordination is fundamental. In particular, a cyberattack can come from anywhere to any jurisdiction. Technology has no border. Collective consideration needs to be given, from a policy perspective, to what the right minimum standards are for all participants in the marketplace, whether that be a central bank, a financial market infrastructure (FMI), a bank or a non-bank. Equally importantly, consideration needs to be given to a co-ordinated approach to assessing that those minimum standards are met and what the consequences would be of a fragmented approach to, for example, penetration testing. Ultimately, a lack of co-ordination can lead not just to operational inefficiency but operational risk and vulnerability, allowing the 'enemy', the people engaged in cyber trouble, to attack banks more effectively. The recent FSB paper on this issue is particularly noteworthy, with 72% of the FSB jurisdictions updating their cyber framework, cyber controls and cyber assessment methodologies. Co-ordination is needed in this area.

The same is true with the new financial technology, whether that be storage, communication or computing, which is leading to disciplines such as machine learning and cloud computing. This technology allows for direct access to investors and consumers across borders and it is therefore essential, with this fast-paced development that is occurring outside the regulatory perimeter, that consideration be given to what policy objectives need to be achieved, whether that be financial stability, consumer protection or investor protection. Collective delivery is required here. It is not only about collaborative and effective rule-writing but it is also about having those discussions. There is private sector expertise and public sector policy intent. This is not about what the rule needs to be but about what it is that the sector is trying to create.

The chair agreed, noting that, once laws are embedded, jurisdictions are unwilling to change them. Now, therefore, is the time to co-ordinate, particularly on cyber issues. However, political understanding is required to achieve this and too often it is a case of 'going it alone' and putting a law into place, sometimes to create a 'first mover' advantage. Ex ante co-ordination is fundamental, without which there will be fragmented laws from different jurisdictions that are impossible to bolt together.

An industry representative underlined that there are both elements that create confidence and elements that create concern, noting that much of what has been achieved in terms of the post-crisis reforms was ultimately designed to give market participants and investors, as well as taxpayers, regulators and government officials, the confidence that the financial system should be allowed to operate and to do what it does best, which is to allocate capital to its best use.

2.3. Steps need to be taken to depoliticise those issues where possible

A regulator stressed that fragmentation can result from regulators believing that they are right and that the others are wrong, instead of combining their approaches. However, regulators need to be aware that they 'do not rule the world'. That power lies with the politicians, and indeed fragmentation can be politically driven or politically desired. Brexit is an example of this. The regulatory and supervisory community cannot be expected to cure politics or to hold it at bay.

It is important to stay in the realm of the possible. A good illustration of this is the issue of cyber risk where some jurisdictions around the G20 table believe that they have been cyberattacked by other jurisdictions. In that light, questions need to asked about whether those jurisdictions will share information with each other. Small steps need to be taken to try to depoliticise the issues where possible, which will help to avoid unnecessary and undesired cost.

2.4. The objective should be to minimise fragmentation

An industry speaker stated that the objective should be to minimise fragmentation, particularly in capital markets because the underlying benefit is enormous with regard to liquidity pools, netting of risk and transparency. It is believed that this should be one of the easiest things for the sector to be aligned around. The Capital Markets Union (CMU) is needed because too much of the economy in Europe is financed by banks. Greater diversification in markets is required.

2.5. The industry has taken a leadership position where there is an opportunity for standardisation

Multiple industry speakers highlighted that the industry has tried to be deeply engaged in where it thinks there is an opportunity for standardisation. For example, the industry has written 10 White Papers in the last couple of years on issues such as cybersecurity, how to standardise data and how to better focus on key issues. The industry has also worked on the financial sector profile in order to outline areas in which consolidation could lead to a more harmonised foundation.

The speakers maintained that the industry has taken a leadership position to try to make certain that it is focused on these issues as well as to make certain that it has the right kinds of standards in place and to standardise the data so that the data can be better used for things such as AI and monitoring and supervision of risks.

3. The way forward for improving the consistent implementation of global standards

3.1. Basic principles for proper mutual recognition and addressing conflicts between national regulations

A public decision maker noted that regulatory fragmentation needs to be addressed, but that this should not necessarily be done via additional regulations. National differences should not be eliminated. Each national authority operates under its own democratic oversight and has responsibility to its own depositors and consumers. Full harmonisation should therefore not be aimed for. However, there are many things that can be done to alleviate unnecessary problems. For example, with regard to the equivalence assessment, there should be a benchmark against an international standard as opposed to individual gold-plating approaches country by country. There should be a focus on outcomes rather than specific methods and approaches to attain them. Basic principles for proper mutual recognition should be agreed.

If domestic regulations are to be produced with explicit extraterritorial elements, it may be good practice to engage with overseas stakeholders at the preparatory stage, possibly in an informal manner, as opposed to simply focusing on domestic constituencies.

This speaker presented a process to address conflicting national regulations and supervisory actions. If a bank is faced with conflicting and incompatible regulatory requirements from two different countries in which it operates, that bank can address the issue with both of the regulators – by submitting a letter describing the conflict to the two regulators- with all the responses being published online. Though this may not necessarily solve the problem, it can draw the regulators' attention to the issues that they are causing. Such a process could be agreed bilaterally or be incorporated in a multilateral memorandum of understanding.

An industry speaker agreed, in principle, with this suggestion but noted that in some places information cannot be shared because it is confidential. Legal impediments, therefore, can hamper transparent discussion and can preclude banks from sharing confidential supervisory information even when faced with contradictory requests from two different regulators.

3.2. Enhancing global equivalence

A regulator stated that, while everything existing in a relationship between jurisdictions has an effect on everything else, there are consequences in complex relationships that may be politically intended but that have negative impacts which go beyond the case in issue. It is extremely negative for jurisdictions to deliberately make it more difficult to access one another's markets despite being well regulated.

The chair agreed but noted that, while there is a supposition of a continuation of global integrated markets, there is in fact a shift towards bilateral determinations of access, which creates a matrix of complexity and which makes no sense. The argument is that this leads to global standards being implemented in inflexible ways.

A policy-maker underlined that, in many areas, international standards have not been sufficiently developed and that there is, therefore, a strong case for relying on equivalence. Though this might be an imperfect system to manage bilateral relationships, much like democracy it remains the best option available, and it creates the possibility for an open market. The policy-maker noted the regulator's concerns above but emphasised that 99.9% of the equivalence assessments are technical, sober and objective. Exceptions might arise but it must be borne in mind that there are issues that are more important than financial regulation.

3.3. Is regulatory and supervisory deference the best way to ensure harmony between regulatory regimes of cross-border markets?

Deference is a regulatory approach that can be applied to swap trading venues, central clearing houses and swap dealers, which expands the use of equivalence and recognition and therefore focuses on achieving comparable regulatory outcomes and not rule-by-rule exactitude.

A regulator cited Chairman Giancarlo's observation that there is currently an important opportunity, which did not exist before and which may not exist in the future, whereby the large swaps markets of the world are intellectually in a similar place. If there is a commitment by all of these swaps jurisdictions to apply the same regulatory approaches, regulatory co-ordination could be achieved in this area of the financial market. This, essentially, is deference, and the opportunity is tantalisingly close.

Deference refers to the tools that jurisdictions use, whether that be equivalence in Europe, substituted compliance or the use of exemptive power in the United States. It is a belief that peer authorities recognise the importance of each other's interests in the markets and therefore say that that authority has responsibility for its market and should set the rules for its market. It also underpins trust. Regulatory and supervisory deference is essentially about whether one authority has the confidence that the other authority, through supervisory power, rule-making, enforcement and other regulatory devices, will safeguard their markets in a way that will achieve the same regulatory outcome.

The chair noted that Chairman Giancarlo had differentiated between domestic issues of market structure and trading on the one hand and, on the other, the stability aspects, which is an important distinction of the scope of deference. In addition, the initial approaches on equivalence were outcome-based and, as such, did not involve a line-by-line examination. Ultimately, it is a political judgement of whether a jurisdiction that is trading swaps in the swaps market with the United States broadly follows the same type of rules.

The regulator was in general agreement with this statement but maintained that outcomes-based deference was not a political decision but a regulatory one. It was accepted, however, that there is more than one way to achieve an outcome. Each jurisdiction has unique legal systems, unique market characteristics and unique institutions. It would be difficult to insist upon exactly identical approaches. Instead, jurisdictions can accept that they each have their own methods that lead in the right direction, which is essentially the goal of a deference based approach. For example, the CFTC's main interest is in the parts of the financial system that have a systemic risk on the US market. In that respect, the case for having the stronger hand of the CFTC is much more legitimate and intuitive. Beyond that, it does not make sense for the CFTC to dictate that other jurisdictions should follow the CFTC's preferred approach.

A policy-maker stated that the Commission has promoted deference in derivatives markets. Looking at outcomes rather than line-by-line analyses of third country legislation is understandable but, for some markets, a word can make a significant difference in terms of competition distortions, in terms of investor protection and, in some cases, in terms of protecting financial stability. For this reason, in the absence of global granular standards, the Commission does not want to take any risks and instead wants to have a very robust equivalence process that indeed should not lead to political decisions as much as possible but only to technical regulatory decisions. That is what the Commission does in the vast majority of cases.

The answer to all of this is promoting granular detailed international standards in the future. Because of this, global co-ordination will become even more important. The Commission is prepared to be active in fostering international co-operation, but this needs to be realistic. Difficulties can be seen in insurance, for example, in terms of building an international standard and determining who is systemic and who is not. There is a great deal of work ahead but the Commission is determined to do this work and to therefore, after some time, get to more open markets.

An official commented that a recently concluded EU/Japan economic partnership agreement (EPA) incorporates close regulatory dialogue in financial regulatory areas. Those EPA clauses are not necessarily binding but it is expected that both the EU and Japan will have a dialogue in the early stage of rule-making rather than after the rule-making, which is a big step in formalising the necessary co-ordination.

4. Conclusion

The chair stressed that there is now an opportunity to develop global co-ordination as much as possible. Jurisdictions should avoid internal regulatory and legal difficulties and should trust each other, exchange ideas and give each other the heads up of where they are going. Ex ante co-ordination would reduce a great deal of the fragmentation that the industry and, eventually, the consumers will have to pay for. Bank resolution still has a long way to go.

It is important to note that Christopher Giancarlo's comments should apply not just to swaps but to other areas as well such as money laundering and terrorist financing, as the same principles apply. This should not be a narrow sectoral discussion but a much broader based discussion on deepening global co-ordination, which could lead to a better world.