Discussion note

The Importance of International Considerations in Pan-European Capital Markets Regulation

Examples of Barriers to Access, Competitiveness and Efficiency

April 2018

Introduction

Capital Markets are an essential driver of economic growth, wealth creation and funding diversification in Europe. Deepening and broadening capital markets provides borrowers and investors access to greater funding diversification and investment choice. This note seeks to promote discussion on the importance of continuing to grow the capacity of European capital markets and to provide initial ideas for how pan-European capital markets can remain globally competitive in a changing environment. These issues apply to all entities and countries operating within geographic Europe – the post-Brexit European Union, the UK, Switzerland and others.

AFME has been a supporter of a wide variety of initiatives in the European Union, UK, Switzerland and elsewhere to identify barriers which restrict the movement of capital and liquidity. These barriers reduce competition and efficiency, create fragmentation, reduce access to capital flows and inhibit cross-border private risk-sharing between both internal markets and across national and market boundaries. A very important initiative to help identify and resolve specific barriers is the European Union's Capital Markets Union (CMU), although there are many initiatives between other global and regional regulatory authorities which also seek to reduce market fragmentation, and identify cross-border barriers to investment, trading, advisory, post-trade and related capital markets services.

AFME fully supported and continues to support the measures set out in the original CMU 2015 Action Plan, but recognises that today's context is markedly changed. The Basel Committee on Banking Supervision has finalised the Basel III framework, completing the last major piece of the regulatory reform programme that was launched in the wake of the financial crisis, while the UK's decision to leave the European Union raises many challenges for capital market participants and supervisors.

As we enter the next phase of the CMU, AFME would urge policymakers to take stock of this new context, the work done so far, and the scope for further progress, and to develop policy measures that balance market resiliency, market integrity and appropriate supervision that ensures the level playing field with keeping Europe's capital markets sufficiently open and competitive to grow their capacity, boost the stimulation of investment, reduce reliance on banks, and create jobs.

Facilitating international investments in the EU

Facilitating international investment was specifically mentioned as an important area of focus in the CMU project.

The Commission argued that:

> "*For EU capital markets to thrive, they will need to be open and globally competitive, and able to attract additional equity and debt investment from international investors. CMU will help to make EU capital markets more attractive to international investors by eliminating legal and administrative cost to cross-*

border operations, and enhancing convergence of supervisory outcomes across Europe. Given the global nature of capital markets, Capital Markets Union must take account of the wider global context and ensure that European capital markets remain an integral part of the international financial system. The Commission will continue to work closely with EU Member States and third countries in international fora such as the FSB and IOSCO to develop convergent policy responses in order to support the development of global capital markets. In addition, the Commission will seek to establish frameworks for regulatory cooperation in financial services with key third countries to strengthen integration of capital markets."[1]

We very much support this objective. Developing the CMU is not an objective in itself but its purpose is to support economic growth in Europe, from both internal and external sources. Maximising efficiencies in the EU's internal capital markets by harmonising standards and removing barriers between EU member states, while vitally important, will only go so far in increasing their capacity. As well as positive steps like the Pan-European Personal Pension Products (PEPP) proposal, which aim to increase EU-based private pensions and insurance savings available for investment in risk capital such as equity and other corporate instruments, to be truly transformative the CMU must also aim to attract additional sources of financial capital. The ability for non-EU sources of financial capital to be deployed within Europe, to aid economic and employment growth, is supported by global financial services firms operating within Europe on the same terms as European institutions – in as similar way as European institutions participate in non-European markets. We agree with the Commission's communication completing the CMU by 2019, published on 8 March 2018, when it says:

"A successful Capital Markets Union also needs to open-up markets to give better access to finance for EU businesses and more and innovative investment opportunities for savers, who today have greater means to understand how their investments are used and a greater appetite for investor choice."[2]

However, as we set out in more detail below, in some cases, recent regulatory steps have introduced new barriers to third-countries intermediaries' participation in Europe's capital markets, which risks shrinking the total pool of available capital and liquidity.

Indeed, between these two steps of the CMU project, the decision of the UK to leave the EU has fundamentally modified the context. The fact that the main financial centre of the EU is about to leave the EU has understandably raised questions about the post-Brexit priorities of CMU, whether they be focused within the growing capital markets capacity of the EU27, including harmonisation and the removal of barriers among member states, or rather the external dimension.

AFME believes that both are possible – to support an improved inter-EU internal dimension be complemented by an external dimension aimed at creating conditions to attract competitive international investment and trading.

Adapting capital markets regulation for a new environment

As acknowledged in the original CMU Action Plan, CMU should be concerned with the identification of barriers and solutions so that "*European capital markets remain an integral part of the international financial system*[3]". However, since the publication of the Action Plan, the decision of the UK to leave the EU has fundamentally modified the context.

[1] European Commission CMU Action Plan (2015), link
[2] European Commission Communication on completing the Capital Markets Union by 2019. link
[3] European Commission CMU Action Plan (2015), link

With Brexit negotiations underway, European Commission Vice-President Dombrovskis has acknowledged that "*Brexit makes completing the [CMU] more challenging, yet more important*"[4]. Brexit will indeed bring certain challenges and uncertainties to Europe's capital markets in the short term. But it can also serve as a catalyst to provide further momentum and ambition to drive the CMU project in the coming years.

Brexit also means that the international dimension of the CMU becomes increasingly important as a topic of reflection.

In addition, since the Commission published the original Action Plan, The Group of Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee on Banking Supervision, has finalised the post-crisis financial regulatory reforms by endorsing a package of amendments to the Basel III framework. While implementation of the Basel framework is in its early stages, and the standards will need to be implemented globally and as consistently as possible to realise the full benefits, the agreement provides a robust global minimum standard that should encourage a level of consistency across markets, avoid regulatory arbitrage, and reduce the possibility of importing financial stability risk from the cross-border provision of services. Greater emphasis on regulatory cooperation and international standards would also make future equivalence decisions easier to achieve, limiting the need for extraterritorial rules which cause market fragmentation and inefficiencies.

Examples of current cross-border regulatory impediments in pan-European capital markets

The European Commission with approval from the EU28 member states and European Parliament, has implemented a wide variety of capital markets and banking regulatory initiatives since the financial crisis. Many of them have an important cross-border aspect. To attract new sources of financial capital and liquidity pools, both from within and outside the EU, it is important to examine whether EU legislation and frameworks create conditions and incentives to attract not only EU firms, but also non-EU firms to participate in EU capital markets or comply with EU-developed standards. Likewise, it is also important to review whether non-EU legislation and frameworks discourage participation in non-EU markets by institutions based in the EU and other third countries.

In an attempt to aid the policy debate, in the sections below we list examples of recent EU regulatory steps that risk introducing new barriers in contradiction with the policy orientation of the initial CMU Action Plan.

- *Simple, Transparent and Standardised (STS) Securitisation Framework*

The Securitisation Regulation and STS framework, CMU's initial large initiative, does not include a third country equivalence regime for potential non-EU STS securitisations. AFME was highly engaged on this topic, arguing that enabling the participation of securitisations from third countries in the EU STS framework would provide EU investors with an expanded range of investment opportunities, make it more likely that third countries would extend STS treatment to EU securitisation and generally contribute to creating the larger, more liquid and less volatile securitisation markets essential to the safe revival of the product.

- *CRD V Holdco Rules*[5]

The Commission's Capital Requirements Directive (CRD) V proposals require third country banking entities operating with two or more institutions in the EU and which have total EU assets of more than EUR30bn, or which are part of a Globally Significant Institution, to establish an EU-located intermediated parent undertaking (IPU).

[4] Vice-President Dombrovskis speech at the Pensions Europe 2017 conference, 8 June 2017, link
[5] See AFME's *The links between Risk Reduction package and the development of Europe's capital markets*, December 2017, link

In AFME's view, this proposal will require a number of changes to ensure it can be operationalised, for instance when the creation of a single IPU would not be proportionate or would conflict with bank structural requirements for non-EU headquartered banks. The conflict in EU and third country bank structure rules would either result in a withdrawal from certain financing activities in the EU or reduced access to non-EU bank funding to finance EU financing and capital markets activities. Without allowing a second IPU or the ability to have smaller entities excluded from the single IPU requirement, these restrictions are likely to have significant implications/business constraints. In either case, US firms' ability to service clients in Europe would be curtailed. In addition to the concerns regarding the compatibility of the IPU requirement with non-EU bank structure requirements, the short timeframe of the existing Commission proposal creates difficulty for third country groups, given potential legal entity changes resulting from the UK's exit from the EU. A longer implementation period for the IPU requirement would allow a less disruptive transition to revisions to legal entity structures for non-EU banking groups.[6]

- *BRRD Moratorium Tools*[7]

The Commission's amendments to the Bank Recovery and Resolution Directive (BRRD) introduce new moratorium powers, especially prior to resolution.

The existence of the tool, even if not exercised, could itself create uncertainty in the market and incentivise counterparties, including uninsured depositors (but also potentially insured depositors who are unwilling to rely on deposit insurance) to run at an earlier stage than they would otherwise. The trigger for early intervention is vague and therefore markets could react at the first sign or rumour of difficulties. This could be counterproductive and make recovery actions less likely to succeed.[8] As drafted, it appears that the moratoria could apply successively such that a counterparty could be subject to a stay for 15 business days which is a long period in what could be a volatile and stressed market.

The legal implications for legal opinions and any requirement for contractual recognition of the moratoria also require very careful consideration. The proposed moratoria go beyond the global standard under the FSB Key Attributes of Effective Resolution Regimes, which provide for a limited stay on termination rights in certain circumstances (see Key Attribute 4.3 and I-Annex 5) which were broadly implemented under the BRRD. This could have an adverse impact on European banks which would be subject to additional uncertain powers prior to resolution which do not apply globally.

- *CCP Supervision*[9]

AFME recognises that European markets will play a major role within an integrated global financial system. As such, we believe that EU regulation that minimises disruptive effects on users of financial services, such as a fragmentation of clearing markets or an unlevel playing field across the industry and ensures the robustness

[6] We have suggested that Article 21.b of the CRD5 proposal is amended by adding the following:
"By way of derogation from paragraph 1, Competent Authorities shall permit alternative structures where the establishment of a single EU parent undertaking would:
i. conflict with the legal framework for bank structures in third countries or the third country group's global resolution plan; or
ii. not be proportionate given the third country group's activities, scope of operations, structure, resolvability, or other similar considerations."

[7] See AFME Resolution aspects of the EU Risk Reduction Measures Package, Recommendations for effective implementation of TLAC, MREL and related reforms, link

[8] As drafted, it appears that the moratoria could apply successively such that a counterparty could be subject to a stay for potentially for 12 working days or longer which is significantly longer that the internationally-agreed standard of up to 48 hours (in total).
The legal implications for legal opinions and any requirement for contractual recognition of the moratoria also require very careful consideration. The proposed moratoria go beyond the global standard under the FSB Key Attributes of Effective Resolution Regimes, which provide for a limited stay on termination rights in certain circumstances which were broadly implemented under the BRRD. This could have an adverse impact on European banks which would be subject to additional uncertain powers prior to resolution which do not apply globally.
Additionally, some jurisdictions have introduced requirements for firms to amend certain contracts to give contractual recognition of resolution stays. If these requirements were expanded to address the proposed new moratoria this would create a significant burden on firms including the need to amend again contracts which have already been amended to recognise existing stays. Such an exercise would be burdensome and could create significant confusion in the market.

[9] See AFME position paper on European Commission's proposal for a regulation amending EMIR as regards the procedure and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs and amending the regulation establishing ESMA, link

of the Capital Markets Union is the most desirable outcome. We note that other jurisdictions such as the US, Australia and Canada have already adopted a similar integrated approach.

EMIR laid the groundwork for CCP supervision and cross-border cooperation, and the Commission's proposal seeks to further improve this framework for effective communication between the CCPs, ESMA, central banks and the ESRB. In conjunction with the new Commission proposal which foresees joint supervision between ESMA and home regulators and the globally agreed international standards for CCPs, we believe EU and third country regulators will now have an appropriate forum to discuss and address their respective concerns and an appropriate supervisory toolkit, without risking fragmentation of clearing markets.

- *Benchmarks Regulation*

The Benchmarks Regulation (BMR) that entered into application on 1 January 2020, does not seem to provide a workable third country regime to allow for the unfettered use in the EU of benchmarks provided by third country administrators.

The BMR allows third country administrators to leverage three mechanisms for the use of their benchmarks in the EU: (1) Equivalence, (2) Endorsement, or (3) Recognition. However:

- Since third-country has a similar regulatory framework in place, it is highly unlikely that administrators in third countries will be able to achieve equivalence broadly;

- Under endorsement, an EU entity would take responsibility for a third country benchmark only if the third country administrator has a local EU presence. This is a burdensome requirement that would result in unbearable costs especially for small benchmark administrators who may ultimately decide to retire their benchmarks from the EU market;

- As a result, recognition may be a more practical alternative for many third country administrators. However, the recognition regime includes several conditions that may be difficult to implement in practice and in particular:
    - there are significant uncertainties as to what constitutes compliance with the IOSCO Principles in a manner that achieves equivalent compliance with the BMR; in addition, the recently proposed European Commission (EC) legislative proposal amending the mandate of the European Supervisory Authorities (ESAs) and introducing a number of changes to the BMR, is suggesting language that may weaken the effective recognition of the IOSCO principles for the purpose of compliance of third country administrators with the requirements of the BMR;
    - there is a requirement for third-country administrators to have a natural or legal representative in the EU, to act on behalf of the administrator regarding their responsibilities under the BMR. One of the key matters on which guidance is currently sought from third country administrators is in relation to the legal liability of a legal representative as it is currently unclear what form this accountability will take.

Conclusion

To increase the role of markets-based finance to European economic growth and job creation, regulation from the EU, the UK, Switzerland and other markets/countries should be firmly integrated in a global network with other leading capital markets regions.

Europe has the ability to play a leading role in the development of a coordinated and consistent global regulatory framework for cross border financial services. Conflicting regulatory policies and divergent implementation of global standards create barriers to capital flows and reduce market efficiency.

A successful global capital market will need to continue to benefit from reciprocal openness and investment from and into Europe. With the expected departure of the UK from the EU, it becomes even more important to consider the external global dimension of capital markets in both directions.

We have listed above five important examples of EU regulation where third-country issues make an important impact on cross-border investment and trading. There are many other examples of similar types of non-EU regional regulation which impacts third countries from the EU. AFME recommends for all regulatory initiatives going forward, the impact of any measures on the intermediating role that banks play in connecting the EU with global pools of capital should be considered as part of the Better Regulation initiative. This can be done through improved impact assessments and additional consultation, taken from both the EU and non-EU perspective.

The CMU is essential for EU economic growth and prosperity. AFME will continue to provide data and fact-based analysis to make an active contribution to policy development in this area.