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Brexit and EU Financial Governance: Business as Usual or Institutional Change?

Abstract

This article considers the implications of Brexit for EU financial governance. It first examines the implications for regulation. Drawing on the political economy of EU financial regulation and considering the UK's generally facilitative and liberal approach, it predicts that a more interventionist period might follow Brexit. Major change in EU regulatory style is unlikely, however, not least given the influence of international financial governance on the EU.

The article also considers the likely consequences for institutional governance and for the current uneasy arrangement, based on distinct euro area (Banking Union) and single market structures. It suggests that a strengthening of the European Supervisory Authorities is the most likely outcome and that functionally this involves the lowest risk. This strengthening is likely to be a function of a number of factors, including the greater prominence which the Authorities will have in relation to third country 'equivalence' assessments. The article also considers the conditions which may lead to a more radical re-organization of institutional governance and suggests that other environmental conditions, beyond Brexit, are likely to shape future developments.

Key words: Brexit; ECB; European Supervisory Authorities; equivalence; third country

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Introduction

Some six months on from the Brexit decision on 23 June 2016, the nature of the UK's future relationship with the EU remains unclear. In the financial services sphere alone the questions are many and complex. How will the patchwork of 'equivalence' rules which currently governs (albeit to a limited and partial extent) third country access to the EU financial market apply to the UK, and might these rules change?¹ What are the costs and benefits to the UK financial sector of the wide range of possible exit models – ranging from EEA membership to third country, non-equivalent status?² How might a transitional access arrangement work?³ This discussion addresses just one of the many questions. It takes an EU perspective and its concern is with EU financial governance, or the arrangements which support the regulation and supervision of the EU financial market: will Brexit lead to further change to how financial governance is designed?

Certainly, the recent history of EU financial market governance has been punctuated by disruptive shocks which have led to major reforms. The 2008 financial crisis led to the construction of the highly detailed 'single rulebook' which now governs the EU financial market. It also led to the 2011 establishment of the European System of Financial Supervision (ESFS) within which pan-EU supervisory coordination is managed through the three fast-maturing European Supervisory Authorities – the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA), and the European Insurance and Occupational Pensions Authority (EIOPA). The 2010-2012 euro-area fiscal crisis (and the related existential threat to the euro) led to the construction of Banking Union and to related risk-sharing through the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). The SSM and SRM currently apply to euro area Member States although other Member States may join. Banking Union is continuing to evolve. In late 2015 the Commission presented a proposal for the 'third pillar' of Banking Union – the mutualization of national deposit insurance schemes through a European Deposit Insurance Scheme (EDIS).⁴ Discussions are also underway on the long-awaited 'common fiscal backstop' which is designed to provide funding support to Banking

¹ For a review of the equivalence rules see Shearman and Sterling, "Brexit and Equivalence: Review of the Financial Services Framework Across All Sectors", 10 August 2016 and for an assessment of the UK's future as a third country see E. Ferran, "The UK as a Third Country in EU Financial Services Regulation", University of Cambridge Faculty of Law Legal Studies Research Paper No 47/2016, SSRN, <http://ssrn.com/abstract=2844474> [Accessed 24 November 2016]. It has been reported that the current equivalence rules may be reviewed by the Commission: A. Barber and J. Brunsten, "EU review casts doubt on City's hopes for 'equivalence' as Brexit last resort" *Financial Times*, 7 November 2016.

² See, e.g., Oliver Wyman, "The Impact of the UK's Exit from the EU on the UK-Based Financial Services Sector", 5 October 2016.

³ Current indications suggest the UK will seek a transitional arrangement to avoid 'cliff edge' effects.

⁴ Commission, "Proposal for a European Deposit Insurance Scheme" COM(2015) 586, final.

Union banks in the event of a systemic banking crisis overwhelming the risk-reduction and risk-sharing mechanisms of the SSM and SRM.⁵

The likelihood of a third re-setting shock seemed remote in early 2016. Despite ongoing difficulties with domestic banking markets, notably the Italian banking market,⁶ and persistent problems with non-performing loans in the euro area,⁷ the April 2016 reports from the European Commission and the ECB on the health of the EU financial system had a reassuring tone.⁸ They reported that financial stability was being restored and that levels of cross-border funding activity, while subdued, were recovering. The likelihood of a market shock and of related regulatory reform seemed small.

The Brexit vote may, however, have marked the start of a third re-setting shock with lasting implications for how EU financial governance is organized. This short note speculates as to the potential consequences of the Brexit decision for EU financial governance, from regulatory, supervisory, and institutional perspectives.

The UK and EU Financial Governance

The design of EU financial governance, the extent to which it is centralized or decentralized, and the pace at which the financial integration project has been pursued are a function of how competing and powerful national, supranational, and private sector interests intersect.⁹ Chief among these interests are the national interests which are primarily expressed through ECOFIN Council negotiations.¹⁰ These national interests have been usefully characterized in the political economy literature in terms of ‘market-shaping’ and ‘market-making’ coalitions.¹¹ The market-making coalition in the Council has typically advocated for a style of EU financial market regulation which is facilitative and promotes liberalization; is broadly sympathetic to market

⁵ Commission, Communication, “On Steps Towards Completing Economic and Monetary Union” COM(2015) 600 final and ECOFIN Council, “Conclusions on a Roadmap to Complete the Banking Union”, Press Release 353/16 (17 June 2016).

⁶ See e.g. R. Sanderson and C. Jones, “Essential Repairs”, *Financial Times*, 11 July 2016.

⁷ The ECB issued draft Guidelines on the management by SSM banks of non-performing loans in September 2016: ECB, “Draft Guidelines to Banks on Non-Performing Loans.”

⁸ Commission, “European Financial Stability and Integration Review” (2016) ((SWD) 2016 146) and ECB, “Financial Integration in Europe” (2016).

⁹ D. Mügge, “The Political Economy of Europeanized Financial Regulation” (2013) 20(3) *Journal of European Public Policy* 458

¹⁰ For a recent assessment in the context of Capital Markets Union see L. Quaglia, D. Howarth, and M. Liebe, “The Political Economy of European Capital Markets Union” (2016) 54 (S1) *J.C.M.S.* 185.

¹¹ L. Quaglia, “The ‘Old’ and ‘New’ Politics of Financial Services Regulation in the EU” (2012) 17(4) *New Political Economy* 515.

intermediation;¹² privileges transparency and disclosure techniques over behavioural regulation where possible; is open to market substitutes for intervention; and advocates for national discretion, particularly where fiscal risks are high. The market-shaping coalition has a stronger regulatory bias; can be suspicious of intense levels of market intermediation; is often wary of market substitutes for regulatory intervention; promotes harmonization over national discretion; and is more open to risk-sharing through institutional design.

The UK has been a leading member of the market-making coalition. Over the financial crisis, the UK advocated for greater national discretion under the pivotal 2013 Capital Requirements Directive IV/Capital Requirements Regulation (CRD IV/CRR)¹³ - which provides the spine of the EU's banking rulebook and implements the Basel III Accord - particularly with respect to the domestic application of capital and other supervisory tools to local risks to financial stability.¹⁴ Over the negotiations on CRD IV/CRR's sister measure, the 2014 Markets in Financial Instruments Directive II/Market in Financial Instruments Regulation (MiFID II/MiFIR)¹⁵ which provides the spine of the EU's investment services/trading rulebook, the UK was in the vanguard of the Council coalition which successfully protected a degree of Member State autonomy and industry choice in relation to the otherwise extensive transparency and other rules which apply to trading in financial instruments under MiFID II/MiFIR.¹⁶ Similarly, the UK has been a strong supporter of proportionality in the application of EU financial regulation. The UK's Financial Conduct Authority and Prudential Regulation Authority recently notified their intention not to comply with an element of EBA's 2015 Guidelines on bank remuneration policies (as is their prerogative¹⁷), and to instead dis-apply, in pursuit of proportionality, a contested element of the Guidelines.¹⁸ To take a final example, the UK (presciently) has often argued for a facilitative approach to third country access to the EU financial market.¹⁹ It was influential during

¹² Market intermediation refers to the process whereby actors in the financial markets 'intermediate' between suppliers and seekers of capital by, for example, providing risk management products and supporting trading in securities.

¹³ Capital Requirements Directive 2013/36 [2013] OJ L176/338 (CRD IV) and Regulation 575/2013 [2013] OJ L176/1 (CRR).

¹⁴ On the UK negotiating position see S. James, "The domestic politics of financial regulation: informal ratification games and the EU capital requirement negotiations" 21(2) *New Political Economy* (2016) 187.

¹⁵ Directive 2014/65 [2014] OJ L173/349 (MiFID II) and Regulation 600/2014 [2014] OJ L173/84 (MiFIR).

¹⁶ On the negotiations see N. Moloney, *EU Securities and Financial Markets Regulation* (Oxford: Oxford University Press, 2014) pp. 456-457.

¹⁷ European Supervisory Authority Guidelines to national supervisory authorities operate on a 'comply or explain' basis.

¹⁸ FCA and PRA, "Statement on Compliance with the EBA Guidelines on Sound Remuneration Principles", February 2016.

¹⁹ E. Ferran, "The UK as a Third Country" and L. Quaglia, "The Politics of 'Third Country Equivalence' in Post Crisis Financial Services Regulation in the European Union" (2015) 38 *West European Politics* 167.

the Council negotiations on the MiFID II/MiFIR market access regime, for example, and supported a more liberal approach to access to the EU investment fund market under the 2011 Alternative Investment Fund Managers Directive.²⁰ The UK has, however, supported the single rulebook, given in particular the transaction cost reduction and risk management benefits which follow as well as the significant ‘passporting’ benefits for the City of London:²¹ once authorized in its home Member State (typically the State of registration), a financial actor registered in the EU can, under the financial ‘passport,’ provide services and establish branches cross-border without host State regulation or supervision, subject to some limited exceptions. Accordingly, at an early stage of the financial crisis reforms the UK Financial Services Authority suggested that as between ‘More Europe’ and ‘Less Europe’ the better choice was ‘More Europe’.²²

The UK has been much less accommodating of the harmonization of supervisory practices, and of the construction of related EU institutional structures for risk-sharing. It has typically regarded supervision as the prerogative of domestic supervisors, given the national fiscal risks which supervisory intervention in support of financial stability can generate. This opposition has often been expressed by means of the UK’s adherence to a strict interpretation of the *Meroni* ruling which limits the discretionary powers of EU agencies.²³ The UK has, for example, generally favoured Commission control over the discretionary powers of the European Supervisory Authorities (as was the case over the Council negotiations on the crisis-era credit rating agency regime which confers exclusive supervisory powers over EU rating agencies on ESMA²⁴) and has frequently argued against the conferral of direct supervisory powers on the Authorities. For example, it unsuccessfully resisted ESMA’s direct intervention powers in relation to short selling during the Council negotiations on the 2012 Short Selling Regulation,²⁵ and was also unsuccessful in its subsequent challenge before the Court of Justice of the EU of these powers on the grounds, inter alia, that they breached the *Meroni* conditions and were not based on a valid Treaty competence.²⁶

This suspicion towards institutional centralization has also shaped the UK’s interaction with recent euro area reforms. As Banking Union’s distinct euro area risk-sharing structures have

²⁰ Directive 2011/61 [2011] OJ L174/1. On the two negotiations see Moloney, *EU Securities and Financial Markets Regulation* (2014), pp. 307-308 and 403-404 and E. Ferran, “After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU” (2011) 12 *European Business Organization Law Review* 379.

²¹ Which were highlighted in HM Treasury, “The Long Term Economic Impact of EU Membership and the Alternatives”, March 2016.

²² Financial Services Authority, “The Turner Review. A Regulatory Response to the Global Financial Crisis,” March 2009, pp.100-105.

²³ *Meroni v High Authority* (9/56) [1957-1958 E.C.R. 133.

²⁴ See Moloney, *EU Securities and Financial Markets Regulation* (2014), pp. 997-998.

²⁵ Regulation 236/2012 [2012] OJ L86/1.

²⁶ *UK v Council and Parliament* (C-270/12) EU:C:2014:18; [2014] 2 C.M.L.R. 44.

developed, the UK has been the Council's strongest advocate for single market interests to be protected against the risks of euro area caucusing; for the non-discrimination principle (Article 18 TFEU) to be adhered to in relation to non-euro currencies; and in support of a multi-currency form of EU financial system integration and governance. As is clear from the now null and void February 2016 New Settlement,²⁷ the UK has been in the vanguard of efforts to ensure single market financial governance is not dominated by euro area interests, experiences, and design preferences. The New Settlement stated, for example, that legal acts on the further deepening of the euro area must respect the single market. It also affirmed that (given the sensitivity of any further institutional centralization of supervision beyond banks and Banking Union) the implementation of 'measures' relating to the supervision or resolution of financial institutions and markets remained the preserve of non-euro-area Member States - unless they wished to join 'common mechanisms' which might be developed by the euro area. The UK was similarly the driving force behind the 'double lock' which applies to EBA Board of Supervisors decision-making; the lock is designed to prevent euro area caucusing on the Board by requiring majorities from both Banking Union and non-Banking Union supervisors.²⁸ To take a final example, the UK took a successful action against the ECB's 'location policy' for central clearing counterparties (CCPs - a critical element of financial market infrastructure) on the grounds that the ECB's requirement that certain CCPs be established in the euro area breached a number of Treaty provisions, including the non-discrimination principle.²⁹

What, accordingly, might be the consequences of the removal of the distinctive UK voice from deliberations on EU financial governance? The question is all the more germane as EU financial governance, after years of crisis-driven reform, is at something of a cross-roads. From a regulatory perspective, the Capital Markets Union regulatory agenda³⁰ is underway and the Commission's wide-ranging review of the crisis-era regulatory reforms³¹ is progressing. A swathe of reforms is in train in relation to banking regulation, designed to enhance risk reduction

²⁷ Decision of the Heads of State or Government Meeting Within the European Council, Concerning a New Settlement for the United Kingdom with the European Union, European Council Meeting, 18 and 19 February 2016 EUCO 1/16 (Annex 1).

²⁸ Regulation 1093/2010 [2010] OJ L331/12 (as revised), art. 44. On the UK position see House of Commons, Foreign Affairs Committee, "The Future of the European Union: UK government policy", First Report of Session 2013-2014, 21 May 2013, para 12.

²⁹ *UK v ECB* (T-496/11) EU: T: 2015: 133; [2015] C.M.L.R. 8.

³⁰ Set out in Commission, Green Paper, "Building a Capital Markets Union" COM (2015) 63 final and Commission, "Action Plan on Building a Capital Markets Union" COM (2015) 468 final. See further N. Moloney, "Capital Markets Union: 'Ever Closer Union' for the EU Financial System?" (2016) 41 *European Law Review* 307.

³¹ See, e.g., Commission, "Call for Evidence. EU Regulatory Framework for Financial Services" September 2015.

and to support Banking Union as well as the single banking market more generally.³² How these projects fare will reveal much as to the future nature of EU financial regulation. From a supervisory and institutional perspective, the critical question relates to whether further risk-sharing and the related construction of institutions (based on the Banking Union template) will occur. In particular, will the vision of a wider euro area ‘Financial Union’ which incorporates Banking Union and which was articulated in the summer 2015 Five Presidents’ Report,³³ come to pass? The absence of the UK from both of these regulatory and supervisory/institutional debates is likely to have effects, although their scale is not yet clear.

Regulatory Governance and Brexit

From the regulatory governance perspective, Capital Markets Union (CMU), the ongoing ‘stock take’ of the crisis-era regulatory reforms, the array of proposals to finesse EU banking regulation, and the appropriate application of the proportionality principle in regulatory governance are the main current preoccupations of the EU.

CMU, launched in September 2015, is designed to deepen EU capital markets and to reduce the EU’s current dependence on bank funding by promoting alternative, market-based funding sources, particularly for small and medium-sized enterprises (SMEs). The CMU agenda contains a number of regulatory reform proposals which are designed to: increase funding choices for businesses; provide an appropriate regulatory environment for long-term and sustainable investment in infrastructure; increase choice for retail and institutional investors; enhance bank lending capacity; and bring down barriers across the 28 (27) national capital markets. The UK is the major centre for market-based funding in the EU, with particular strengths in alternative funding and in the funding of smaller firms³⁴ as well as in relation to the professional over-the-counter (OTC) markets which facilitate risk management and so support the funding markets. It accordingly has a strong interest in the CMU agenda and in ensuring the agenda retains its current facilitative approach.³⁵ On Brexit the UK will no longer participate in CMU-related Council

³² A major package of reforms, covering CRD IV/CRR as well as the Bank Recovery and Resolution Directive and the Single Resolution Mechanism Regulation (Directive 2014/59 [2014] OJ L173/190 and Regulation 806/2014 [2014] OJ L225/1) was announced by the Commission on 23 November 2016 (Commission “Frequently Asked Questions: capital requirements and resolution framework amendments” MEMO/16/3840).

³³ *Completing Europe’s Economic and Monetary Union*. Report by J.-C. Juncker, in close cooperation with D. Tusk, J. Dijsselbloem, M. Draghi, and M. Schulz (2015), p. 12.

³⁴ The UK is, e.g., the largest EU market for funding through ‘business angels’, venture capital, and private equity investment: Commission, *2016 European Financial Stability and Integration Report*, p. 26.

³⁵ The current proposals for a new prospectus regime (governing the disclosures required when a company accesses the public funding markets: COM(2015) 583, final) and securitization regime (governing the

negotiations. But before then the UK's influence will, as a matter of practical politics, be minimal – particularly as a euro area qualified majority vote is now in place on the Council. Might the nature of CMU accordingly change?

First, might CMU lose traction?³⁶ The scale of the project is becoming clear. The Commission has recently warned that an integrated European capital market demands the changing of longstanding behaviours and attitudes 'which will require sustained application of effort and resources,' while the ECB has highlighted that developing CMU requires changing long-run savings patterns, and asking savers to operate under different risk-return objectives, which is 'notoriously difficult.'³⁷ Given the significant policy effort required and the related demands on institutional and political capital, might the weakening of the UK's position, and its ultimate absence, lead to a loss of political momentum?³⁸

It is unlikely that, without the UK voice, the CMU agenda will disappear entirely. The major bank-based economies of the EU (notably France and Germany) have strong market finance elements in that banks in these economies often have extensive market-based operations.³⁹ Other euro area economies (notably Ireland, Luxembourg, and the Netherlands) have, in relative terms, larger capital markets than the US.⁴⁰ Significant political interest can accordingly be expected. The Commission also appears committed to the project,⁴¹ with its September 2016 report on CMU calling for an acceleration of the reform agenda.⁴² But the nature of the CMU reform may change in two ways.

First, it may become more of a regulatory than a liberalization project and acquire a more intrusive 'market-shaping' quality. There may, for example, be less enthusiasm for the extensive investment fund market reforms which are of particular importance to the UK market,⁴³ and

transformation of bank loans into marketable ('securitized') instruments (COM(2015) 472, final and COM(2015) 473, final), e.g., are facilitative in design,

³⁶ The fate of the CMU project post-Brexit has been canvassed extensively in the financial press. See, e.g., J. Brunsdon and A. Barker, "City to be sidelined by capital markets union plan", *Financial Times*, 30 June 2016, and A. Mooney, "Fears Brexit will slow Capital Markets Union", *Financial Times, Fund Management Supplement*, 18 July 2016.

³⁷ Commission, *2016 European Financial Stability and Integration Report*, p. 25 and ECB, *2016 Financial Integration in Europe Report*, p. 97.

³⁸ ESMA Chairman Maijor warned prior to the Brexit vote that 'if the biggest capital market of the EU would not be part anymore of that CMU, obviously that would be detrimental': H. Jones, "Brexit would damage EU Capital Market Union: watchdog says" Reuters, 18 May 2016.

³⁹ I. Hardie, and D. Howarth, (eds), *Market-based Banking and the International Financial Crisis* (Oxford: Oxford University Press, 2013).

⁴⁰ ECB, *Financial Integration in Europe 2016*, p. 96.

⁴¹ The EU Commissioner with charge of CMU stated in the wake of the vote that CMU was needed 'more than ever': Commissioner Dombrovskis, "Remarks at the Atlantic Council", 18 July 2016.

⁴² Commission, "Capital Markets Union: Accelerating Reform" COM(2016) 601, final.

⁴³ J. Brunsdon, "Brussels aims to knock down hedge fund barriers", *Financial Times*, 3 June 2016.

which include liberating funds to engage in lending⁴⁴ and removing the persistent cross-border barriers to fund marketing.⁴⁵ While Ireland and Luxembourg, as major EU fund centres, are typically champions of fund reform, in the absence of the UK they may find it harder to build coalitions. To take another example, while the securitization reforms, which are in part designed to enhance banks' ability to lend to SMEs, had a speedy progression through the Council (where they were supported by the UK⁴⁶), the European Parliament is proving to be more sceptical and interventionist.⁴⁷ In the absence of a strong UK voice, trilogue discussions between the Commission, Council and European Parliament on the reforms could lead to a more restrictive approach, particularly given some evidence of growing French opposition.⁴⁸

Second, the CMU agenda may become entangled with (and slowed down by) institutional reforms for the euro area. There were already signs before the Brexit vote of CMU being harnessed to the ongoing efforts to 'complete EMU'. As noted above, the 2015 Five Presidents' Report called for a 'Financial Union', incorporating CMU and Banking Union, in order to complete EMU; the ECB has emphasized the importance of CMU in improving cross-border risk-sharing and in making the financial system more resilient;⁴⁹ and the Commission and ECOFIN Council have both linked CMU to the completion of EMU.⁵⁰ CMU may accordingly change character from being multi-currency and market-opening in design (as sought by the UK) to becoming a euro area institutional construction project. This outcome may be all the more likely given the nullification of the New Settlement by the Brexit vote. The New Settlement recognized the possibility of 'different paths of integration' for all Member States. It also provided a political brake in relation to further euro area integration: if at least one Council Member State not participating in Banking Union indicated its reasoned opposition to the Council adopting a euro-area-related measure under a QMV, a pathway for further discussion was provided. The

⁴⁴ E.g., ESMA, "Opinion on Key Principles for a European Framework on Loan Origination by Funds" (ESMA/2016/196)(2016).

⁴⁵ Commission, "CMU Action on Cross-border Distribution of Funds (UCITS, AIF, ELTIF, EUVECA, and EUSEF) Across the EU" (2016).

⁴⁶ The Bank of England was an early supporter of the reforms: Bank of England and ECB, Discussion Paper, "The Case for a Better Functioning Securitization Market in the EU" (2014).

⁴⁷ In March 2016 the European Parliament refused to 'fast-track' the reforms, while the initial June 2016 report by ECON Rapporteur Tsang on the reforms took a more restrictive approach than the Council to the new regime: Draft ECON Report PE583.961, 6 June 2016.

⁴⁸ European Parliament, "Briefing on EU Legislation in Progress: Common Rules and a New Framework for Securitization", February 2016.

⁴⁹ ECB, *2016 Financial Integration in Europe Report*, p. 56.

⁵⁰ Commission, *2015 Communication on Steps Towards Completing EMU* and Council, "Conclusions on the Commission Action Plan on Building a Capital Markets Union" Press Release 79/15, 10 November 2015.

likelihood of further risk-sharing and related institution-building in relation to the euro area capital market on Brexit is discussed further below.

CMU aside, the absence/reduced influence of the UK could also have implications for the current review process. The Commission is engaging in a wide-ranging ‘stock take’ of the crisis-era programme generally,⁵¹ and is also pursuing the different mandatory reviews required of specific crisis-era measures under their respective review clauses. The review of the pivotal 2012 European Market Infrastructure Regulation (EMIR),⁵² which has restructured derivatives markets in the EU, for example, was launched in 2015;⁵³ the opening of the alternative investment fund market to third country access under the 2011 Alternative Investment Fund Managers Directive is currently under review,⁵⁴ while the behemoth MiFID II/MiFIR regime will be subject to review over 2020-2022, after the delayed start to its application in January 2018 (from January 2017).

The UK could have been expected to have brought an empirically-informed and productively sceptical perspective to the review process, which might have provided a brake against the tendency of the EU to intensify financial regulation and the related level of harmonization during reviews. The 2016 response by HM Treasury to the Commission’s ‘stock take’, for example, is detailed, specific, and suggests a concern to calibrate and refine the financial regulatory regime.⁵⁵ It highlighted, for example: inconsistencies in the disclosure regime; weaknesses in EU fund regulation which were limiting cross-border activity; inconsistent approaches to supervision across the single market; multiple barriers to entry; outdated rules; and the importance of the EU marketplace being open to the global financial market. The UK’s concerns are unlikely to be isolated, but the absence of the UK from the Commission’s review process makes it more likely that the review does not engage in the potentially disruptive reforms which may be necessary.

The current reforms to EU banking regulation may also be shaped by Brexit. The package of reforms is designed to implement recent proposals by the Basel Committee and the Financial Stability Board. The UK is active in both of these fora and is unlikely to resist the related reforms. But the reforms also include EU-specific proposals. These include adjustments to the relevant international standards to reflect the EU market context. They also include a more intrusive approach to harmonization, notably a limitation of the discretion which national

⁵¹ Commission, “Call for Evidence. EU Regulatory Framework for Financial Services” September 2015.

⁵² Regulation 648/2012 [2012] OJ L201/1

⁵³ Commission, “Public Consultation on Regulation EU No 648/2012” (2015).

⁵⁴ See, e.g., ESMA, “Advice on the Application of the AIFMD Passport to non EU Alternative Investment Fund Managers and Funds” (ESMA/2016/1140 and ESMA/2015/1230).

⁵⁵ HM Treasury, “Response to the EU Commission: Call for Evidence on EU Regulatory Framework for Financial Services”, February 2016.

supervisors currently have in relation to the imposition of additional capital requirements on banks (the CRD IV ‘pillar 2’ requirements). The weakened UK voice means that opposition to greater harmonization and EU calibration of international standards may be less strong in the Council than it was over the original CRD IV negotiations. Conversely, while the UK can be expected to support the proposal to lift certain of the contested CRD IV remuneration rules from smaller and less complex firms, other Member States may be less accommodating and more influential.

Finally, the absence/weakened influence of the UK may shape the current debate on how the proportionality principle should apply. A tempering of the application of financial market rules by means of a proportionality assessment is a common feature of the single rulebook. The contested remuneration requirements (including the famous ‘bonus cap’) which apply to banks under CRD IV, for example, are to apply ‘in a manner and to the extent that is appropriate to [relevant firms’] size, internal organisation and the nature, scope, and complexity of their activities’ (Article 92(2)). A similar requirement applies to the extensive organizational requirements which apply to investment firms under MiFID II (Article 16). But while proportionality clauses provide a means for addressing regulatory stalemates during negotiations, and for reducing the risk of unintended consequences, they can also generate risks to the single market. These include divergent rule application, regulatory arbitrage, transaction costs, and the imposition of national preferences. The appropriate application of the proportionality principle has recently come to preoccupy the EU institutions as the costs and unintended consequences of the crisis-era reforms emerge. The European Parliament’s 2016 Balz Resolution on the Commission’s ‘stock take’, for example, underlined that EU financial legislation should be proportionate and highlighted a number of areas where it had disproportionate effects.⁵⁶ Similarly, its 2016 Resolution on Banking Union called on the ECB to ensure its supervisory strategies within the SSM complied with the proportionality principle.⁵⁷ While there seems to be considerable support within the EU institutions for an appropriately proportionate application of rules, the absence of the UK⁵⁸ may diminish the importance of the debate and ease pressure for reform.

⁵⁶ European Parliament, “Stocktaking and Challenges of EU Financial Services Regulation”, 19 January 2016 (P8_TA(2015)0268) (Balz Resolution).

⁵⁷ European Parliament, “Resolution on Banking Union – Annual Report (2015)”, 10 March 2016 (P8_TA-PROV(2016)0093).

⁵⁸ HM Treasury’s response to the Commission ‘stock take’, e.g., highlights difficulties with the proportionate application of: financial reporting rules to smaller firms; capital requirements to smaller banks; and financial rules more generally to non-financial counterparties.

One final speculation on regulatory reform can be offered. The possibility that EU financial regulation will come to include euro area ‘location’ requirements - requiring that certain trading and other business in euro instruments be carried out in the euro area - cannot be entirely discounted. It is all the more likely to transpire if single market and euro area interests come to be more closely aligned after Brexit. At the least, the EU institutions (including the ECB) and many Member States are unlikely to be disinterested with respect to the continuing concentration of some one-third of all euro-denominated trading occurring outside the EU in the UK (whether their interest is driven by financial stability or competitive concerns).⁵⁹ The extent to which the UK, as a third country, would be protected from such rules by WTO requirements, and, from the EU perspective, the extent to which the trade law ‘prudential carve out’ (which provides that states (and the EU) cannot be prevented by trade agreement commitments from applying rules for prudential purposes), will likely be tested by any such reform.⁶⁰

Overall, the absence of the UK from EU financial regulation is not likely to lead to major changes in the medium term, although the regime is likely to become more, and not less, interventionist over time. The major influence on the development of EU financial regulation in the future is likely to be the international standard setters. Much of EU financial regulation has been shaped by the international standard setting bodies, such as the Financial Stability Board, and it will continue to be so.⁶¹ The EU is also likely to be acutely sensitive post Brexit to the competitive position of EU firms internationally, particularly given current indications of large-scale deregulation in the US.⁶² For example, while the Commission in its November 2016 package of banking regulation reforms has proposed refinements to recent Basel Committee standards to reflect EU market features, it has also proposed a more onerous regime for third country financial firms operating in the EU, requiring that they establish an EU-regulated holding company in some circumstances.⁶³

⁵⁹ Media reports have frequently referenced some support in the EU to repatriate euro trading and clearing business to the euro area. See, e.g., G. Parker, “May poised to unveil more Brexit plan details” *Financial Times*, 8 November 2016.

⁶⁰ On the relationship between EU financial regulation and trade law/agreements see A. Lang and C. Conyers “Financial Services in EU Trade Agreements”, Study for the ECON Committee (2014) IP/A/ECON/2014-08.

⁶¹ N. Moloney, “International Financial Governance, the EU, and Brexit: the agencification of EU financial governance and the implications” (2016) 17 *European Business Organization Law Review* 451.

⁶² Some reports have indicated that following the November US election significant deregulation may follow, including repeal of some elements of the US crisis era Dodd Frank Act: J. Hamilton and E. Dexheimer, “Trump’s Transition Team Pledges to Dismantle Dodd Frank”, Bloomberg 10 November 2016.

⁶³ This proposal has been interpreted as a ‘tit for tat’ measure following the adoption by the US of a similar rule: A. Barker and J. Brunsden, “EU to retaliate against US bank capital rules” *Financial Times*, 21 November 2016.

But while changes in regulatory substance are more likely to be at the margins given that EU regulation sits in an international market, a more interventionist approach overall can be expected. So too can an ever-more harmonized approach. The ECB, for example, has been leading the charge to remove ‘national options and discretions’ from the banking rulebook, at least in relation to the SSM zone;⁶⁴ the CMU agenda is in part designed to deliver greater harmonization, including in relation to areas not traditionally harmonized, such as insolvency law; and the November 2016 package of banking regulation reforms reduces Member State and national supervisory discretion. In the absence of the UK and its support for national discretion, more, and not less, harmonization can be expected.

Supervisory/Institutional Governance and Brexit: the ascendancy of the euro area?

Brexit will remove one of the prominent frictions slowing the further integration of institutional governance for the EU financial system. With respect to euro area institutional integration, the UK did not obstruct the Banking Union institutional reforms and indeed supported them as a means of strengthening the financial stability of the euro area.⁶⁵ But the UK/EU negotiations prior to the February 2016 New Settlement made clear the UK’s increasing unease as to the consequent risks from Banking Union of an intensification of euro area caucusing; of euro area interests coming to shape single market financial governance; and of pressure for greater institutional centralization. The New Settlement accordingly promised a political brake in relation to further euro-area integration (including institutional centralization). It also contained an affirmation that financial stability measures taken in relation to financial institutions and markets would, for non-euro-area Member States, remain at national level. These commitments were designed to address the UK’s concern that the Banking Union structures might be replicated for the capital markets in the euro area, in the first instance, and might ultimately lead to single-market-wide financial supervisory authorities for the capital markets and to a related loss of national autonomy over supervision. Given this posture on institutional reform, the UK could have been expected to resist further euro area institutional integration, particularly with respect to capital market supervision. In addition, any attempt to design risk-sharing institutional structures for the wider single market would likely have been fiercely resisted by the UK.

The withdrawal of the UK does not necessarily imply, however, that new supervisory/resolution structures and institutions designed to support risk sharing (on the lines of

⁶⁴ Regulation (EU) 2016/445 of the ECB [2016] OJ L78/60 and ECB Banking Supervision, “ECB Guide on Options and Discretions Available in Union Law” (2016).

⁶⁵ See House of Lords EU Committee, “European Banking Union: key issues and challenges” Seventh Report of Session 2012-13, 12 December 2012.

the SSM and SRM) are likely to appear for the capital markets or the insurance markets over the medium term – whether for the euro area or the single market. Some straws in the wind could be read as auguring change, notably the 2015 Five Presidents’ Report’s call for a ‘Financial Union’ for the euro area, and the ECB’s support for centralized capital market supervision for the euro area.⁶⁶ Similarly, in its September 2016 CMU report the Commission suggested, in the context of the Five Presidents’ Report, that ‘further steps’ relating to the EU supervisory framework were to be considered, so that the full potential of CMU could be reached.⁶⁷

In practice (and whether for the euro area or single market) the political, institutional, technical, and constitutional obstacles are immense⁶⁸ and include: the persistent and significant differences in the structure of capital and other markets across the euro area/single market and the related political difficulties associated with building a consensus on risk-sharing; Treaty competence difficulties; and the immense functional challenge posed by the design of a supervisory and resolution mechanism or mechanisms which could deliver supervision and rescue for a vast and heterogeneous population of financial market actors, ranging from systemically significant multi-function financial groups and financial market infrastructures, to small financial advisers and non-financial counterparties active in the financial system. These challenges are independent of the political challenges posed by the UK’s opposition.

There are also indications that, as Banking Union’s risk-sharing structures embed (and even though initial institutional reaction to the SSM and SRM appears to be broadly positive⁶⁹), there is more rather than less discomfort with risk-sharing and with related institution-building. The Commission’s 2015 report on Banking Union called for Banking Union to be completed, most notably by means of, first, a European Deposit Insurance Scheme (EDIS) and, second, the ‘common fiscal backstop,’ as noted above.⁷⁰ Institutional reaction to such further reforms has been relatively cool. Indications from the European Parliament suggest that, prior to the construction of an EDIS for Banking Union, significantly more effort needs to be expended on the adoption of ex-ante legislative risk control/reduction measures for the single market

⁶⁶ See recently ECB, *2016 Financial Integration Report*, p. 97. in which the ECB noted its preference for a ‘single European capital markets supervisor’ and similarly, ECB, “Building a Capital Markets Union – Eurosystem Contribution to the European Commission’s Green Paper” (2015).

⁶⁷ Commission, *Accelerating CMU*, p. 7.

⁶⁸ See further N. Moloney, “Institutional Governance and Capital Markets Union: Incrementalism or a ‘Big Bang?’” (2016) *European Company and Financial Law Review* 376.

⁶⁹ E.g., European Parliament, *2016 Resolution on Banking Union* and ECOFIN Council, *Banking Union Roadmap Conclusions*. The recent report from the European Court of Auditors, however, is more mixed, and raises concerns with respect to, e.g., staffing levels, over reliance on national supervisors, and access to documents: European Court of Auditors, “Single Supervisory Mechanism – Good start but further improvements needed” (Special Report No 29/2016).

⁷⁰ Commission, Communication, “Towards the Completion of the Banking Union” COM(2015) 587 final.

generally.⁷¹ The Council's reaction to EDIS has been similarly muted; it has linked progress on EDIS to the strengthening of ex-ante risk reduction measures.⁷² Movement on the 'common fiscal backstop' for Banking Union is also sluggish. While the euro area Member States have agreed to bilaterally support their individual national funding compartments within the SRM's Single Resolution Fund through national credit lines,⁷³ progress on the mutualized, common fiscal backstop needed to complete Banking Union is slow.⁷⁴

If the euro area struggles with the further risk mutualization needed to complete the already-established Banking Union, it is highly unlikely that new adventures in risk-sharing in the euro area insurance and capital markets segments will be pursued – and even more unlikely that new single market institutions will be contemplated. This is all the more the case as the list of pending legislative risk reduction measures, which the Commission has committed to pursuing, is long and includes matters which are both technically complex and politically sensitive. These include further harmonization of national deposit insurance schemes across the single market and review of the regulatory treatment of sovereign debt.⁷⁵

This is not to suggest that the UK's withdrawal will have no effect on current institutional arrangements. The most likely impact will be on single market institutional governance, which is currently primarily coordination-based. In particular, a strengthening of the European Supervisory Authorities (ESAs) may follow. The ESAs, within the single market ESFS, carry out a range of quasi-regulatory and supervisory co-ordination functions. The UK has been a strong supporter of the ESAs' quasi-regulatory activities,⁷⁶ which include advising the Commission on administrative rules, proposing Binding Technical Standards (a form of administrative rule) for adoption by the Commission, and adopting Guidelines. But the UK has typically not been supportive of the conferral of direct, executive powers on the ESAs, regarding supervision as a Member State competence. It has, for example, taken a restrictive approach to the interpretation of the binding mediation power conferred on the ESAs by Article 19 of their founding Regulations, which empowers the ESAs to impose a binding decision on national supervisory authorities who are in conflict. The UK has argued that, given the *Meroni* prohibition on the exercise of wide executive

⁷¹ European Parliament, ECON Committee, "Working Document on a European Deposit Insurance Scheme", 16 June 2016.

⁷² ECOFIN Council, *Banking Union Roadmap Conclusions*.

⁷³ The different national funding 'pots' within the SRM which are available to support rescue and resolution are, however, being progressively mutualised over an eight-year period. At the end of the eight years the pots will be fully mutualised into one fund and thus the national credit lines provided are limited as they apply to progressively dwindling national pots.

⁷⁴ ECOFIN Council, *Banking Union Roadmap Conclusions*.

⁷⁵ Commission, *2016 Completing Banking Union*, pp. 9-11.

⁷⁶ E.g., HM Treasury, "Response to the Commission Services Consultation on the Review of the ESFS" (2013).

discretion by EU agencies, national supervisory discretion which is exercised in accordance with EU law cannot be overridden by an ESA.⁷⁷ Given that EU financial regulation is increasingly adopting an operational posture and focusing closely on the implementation and supervision of the crisis-era reforms,⁷⁸ it is not unlikely that Article 19, which allows an ESA to cut through practical differences which may arise between national supervisors on the application of EU law, may be revisited. Similarly, it is no longer politically improbable that the ESAs could become vehicles through which additional supervisory powers are transferred to the single market level. Thus far, only very limited supervisory powers have been conferred on the ESAs,⁷⁹ but this may change although, as noted below, there are significant environmental frictions.

Brexit may also have the effect of strengthening the ESAs' regulatory capacity, or their ability to achieve outcomes, more generally. The ability and appetite of the ESAs to deploy their primarily soft coordination/convergence powers more assertively (including their powers to adopt Guidelines for national supervisors and to engage in peer review of national supervisors) may therefore be strengthened. An incremental hardening of supervisory convergence and coordination, and more central steering of national supervisors by the ESAs, might follow. This strengthening of regulatory capacity and credibility could follow from the ESAs' competences in relation to third-country access to the EU single market and the related equivalence assessments.

The nature of the settlement which will govern the UK's relationship with the EU is not yet clear. But it is likely that it will require some form of third-country access arrangement, and a related assessment, accordingly, of the 'equivalence' of UK financial regulation, supervision, and enforcement with EU requirements. A number of potential flashpoints relating to the UK/EU equivalence assessment can be identified. As financial regulation is highly dynamic, UK and EU financial regulation can be expected to diverge over time. In addition, equivalence determinations relating to supervision and enforcement are notoriously elusive given the multiplicity of factors which shape states' supervisory and enforcement approaches as well as the difficulties in

⁷⁷ The UK supported the insertion of a recital into the European Supervisory Authority regulations which provides that where the relevant EU legislation at issue in an art. 19 binding mediation confers discretion on national supervisory authorities, any related decision taken by an Authority cannot replace the exercise in compliance with EU law of that discretion (e.g., ESMA Regulation 1095/2010 [2010] OJ L331/84, recital 32).

⁷⁸ As is clear from the CMU agenda which emphasizes the importance of convergence in supervisory practices: Commission, *CMU Action Plan*, p. 27.

⁷⁹ ESMA has exclusive supervisory and enforcement powers over rating agencies and trade repositories, and can intervene in relation to short selling activity, while ESMA and EBA will be empowered to prohibit certain products once the relevant legislation comes into force.

quantifying supervisory and enforcement outcomes.⁸⁰ Finally, as currently designed, the EU equivalence arrangements typically leave the equivalence determination to the Commission's discretion, there are few procedural protections for third countries who seek such an assessment (the Commission is not, for example, required to undertake an assessment at the request of a third country but retains discretion⁸¹), and equivalence decisions can be withdrawn.

These uncertainties increase the importance and political sensitivity of any future UK/EU equivalence determinations and of the mechanism(s) deployed to reach such determinations. While the Commission is currently the decision-maker with respect to equivalence, the ESAs, to differing extents, are/can be charged with advising the Commission on the different types of equivalence determinations required across EU financial regulation.⁸² The most extensive functions are conferred on ESMA which has played a central role in advising the Commission on the equivalence of third country regimes internationally, including in relation to access by third country credit rating agencies, alternative investment funds, and central clearing counterparties (CCPs), and with respect to financial reporting. Advice to the Commission on equivalence determinations can place ESMA in politically challenging territory given the market and political sensitivities.⁸³ But providing such advice to the Commission also affords ESMA significant opportunities to strengthen its capacity and credibility given the technical competence, international financial diplomacy, and deft institutional politicking which these determinations require.⁸⁴

The opportunities for ESMA will be all the greater on Brexit. The equivalence requirements relating to investment services and to the trading of financial instruments, which are governed by the MiFID II/MiFIR regime, are likely to be of acute importance to UK/EU relations post Brexit. MiFIR Article 46, to take one example, allows a third country firm to provide services from the third country to professional investors in the EU without EU authorization and

⁸⁰ H. Jackson, "Substituted Compliance: The Emergence, Challenges, and Evolution of a New Regulatory Paradigm" 1 (2) *Journal of Financial Regulation* (2015) 169. For a policy perspective see Australian Securities and Investment Commission, Regulatory Guide 54 (2012).

⁸¹ See, e.g., MiFIR, recital 41.

⁸² The different legislative measures of EU financial regulation take varying approaches to third country access, although the most recent crisis-era reforms typically require that some form of equivalence determination is made by the Commission. All the Authorities are charged under their founding regulations with assisting in the preparation of equivalence decisions (e.g. ESMA Regulation, art. 33).

⁸³ The CCP equivalence discussions with the US were difficult and were only completed after high level EU/US political intervention, following which the Commission ruled in March 2016 that US regulation of CCPs was equivalent for the purpose of EU market access.

⁸⁴ As is clear from, e.g., ESMA's advice on the equivalence of third country CCP regulatory regimes. ESMA's technical advice on the Australian regime was detailed, technical, reviewed supervision as well as regulation, and involved engagement with the relevant Australian regulators (ESMA/2013/BS/1159). ESMA's advice was followed by the Commission which subsequently adopted an equivalence decision (2014/755/EU).

related regulation, once a Commission determination of equivalence is made (and other conditions met). ESMA will likely be required to provide ‘technical advice’ to the Commission on the related and highly sensitive equivalence decision. The importance of the MiFID II/MiFIR equivalence regime to EU/UK relations is not limited to market access. It also shapes how EU financial actors interact with third country actors, and thus has serious implications for the UK as a third country. For example, while MiFID II/MiFIR requires certain instruments to be traded on EU trading venues, a third country venue (such as a UK trading venue) can be used once an equivalence decision has been made; in the absence of such a decision, UK trading venues would risk losing trading business. Assuming that the third country equivalence route forms part of the post-Brexit access arrangements between the UK and the EU, ESMA will play a critical role in the management of the UK/EU relationship.

The provision of equivalence-related advice is, of course, only one of ESMA’s extensive (albeit primarily ‘soft’) competences. But at a time when there is some uncertainty as to the future of institutional governance for the EU financial market, and when the ESAs are under review more generally,⁸⁵ advising on the UK’s equivalence status is likely to strengthen ESMA’s position more generally. There are already signs that ESMA sees equivalence determinations as a means for strengthening its institutional position; it has called for reforms to the third country regime for CCPs under EMIR, for example, which would strengthen its position.⁸⁶

Further opportunities may arise. There are indications that the Commission will review the current equivalence regime with a view to bringing more coherence to an unwieldy set of rules.⁸⁷ As Ferran has argued, there is a logic to the adoption of a more streamlined, ‘single point of access’ arrangement (not least given the incentives for the EU to signal its openness to the international market post Brexit) and, in the absence of the UK, the Commission and the co-legislators may find it easier to come to an agreed position.⁸⁸ Any new arrangement may well draw heavily on ESMA (and the other ESAs) given their proven technical capacity in this area.

Whether or not such an incremental strengthening of the ESAs is functionally optimal is outside the scope of this discussion. It can be suggested, however, that change of this nature is more likely to have effects at the margins and is not – in the absence of other environmental changes (whether political, market, or institutional) – likely to lead to a radical change to the current coordination-based nature of the ESAs’ activities. Certainly, current institutional

⁸⁵ A Commission Green Paper is expected in 2017.

⁸⁶ ESMA, EMIR Review Report No. 4 (ESMA/2015/1254).

⁸⁷ See A. Barber and R. Brunsten “EU Review”.

⁸⁸ E. Ferran, “The UK as a Third Country”.

conditions are not favourable to significant change.⁸⁹ The Commission has long been concerned to assert its primacy over the ESAs, while the Parliament is increasingly seeking greater oversight.⁹⁰ From the Member State perspective, while Brexit removes the UK and its often sceptical posture towards the ESAs, Germany, for example, is unlikely to support a significant increase in their powers.⁹¹

Brexit may have more far-reaching effects for EBA. EBA is currently situated within a complex institutional ecosystem. Its sphere of activities is in theory distinct from that of the ECB within the SSM (the ECB/SSM). EBA is charged with supporting the single market rulebook and with single market supervisory convergence/coordination; its jurisdiction is the single market in banking. The jurisdiction of the ECB/SSM is Banking Union; the ECB/SSM is the operational supervisor for banks within Banking Union, having oversight of the SSM and direct supervisory responsibility for 129 of the euro area's most significant banking groups. Nonetheless, the potential for the ECB to encroach into EBA's single market and convergence/coordination territory cannot be ignored. This potential is likely to increase on Brexit given the weakening of EBA's institutional position which may follow from a closer alignment of the membership of the single market and of the euro area/Banking Union.

There are currently nine EBA members who are not members of the euro area or voluntary participants in Banking Union; this will be reduced to eight on the exit of the UK. Whether or not the single market interest which EBA is charged with supporting will become subsumed within the SSM/Banking Union interest, and thereby lead to related calls for a change to EBA's role, will depend to a large extent on whether or not those eight members become members of the SSM and Banking Union. There are incentives for the 'pre-in' euro area Member States to join the SSM/Banking Union ahead of time, but there are also considerable counter-incentives.⁹² At present only Denmark has made a clear statement of intent with respect to joining Banking Union,⁹³ although other non-euro-area Member States are supportive.⁹⁴ There is, of

⁸⁹ In the context of ESMA see N. Moloney, "Institutional Governance and Capital Markets Union".

⁹⁰ *Balz Resolution*.

⁹¹ In February 2016 the Bundestag adopted a resolution which calls for the German federal government to ensure adequate scrutiny of the ESAs. It has also stated that where ESA Guidelines do not correspond to the Bundestag's objectives they should not be adopted in Germany. Centre for European Policy, "European Supervisory Authorities. Room for Improvement at Level 2 and 3." Study on Behalf of the fpmi Munich Financial Centre Initiative (2016) p. 42.

⁹² See E. Ferran, "European Banking Union and the Single Financial Market: More Differentiated Integration or Disintegration?", University of Cambridge, Faculty of Law Legal Studies Research Paper No 26/2014, SSRN, <http://ssrn.com/abstract=2426580> [Accessed 24 November 2016].

⁹³ The Danish central bank called for Denmark to join Banking Union in 2014: Danish Nationalbank, "Danish Participation in the Banking Union" (2014) 4th Quarter *Danmark's Nationalbank Monetary Review*, 41. This was followed by a positive report from the Ministry of Business and Growth in May 2015

course, a temporal inevitability with respect to the alignment of the single banking market and the SSM/Banking Union zone: the ‘pre-ins’ must, over time, join the euro (and Banking Union) as they meet the relevant conditions. Further, if only one or two more Member States either join the euro or choose to participate in the SSM/Banking Union, network effects are likely to develop which make the case for SSM/Banking Union participation more compelling. This will be all the more the case if the reputation of the ECB in relation to the SSM is not, in the meantime, damaged. In addition, the ‘double-lock’ which protects non-SSM/Banking Union Member States within EBA from SSM/Banking Union caucusing is to be reviewed when the number of non-SSM Member States drops to four (2010 EBA Regulation, Article 81a). But even if there is greater alignment between the members of the single market and of the SSM/Banking Union, it does not necessarily follow that the ECB/SSM will take over EBA’s functions and that EBA will become redundant.

The ECB/SSM serves a different function to EBA. The ECB’s competences are operational and supervisory in nature and cover the euro area. EBA’s competences are quasi-regulatory and directed to supervisory coordination, and cover the wider single market. In addition, EBA’s mandate is wider than that of the ECB’s. EBA’s mandate covers convergence and coordination in relation to consumer protection,⁹⁵ market conduct, and financial crime (as well as prudential regulation). It also extends beyond credit institutions to include financial institutions more generally.⁹⁶ By contrast, the mandate of the ECB/SSM is limited to prudential supervision of credit institutions.

It is not, of course, impossible that the ECB’s competences will be extended in the future to match those of EBA by a Treaty revision. The ECB could be empowered to supervise directly a range of institutions, across the single market, and with respect to prudential, conduct, and financial crime regulation, and consumer protection, leaving EBA redundant. The more likely outcome, however, is that the risks of creating such a vastly powerful institution are likely to minimize political, institutional, and market support for such a change - leaving to one side the

and a related supportive statement from two government ministers: Press Release, Ministry of Business and Growth, 11 May 2015.

⁹⁴ Bulgaria and Romania have indicated their support while the Czech Republic, Hungary and Poland are adopting more a sceptical or ‘wait and see’ approach: P. Hüttl and D. Schoenmaker, “Should the ‘outs’ join the European Banking Union?” CEPS Policy Contribution, Issue 2016/3, February 2016.

⁹⁵ It coordinated with ESMA and EIOPA, e.g., on the development of the administrative rules for the consumer-focused Packaged Retail and Insurance-based Investment Products (PRIIPs) regime: ESMA, EBA, EIOPA, “Final Draft RTSs” (JC 2016 21) (2016).

⁹⁶ It has recently been charged with advising the Commission in relation to prudential requirements for investment firms: EBA, “Report on Investment Firms” (EBA/Op/2015/20(2015)).

functional difficulties. As outlined above, there is limited appetite for completing the Banking Union project; a massive increase in the powers of ECB/SSM is unlikely.

Nonetheless, EBA's role may change somewhat on Brexit if single market financial governance interests become more closely aligned with those of the euro area, and if the gravitational pull of the ECB/SSM becomes stronger. EBA will have strong institutional incentives to emphasize its distinctive role and its separation from the ECB. It is likely to prioritize accordingly those areas of its mandate where there is limited overlap with the ECB. In particular, it might become more focused on conduct and on consumer protection. There are already some straws in the wind in this regard. EBA has included conduct risk among the risks which EU banking supervisors must include in their annual supervisory review (SREP) of EU banks.⁹⁷ Consumer protection is also receiving closer attention, including through research and Guidelines⁹⁸ as well as through EBA's supervisory agenda for banks.⁹⁹

Further evidence as to the likely persistence of EBA comes from the reality that, unlike the ECB, EBA is embedded into the EU administrative law-making process as the technical adviser to the Commission on delegated rules and as the proposer of Binding Technical Standards. Although tensions periodically arise, EBA has developed productive relationships with the European Parliament, Council, and Commission in relation to delegated rule-making. It is not at all clear that these institutions would substitute EBA - which, as an agency, has a constrained operating environment which limits its competences as a rule-maker and which allows the institutions to exert significant oversight powers - for a mighty ECB. The constitutional conundrums which any such transfer of functions relating to delegated rule-making would pose would also be significant. Assuming that the ECB were to be conferred with EBA's functions in relation to administrative rules, it is not clear how, to take only one example, the ECB's independence guarantee could be met in a situation where the ECB, proposing administrative rules or providing technical advice (as EBA currently is charged to do), was subject to endorsement by the Commission, and to oversight by the European Parliament and Council.

While prediction is a fraught business, the impact of Brexit on institutional governance, in the medium term at least, is likely to be incremental. The safest prediction is for a gradual strengthening of the ESAs and for a related intensification of supervisory convergence and

⁹⁷ EBA, "Guidelines on Common Procedures and Methodologies for the Supervisory Review and Evaluation Process" (EBA/GL/2014/13) (2014).

⁹⁸ E.g., EBA, "Consumer Trends Report" (2016) and EBA, "Guidelines on Product Oversight and Governance Arrangements for Retail Banking Products" (EBA/GL/2015/18).

⁹⁹ EBA has included mis-selling risks among the risks to be considered by bank supervisors in stress testing: EBA, "EU-Wide Stress Test. Methodological Note" (2016), chapter five.

coordination – a process which is already underway. Functionally, this might be the lowest impact but also lowest risk outcome.

Conclusion

This discussion considers the implications for EU financial governance of the UK's withdrawal from the EU. A degree of regulatory and institutional change can be expected although the quantum is elusive.

Regulatory effects are likely to include the emergence of a more interventionist approach to financial regulation. This may colour the ongoing review of the crisis-era single rulebook as well as the current negotiations on CMU and on banking regulation reform. But major change is unlikely. International financial governance and international competitiveness remain major influences on the EU regime, as is clear from the current discussions on the 'Basel IV' reforms to banking regulation underway at the Basel Committee and the EU's concern to shape these reforms.¹⁰⁰

It is more difficult to predict the likely implications for the institutional structures which support supervision and enforcement in the EU financial market. This discussion suggests that, in the medium term, a strengthening of the credibility and capacity of the ESAs within the single market is likely to be the most probable outcome. But Brexit is not the only or even the main determinant of how the current institutional structures will evolve. The future shape of EU/single market and euro-area institutional financial governance will depend to a significant extent on the political climate, and on the outcome of the 2017 parliamentary elections across the EU. Similarly, much depends on how the euro area develops, and on whether political (and market) conditions, in the EU and globally, lead to support for further intensification of fiscal and regulatory policy within the euro-area zone and to an alignment, ultimately, between the single market and the euro area. In addition, whether or not the EU banking market can grow and address persistent balance sheet weaknesses in the prevailing low interest rate environment, and with the growing challenge from 'fintech' is, in the short term at least, likely to be of greater significance for the shape of EU financial governance than Brexit.

If political, market, and institutional conditions become favourable, a more far-reaching re-shaping of current institutional arrangements may follow. In an attempt to strengthen the EU 27 market, and to communicate the resilience of EU financial governance post Brexit, some largely cosmetic institutional re-ordering may follow the UK's withdrawal. For example, the silo-

¹⁰⁰ B. Groendahl and A. Migliaccio, "Europe Said to Threaten Revolt over Bank Capital Rue Revamp", Bloomberg, 15 September 2016.

based organization of the three single market ESAs (securities (ESMA), banking (EBA), and insurance/pensions (EIOPA)) is not functionally optimal given the cross-sectoral nature of the EU financial system. A ‘twin peaks’ model, based on a single market European Conduct Authority (for all sectors) and a European Prudential Authority (for all sectors), and concerned with supervisory coordination and the development of the single rulebook, might be a logical ‘next step.’ Assuming the two new authorities were based on an agency model, such a reform would also sidestep the most difficult of the constitutional and functional questions raised by institutional reform. These single-market-oriented, coordination-based authorities would be required to sit alongside the distinct supervisory/operational structures of Banking Union. But the EU now has considerable experience with complex institutional ecosystems in the financial sphere. Whether or not such coordination-based structures could evolve to ‘full-blown’ direct operational supervisors for the single market (assuming the distinct existence of the euro area) is difficult to predict – even assuming a functional case could be made.

Brexit will lead to change, but it is likely to be at the margins of EU financial governance. How EU political conditions internally and international trade relations externally develop, at a time of uncertainty in geopolitics, is likely to have greater salience for the future development of EU financial governance.