SUMMER 2022

Divergence Watch

FINANCIAL SERVICES

Divergence Watch is a new quarterly publication by Ibec Global, which looks at the shifting relationship between the EU and the UK across different business sectors and highlights the key areas businesses should keep a close eye on in coming months. In this issue, we focus on the impact of Brexit on the financial services industry, consider where divergence has taken place so far and its impact, and outline the key takeaways for international business leaders.

Ask someone when Brexit occurred, and you may get some very different answers. Some might say 23 June 2016, when the referendum was held, others 31 January 2020, when the UK legally left the EU, and a few might say 31 December 2020, when the Brexit Transitional period ended.

For many businesses, the key date was 31 December 2020 as this was when Brexit impacted on business models. However, the June 2016 and January 2020 dates also mattered for regulated industries like financial services. After the referendum, the UK's influence over financial regulation began to wane and in January 2020 the UK left the room completely. As such, it could be argued that regulatory divergence really began in 2016, first through a reduced UK voice on EU regulation, then with no UK voice at all, and finally with the UK embarking on its own system of financial services regulation – albeit with the EU system, by and large, frozen into UK law.

IMPACT SO FAR

The impact of Brexit on the financial services industry so far can be seen as three strands:

MARKET ACCESS

DUPLICATION

UNCERTAINTY

The main route for access to the EU single market is equivalence. Different pieces of legislation vary widely (from nothing, to quite liberal access), but, in simple terms, where the relevant equivalence provisions exist the European Commission can decide that a third country has a regulatory framework that is equivalent to the EU's, and this opens access to the single market. Despite the UK starting with an identical framework, the EU has not granted the UK equivalence in any areas except CCP (Central Counterparty) recognition. This has disrupted business models and we have seen quite significant changes

in trading patterns, particularly when it comes to equity and derivative trading.

To address this, firms have had to seek authorisation in both the UK and the EU to secure continued access to the EU single market and EU clients as well as being able to operate in the UK, with many choosing Dublin as an EU regulatory base. This is obviously less efficient, and more expensive, than 'before Brexit'.

How to lower the costs associated with this duplication is a question that has been taxing leaders in financial services businesses. So far, however, this has proved difficult as a new, predictable paradigm has yet to emerge to provide firms with the confidence and predictability to plan cost reductions. Worse still, there is also uncertainty about how products will be regulated. Firms do not know if the products they offer will meet future requirements so they can be marketed in both the UK and the EU or if different products will need to be developed for each jurisdiction.

All of this has an impact on product development for firms which will ultimately lead to higher costs for the consumers of financial services in both jurisdictions as well as raising costs for businesses seeking access to finance.

Firms do not know if the products they offer will meet future requirements

DIVERGENCE

As stated above, the EU has been continuing regulatory reform with little or no UK voice since 2016. After 2020, these reforms no longer applied to the UK.

So far, actual divergence between the UK and EU has been relatively limited. 2010 to 2016 saw a fundamental re-regulation of the financial sector following the global financial crisis. Since then, many changes have been largely cosmetic, fixing issues such as timing, or individual measures that were not delivering results in a proportionate way. These have included in the EU, limited changes to MIFID2 (Markets in Financial Instruments Directive) and the Benchmarks Regulation.

This means that industry has not yet felt a significant impact from diverging regulatory requirements. However, there are several interesting measures, which have not yet been fully applied, around the regulation of ESG (Environmental, Social, and Governance) and climate change related issues, digital and operational resilience. There are also reforms around asset management that are currently passing through the EU and UK legislative machinery.

In the UK, following the onshoring of EU legislation, there are significant programmes underway that could deliver considerable divergence. As well as ESG/ Climate change regulation, there is a Future Regulatory Framework Review and a Wholesale Markets Review.

While we cannot cover all areas of divergence, potential or real, in a short report, we will focus on the key areas business leaders should be focussing on.

ESG FINANCIAL REGULATION

On ESG regulation, the EU has made itself a world leader by moving ahead with an ambitious package of regulatory measures. These requirements have created a complicated framework of detailed requirements around disclosure and measures to avoid greenwashing. The key laws include SFDR (Sustainable Finance Disclosure Regulation), CSRD (Corporate Sustainability Reporting Directive) and the Taxonomy regulation.

The key laws include:

SFDR (Sustainable Finance Disclosure Regulation)

CSRD (Corporate Sustainability Reporting Directive)

TAXONOMY REGULATION

The UK has largely held back. Although it said it would follow the same science as the EU, it will design its regulation for the UK. However, its programme has been moving far more slowly than the EU. The UK has implemented some corporate disclosures stemming from the TCFD (Task Force on Climate Related Financial Disclosures) but the detail of the wider regulation is still under development. This has led to concern about the alignment of the two regimes.

The difficult question for the UK authorities and the people seeking to influence policy will be whether it is better to develop a different regime that avoids some of the problems and learning the lessons from the EU, or simply keep the UK regime as close to the EU for consistency.

DIGITAL FINANCE

Similar to the ESG agenda, the EU has moved ahead of other jurisdictions on the regulation of the growing digital sector. This includes rules that aim to address the risk of outsourcing to non-financial digital specialists, known as DORA (Digital Operational Resilience Act) as well as a framework for crypto assets, known as MICA (Markets in Crypto Assets).

The UK has been working to develop and improve its own framework on the risks around outsourcing. While this is an area where the regimes are largely compatible, firms should keep an eye on these developments as the rules can be extraterritorial (given suppliers are often in other countries) and potentially very burdensome if not coordinated.

For example, if the checks required on a digital provider are inconsistent, a firm operating in, or supplying to, the UK and EU could find itself having to meet duplicative and expensive requirements.

In the UK things have run more slowly, with the UK government very clear that it wants the UK to be a centre of crypto assets (although the regulators remain focussed on the risks to investors or financial stability). There is also work ongoing in both jurisdictions on central bank digital currencies. It remains to be seen where the UK will land on this work but there could be a significant burden on firms if the frameworks mean that businesses must implement different compliance frameworks for the UK and EU in what is a very international market.

Firms should keep an eye on developments on digital finance as rules can be extraterritorial and potentially very burdensome

ANTI-MONEY LAUNDERING

AML (Anti-Money Laundering) processes can be extremely burdensome for financial services firms and failures in AML procedures have led to some high profile, and costly, regulatory action. Many firms would prefer to have a single process suitable for all jurisdictions they operate, but this can be difficult to operationalise.

The UK, many EU member states, and the European Commission are members of the Financial Action Task Force, which provides international standards on AML. However, the regulatory system remains fragmented with divergent approaches and Brexit is likely to make things worse.

Back in 2019, the UK decided to opt-out of the EU's sixth AML Directive, which came into force in June 2021, on the basis that requirements were already covered by existing UK legislation and went further than the EU in some areas.

Following Brexit, the UK also introduced the Sanctions and Anti-Money Laundering Act (SAMLA) which gave it powers to introduce a new sanction regime on a much broader scope that the existing EU sanctions regime. Last year, the UK ran a consultation on targeted amendments to the MLR (Money Laundering, Terrorist Financing and Transfer of Funds Regulations 2017) which are due to take effect from 1 September 2022 and will shortly publish its response to its call for evidence on the AML regulatory and supervisory regime.

The EU is updating its own regime and has agreed to the principle of creating a dedicated Anti-Money Laundering Authority (AMLA). AMLA will contribute to the harmonisation and coordination of AML supervisory practices and directly supervise high-risk and cross-border financial entities. While this might reduce divergence between EU Member States, it is likely to increase divergence with the UK. As a burdensome, but high-risk activity, business leaders should monitor these developments and help avoid incompatible processes that lead to uncompetitive or ineffective outcomes.

MARKET REGULATION

An area of real divergence could be in the way financial markets are regulated. The extensive MIFID2 regulation was originally a compromise between different approaches to market regulation and contains significant national discretions, although these generally focus on the treatment of retail consumers.

Within the EU there have been some relatively minor adjustments to the way MIFID2 works since Brexit and these have been largely consistent with actions in the UK. However, the ambition of the UK through the Wholesale Markets Review is expected to lead to significant divergence. This is likely to include transparency and reporting requirements, as well as more flexibility in how markets are structured. Although any moves in the UK are probably going to be relatively friendly to markets, it will be important to ensure there remains compatibility between the regimes, otherwise any gains in efficiency could be lost or lead to duplication, especially if location requirements are introduced by the EU in response to UK regulatory change.

Furthermore, a difference of approach is likely to be seen as the EU appears to have a greater appetite for direct intervention when the market does not appear to be delivering on EU policy objectives. For example, the EU has recently passed the ESAP (European Single Access Point), which will be an ESMA (European Securities and Markets Authority) managed database providing access to a vast amount of data that is required to be reported under EU regulation. Similarly, the EU is working to agree a consolidated tape that would be provided by monopoly providers appointed via public tender.

It is very unlikely that the UK will adopt such interventionist measures, and this could lead to different approaches to the crucial topic of data in the two jurisdictions and leaders at many firms are watching very closely. It remains to be seen whether the EU's approach will lead to easier access to more standardised data thereby encouraging investment, innovation and lowering costs; or have the opposite effect on the business landscape.

ASSET MANAGEMENT

The regulatory framework around investing, including pensions and insurance is already quite diverse as the EU framework sought to accommodate the very different traditions of the member states (including the UK). However, the UK and EU are now looking at these areas in very different ways.

In the UK, the government is seeking to encourage long-term productive investment. It has introduced the LTAF (Long-Term Asset Fund), a new type of authorised open-ended fund that aims to encourage investing in long-term illiquid assets. This should make it easier for pension funds to make investments in private equity, venture capital and infrastructure (which should support UK Government priorities such as sustainability and levelling up). Further changes are expected in the UK to promote such pension investments as well as free up capital from insurance companies for similar purposes (through a review of the key insurance regulation, Solvency II).

For those interested in alternative investments, this could represent a massive opportunity.

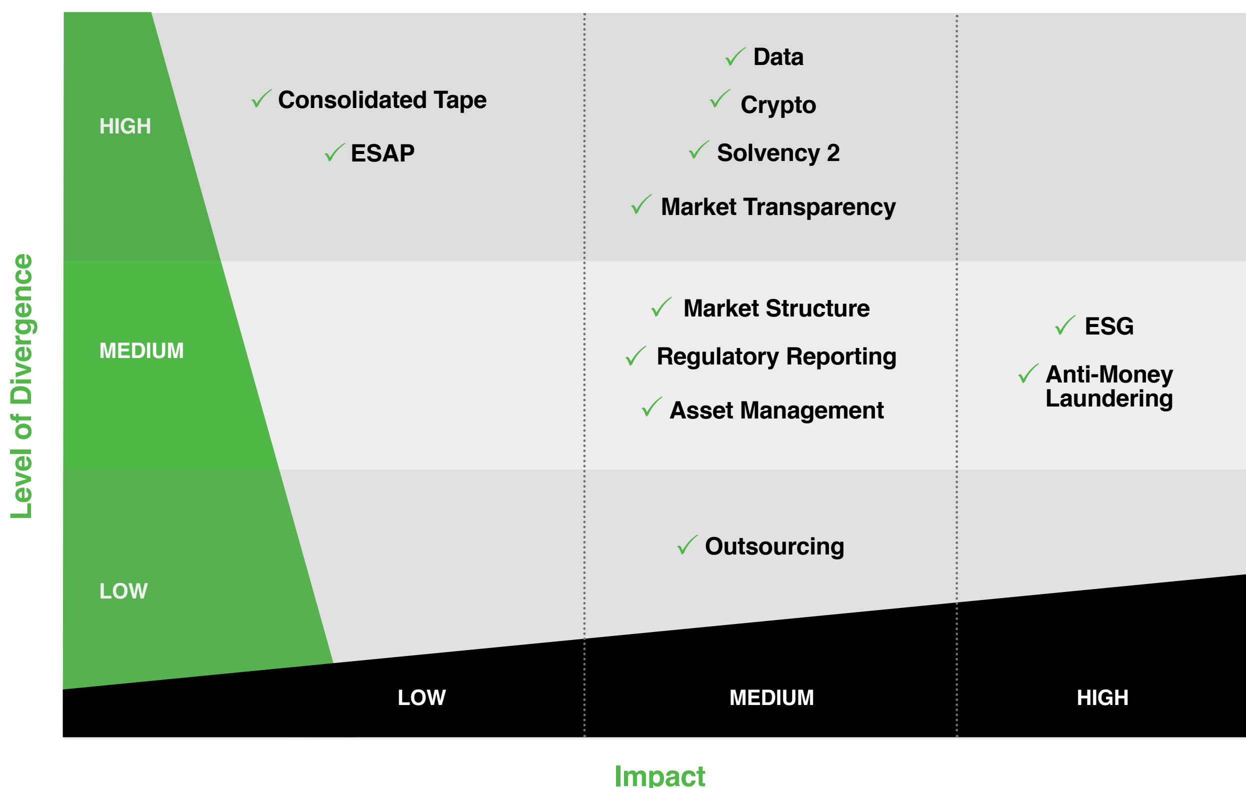
The UK LTAF provides much more flexibility compared to the EU version, ELTIF (European Long Term Investment Fund), which has existed since 2015 but has not been particularly successful. It has more restrictive rules around which assets can be held. Although there are currently negotiations in the EU to provide more flexibility for ELTIFs, it will end up being quite different to the UK LTAF.

Similarly, the UK has introduced adjustments to the rules around PRIIPS (Packaged Retail Insurance and Investment Products), the key information documents that must be supplied to investors into packaged investments. There has been controversy around whether the PRIIPS framework provides useful information in a proportionate way and the UK has acted to make targeted changes, including around disclosures around performance, risk and charges. A more fundamental review is expected to follow, and firms will be hoping for a significant reduction in the compliance burden.

When it comes to investing, the UK and EU are now looking at regulatory frameworks in very different ways

The EU has also been looking at its own changes to PRIIPS and this is likely to mean different disclosures for the same of similar products will be required in the two jurisdictions – something likely to increase the burden on the manufacturers of retail investment products.

DIVERGENCY GRID



KEY TAKEAWAYS

In theory, divergence is not a one-way street. There are some areas of regulation where greater convergence globally is on the table, particularly around the ESG agenda and the regulation of new technologies, including those provided through outsourcing. Financial services businesses will hope that relations will thaw between the UK and EU around regulation and that coordination mechanisms between these jurisdictions, and others, will improve. This would allow the leaders of those firms the clarity to help them make strategic decisions.

However, the reality is that in the medium-term, divergence will be the name of the game in financial services regulation. Business leaders and managers need to be cognisant of how divergent approaches may impact on their firms and include this as a factor in strategic planning and enterprise risk management. A key consideration is that divergence is likely to lead to further duplication and increased costs and a higher administrative and legal burden, which is likely to be an anti-competitive source of friction for firms operating across the two jurisdictions.

As such, business leaders operating in both the UK and EU, will need to monitor regulatory developments, understand the implications for their own firm's strategy, and, where appropriate, engage with policymakers should they feel that the impact of regulatory change risks becoming disproportionate and is impacting the bottom line.

Many firms have a good understanding of the way regulation is formed in Brussels and in the EU supervisory agencies in Paris and Frankfurt. However, the UK represents a new and generally unknown challenge. As the UK's Treasury and regulators evolve their post-Brexit roles, business leaders will need to learn how to understand and engage with a whole new process and set of stakeholders to minimise the risks policy changes present to their business models.

Leaders of international firms, or those with international aspirations, should also take into account that divergence between the two jurisdictions could also lead to higher costs in terms of accessing capital and should consider this variable when it comes to strategic planning and future capital investment decisions.

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GLOSSARY

AML	Anti-Money Laundering
AMLA	Anti-Money Laundering Authority
CCP	Central Counterparty
CSRD	Corporate Sustainability Reporting Directive
DORA	Digital Operational Resilience Act
ELTIF	European Long Term Investment Fund
ESAP	European Single Access Point
ESG	Environment, Social and Governance
ESMA	European Securities & Markets Authority
EU	European Union
LTAF	Long-Term Asset Fund
MICA	Markets in Crypto Assets
MIFID II	Markets in Financial Instruments Directive
MLR	Money Laundering, Terrorist Financing and Transfer of Funds Regulations 2017
PRIIPS	Packaged Retail Insurance & Investment Products
SAMLA	Sanctions and Anti-Money Laundering Act
SFDR	Sustainable Finance Disclosure Regulation
TCFD	Task Force on Climate Related Financial Disclosures
UK	United Kingdom

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TRANSPORT
SECTOR

The next edition of Divergence Watch will focus on the effect of Brexit on the transport sector and the potentially far-reaching impact on transport companies' business models, including HR management, data processing and compliance.