BREXIT
SPECIAL 6

Negotiating a Financial Services Deal

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Negotiating a Financial Services Deal

The upcoming negotiations on the UK's exit from the EU can be expected to take particular account of financial services, the treatment of which has dominated much of the policy discourse on Brexit since June 2016.

In her January 2017 speech on the UK's negotiating objectives, Prime Minister May made express reference to financial services, suggesting that single market access arrangements for certain sectors, including financial services, could take in elements of current single market arrangements. Why this focus on financial services given the array of industry and other sectors competing for attention? The answer lies in the interdependency between the UK financial services industry and that of the EU-27, and in the related and wider economic ramifications. The City of London is one of the world's great centres for financial services. But some 30% of its wholesale market activities (or the professional services relating to, for example, trading, risk management, and asset management which power the financial markets and channel funding to the real economy) derives from EU business; in some areas of derivatives trading business, essential for risk management, the City hosts over 70% of EU trading activity. While speculation can be perilous, it is not unreasonable to suggest that adverse economic consequences will follow, at least in the short term, if the UK loses easy access to the EU market. The EU is similarly dependent on the UK. The City of London exports to the EU 27 some 35% of the wholesale financial market activities which take place in the EU and which power the real economy. While predictions must be made with caution, any significant disruption to this financial pipeline has at least the potential to disrupt the process through which funds are channelled from savers to the real economy, to damage the EU's current efforts to strengthen capital-market-based funding (and thereby to wean the EU from its current dependence on bank-based funding), and to weaken financial stability.

Passporting and the single market

Why should the negotiations between the EU and the UK address Brexit-related disruption to financial services? The financial services sector is one of the most highly regulated sectors of the modern economy given the financial stability and investor protection risks it generates and the potential fiscal risks to taxpayers of any bailouts of financial actors. Jurisdictions accordingly control access to their markets, usually adopting a 'national treatment' approach under which cross-border actors become subject to the rules and supervision of the 'host' state in which they are seeking to provide services – even though these firms are already regulated and supervised in their 'home' jurisdiction. By contrast, under current single market rules EU financial market actors benefit from the financial services 'passport' which allows them to operate cross-border in the EU in host financial markets on the basis (more or less) of home regulation and supervision in the country in which they are registered – the UK for UK firms. A UK firm can therefore operate cross-border in a relatively frictionless manner, at least in relation to financial regulation. The EU passport is heavily based on single market technology: the host regulators of other EU Member States accept passporting actors and defer to home regulators because of the 'single rulebook' which applies to EU financial services – a dense thicket of EU rules which has become ever more granular since the financial crisis – and because of the related supervisory coordination and cooperation arrangements which tie home and host EU regulators together and which include the three European Supervisory Authorities. Current indications suggest that the UK financial services sector will lose the passport when the UK leaves the EU (it is possible that some form of transitional arrangement which retains passporting for a time may be agreed, but the successful conclusion of such an agreement will require solutions to complex questions including regarding the continuing application of the single rulebook and Court of Justice oversight). The Prime Minister has indicated that the UK is to leave the single market and there is little evidence that the EU is likely to agree to bespoke access arrangements based on single market passporting; all indications suggest a commitment to distinguishing between 'membership' of the single market (passporting) and 'access.'

And here the risk of pipeline disruption arises. Unless a harmonized EU access regime applies, access to EU financial markets is governed by the different national laws of the EU 27, who may have distinct competitive interests in obstructing UK access. Access of this type is also limited to national markets only – it does not support passporting. There is, however, a harmonized access regime in place for certain financial sectors under the EU's 'equivalence' rules for 'third countries' (such as the UK on Brexit). But, as noted below, these rules do not provide a legally stable platform from which the UK financial services sector can continue to provide financial services to the EU 27, using current business models and operations. There are other alternatives and the market can be expected to find solutions. UK firms could, for example, establish EU-based subsidiaries through which passporting business could be carried out. Indications are already emerging of a competition between financial centres in the EU for UK-based business. But this strategy is not cost free. Subsidiaries are subject to local rules, including in relation to tax and labour law, and EU rules apply, including in relation to the potentially costly ring-fencing of capital within the subsidiary which may disrupt the operation of the financial group in question.

Equivalence as a solution?

For many firms, access is likely to depend on the availability of an equivalence regime. The equivalence rules are based on the notion that where a third country's financial regulation arrangements are 'equivalent' to those of the EU, access (in different forms) to the EU financial market is permitted, without the third country actor being required to follow EU law. In addition, where a third country regime is equivalent, restrictions which might otherwise apply to an EU actor when contracting with a third country actor are lifted. The current equivalence rules were not designed with the management of the EU's relationship with its largest financial market in mind. They have developed over time, have been shaped by a multitude of different political, market, and institutional interests, and form a messy patchwork. There are many structural weaknesses in the equivalence regime. It is piecemeal, covering only a patchy collection of financial services. It does not cover banking, is limited in the asset management area, and extends only to certain aspects of investment services; it does not map on to the full range of financial services currently funnelled through the EU/UK pipeline. It is powered by single market technology, meaning that UK firms would remain subject to EU law in key respects: the availability (or not) of an equivalence route is set out in EU legislation, which can be amended; the equivalence decision is made by the Commission, advised by the European Supervisory Authorities; and the Court of Justice of the EU retains oversight of the regime. It is unstable. The benchmarks which govern equivalence are high-level in nature and the Commission's decision is discretionary and can be withdrawn. Even assuming the relevant equivalence decisions for those sectors for which equivalence is available were made in advance of the UK leaving the EU (the equivalence process assumes that the state in question is a 'third country' when the assessment is carried out) and 'cliff-edge' effects avoided, the decision could be withdrawn, with related risks and costs, if UK financial regulation began, as is likely, to diverge from EU financial regulation and the high-level conditions on regulatory equivalence were deemed not to be met. A decision could also be withdrawn were an adverse determination subsequently made as to the equivalence of supervisory arrangements – a risk to which the UK could be exposed given the different approaches which regulators adopt to supervision. The equivalence process is technocratic, but it is open to politicization, particularly as Commission decision-making is overseen by a political committee composed of Member States representatives. These difficulties can be surmounted with goodwill, particularly as UK financial regulatory governance is currently heavily based on EU regulatory governance and as its supervisory arrangements have acted as an anchor for pan-EU financial services activity for many years. But the limited coverage of the equivalence regime remains a difficulty while overall the regime does not provide a stable underpinning for the EU/UK financial services pipeline.

A bespoke deal for financial services?

The Brexit negotiations are accordingly likely to include a bespoke EU/UK market access arrangement for financial services, probably in a Free Trade Agreement. Politics aside, a series of design challenges arise, three of which are noted here. First, any arrangement will need to deal with regulatory dynamism, perhaps by linking EU/UK market access to the EU and the UK agreeing to ensure their regulatory regimes conform to a set of principles (rather than being in lock-step), including proportionality requirements. A number of related difficulties will need to be addressed, including in relation to the source of these principles - whether the many international standards of international financial governance (although these international standards are not designed to support market access, being concerned with supporting international financial stability, and it is not clear what happens where the EU has 'carved out' from one of these standards, as it frequently does, and the UK has not) or a bespoke set of agreed principles. Second, a dispute resolution/monitoring mechanism will be required to ensure that parties do not defect and to ensure that regulatory arrangements continue to conform to the relevant principles. Distinct conundrums arise here given the UK's 'red-line' on the Court of Justice of the EU, although there are some models internationally which could be tweaked, including in relation to peer review. Finally, the supervision of cross-border actors, and related solutions governing fiscal risk-sharing, need to be addressed. There are few international templates which allow market access based on home-based supervision; usually, some form of national/host treatment applies. But EU supervision is still a predominantly nationally-located operation, save for within Banking Union, which makes the location of host/EU supervision difficult to pin down. There is a spectrum of potential outcomes, ranging from the highly controversial repatriation solution (requiring that certain businesses be located in the EU – this option is usually associated with the clearing of euro-denominated derivatives trades) through to relying on home/UK supervision. Intermediate solutions could involve an empowerment of the European Supervisory Authorities to register and supervise UK actors – but distinct constitutional and political challenges, particularly in relation to the costs of supervision and firm failure, will need to be addressed.

Conclusion

It is in the EU's and the UK's interests to reach an agreement. But a complex and intersecting array of political, institutional, and market preferences will shape the Brexit negotiations. Member States, for example, can be expected to have different preferences depending on their distinct competitive interests which reflect the still fragmented nature of the EU financial system. Institutionally, initial indications suggest that the Commission may not embrace radical new approaches outside the EU equivalence 'acquis', given its February 2017 Report on Equivalence which underlined that equivalence was not a tool for trade liberalization, suggested that the equivalence regime needed to look more closely at third country supervision, and signalled that markets of greater systemic importance to the EU should receive a closer review. On the other hand, geo-political conditions will matter. There are indications that the US is adopting a less accommodating posture to international financial governance and that global markets may be entering a phase in which domestic retrenchment replaces the coordination and convergence which has largely characterized global financial governance since the financial crisis. The EU/UK negotiations are unlikely to be blind to this development. Perhaps the safest prediction for the upcoming negotiations is that they will produce a workable transitional period over which the complexities of access can be addressed.

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