Course 8

1. The Road to Brexit
2. The quest for Mutual Recognition, then Equivalence
3. Worries about financial instability
4. The difficult road to divergence with EU

The UK Referendum to Leave the EU, 23/6/2016

"Take Back Control"

52% of votes for "Leave" (74% turnout)

No planning and no ideas for what Brexit actually means.

"Brexit means Brexit"

Janurary 2017

OUT of the Single Market

OUT of the Customs Union

In his diaries, *The Grand Illusion: A Secret Diary of Brexit*, (2021), Michel Barnier recalls being "stupefied" by the "number of doors Theresa May shut, one after the other" *in* her Lancaster House speech in January 2017 (reviewed by Jim Brunsden and Sam Fleming, "Boris Johnson's 'madman' dumbfounded Brussels' Brexit chief", *The Financial Times*, May 6, 2021.

By coming out of the Single Market (to take back control of immigration, budget contributions and primacy of domestic laws), Theresa May inevitably set the UK on a hard Brexit path, with no real hope for "mutual recognition" and passporting.

Passports – August 2016

	Total	Inbound[3]	Outbound[4]
Number of passports in total[5],[6]	359,953	23,532	336,421
Number of firms using passporting	13,484	8,008	5,476

Source: Andrew Bailey (FCA), *Letter to Andrew Tyrie MP*, Chairman of the Treasury Committee, House of Commons, 17 August 2016.

Under the Single Market principle of "mutual recognition", the UK and the City in particular had become a base for foreign (and British) financial service institutions, servicing the EU market. This is shown by the number of firms, many holding multiple passports. "Outbound" is for UK-based financial services selling products to the rest of Europe.

Mutual recognition > Equivalence?

Equivalence: unilateral, revocable

Not all activities

Equivalence is a far weaker regime than having passporting rights. First, it applies to far less services, and in particular excludes banking and insurance services for retail clients (see next slide). Second, equivalence is unilateral, and can be withdraw by the European Commission at short notice. This constitutes a poor regime for investors who prefer stable legal conditions.

Table 1: The potential availability of equivalence for UK financial services products

Product-type	EU law	Importance of EU Passport to UK financial services	Is Equivalence Available	Does equivalence permit passporting?
Banking	Market in Financial Instruments Directive II/ Regulation	High: portfolio management, investment advice	Yes	Yes
Banking	Capital Requirements Directive (CRD IV)	High: wholesale and retail banking services such as deposit taking, commercial lending and payment services	No	No
Asset management	Alternative Investment Fund Managers Directive (professional clients)	Medium: marketing and management of investment funds across borders to professional clients	No, but there is trade precedent for indirect portfolio management	No, but absent a deal, individual Member States may permit
Asset management	Undertakings for Collective Investment in Transferable Securities Directive	Medium: as above but to retail clients	No	No
Insurance	Solvency II Directive	Low: cross-border reinsurance	Yes (reinsurance)	Yes
Insurance	Solvency II Directive	Low: cross border direct insurance; most insurers which operate cross-border have established independent subsidiaries in other Member States	No (direct insurance)	No

Andy Tarrant, Peter Holmes and R. Daniel Kelemen, “Equivalence, mutual recognition in financial services and the UK negotiating position”, UKTPO/UK Trade Policy Observatory, Briefing Paper 27 – January 2019. https://blogs.sussex.ac.uk/uktpo/publications/equivalence-in-financial-services/

Political positions harden… over time

For the EU, financial autonomy and regulatory authority became important.
(This is a practical and quasi-sovereignty issue. During the Eurozone sovereign debt crisis, the ECB suspected financial markets in London betting against bonds of southern Member State governments, aggravating the crisis. Also, the ECB needs to have regulatory authority over EU financial activities on the one hand, and does not want to be liable for business outside its jurisdiction on the other hand.)

With Davis, Johnson & Frost <u>politics and sovereignty</u> triumph!

David Davis and his team (right) arrive in Brussels empty-handed to start negotiations in June 2017

Johnson lambasts EU rules for shipping kippers, ignoring that these rules were adopted at Britain's request (Conservative Party conference, July 2019.)

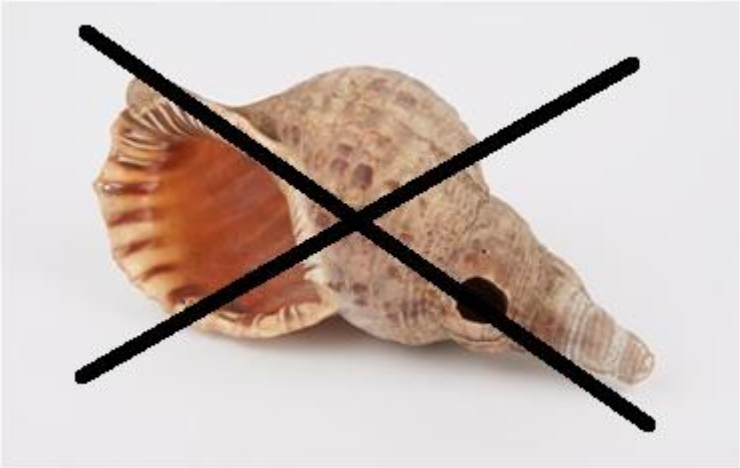
Financial Services $\neq$ Goods

Not in EU-UK Trade and Cooperation Agreement (30 Dec 2020)

(WTO GATS is thus essentially the trade framework, though Britain has granted equivalence unilaterally.)

Hard to track

(But, financial service trade does not cross physical borders. It relies on digital technology and so is hard to track. The EU is especially worried about "shell companies and "fly-and-drive" services. Financial institutions must be capitalised in the EU and have management responsibilities in the EU, etc.)



Separation > Divergence > Separation > Divergence

BUT FINANCIAL INSTABILITY AVOIDED! ... SO FAR ☺

GHOST OF THE GFC

During the various hard-Brexit deadlines (end March 2019, mid-April 2019, end October, and December 2020), there were numerous worries about market cut-offs, contract breakdowns, cliff-edge failures. These concerns led to repeated preparations by UK and EU regulatory authorities. Shocks (like the Lehman bankruptcy (in 2008) were avoided.

Now What

Good News ☺ - G20 / Basel III framework

(The UK took part in the re-regulation of financial services after the global financial crisis. It supports the guidelines set out by the G20, and the Basel committee.)

No “Singapore-upon-Thames”… YET

Bonus cap remains!

“Stringent but **Stylish**” – “agile”

Sam Woods (2019)

Competition through better regulation

(Strong capital ratios, “ring-fencing”, senior managers and certification regime, “sandbox” for fintech, etc.)

The Future – *ce n'est pas la vie en rose*

The City "will survive" but…

could be less competitive with NY

More "agile" regulatory divergence

Possible recruitment problems

EU fragmented finance

Dublin, Paris, Amsterdam, Luxembourg, Frankfurt

The cost of finance will be higher

But maybe more balanced regional/sectoral growth as financial services are dispersed across the EU?

Oliver Wyman Study: Costs of Brexit in Financial Services (October 2016)

UK leaves but retains passporting and equivalence	WTO terms
Fall in EU-related activity -£2bn (2% of int'l business)	40-50% of EU-related activity at risk (£18-20 billion)
3,000 to 4,000 job losses	31,000 to 35,000 job losses
£500 million less tax	£5 billion less tax

New Financial estimates: April 2021

Little equivalence

Trading of EU listed firms must occur in Eurozone – shifted to Amsterdam (nearly £6 bn in share dealing – first trading day of 2021).

- **New Financial survey**:
  - 440 firms have located so far;
  - £900 bn in bank assets (about 10% of UK banking system);
  - 7,400 staff moves identified;
  - Main moves to Dublin 25% of moves (a 1/3 of all asset management movers); Paris, Luxembourg, Frankfurt (banks' main base); Amsterdam (trading platforms)

Trade in Financial Services between the UK and the EU

	2015	2019	2020
Exports to the EU			
-Financial	22,424	23,928	21,409
-Insurance & pension	3,627	3,205	3,311
Imports from the EU			
-Financial	3,291	5,720	4,887
-Insurance & pension	--	1,406	1,381
Balance			
-Financial	19,133	18,208	16,522
-Insurance & pension	--	1,799	1,930
Source: ONS, Pink Book, 2016 (Table 9.11); 2020 (Table 9.13); 2021 (Table 9.13).			

The UK trade surplus in financial Services has already to fallen between from 2015 to 2020.

But these are early times still.

Scott James and Lucia Quaglia, “Three challenges the UK faces in de-Europeanising financial sector policies after Brexit”, LSE Blog 9 May 2023

Domestic institutional framework:

Government & Parliament set framework > Prudential Regulatory Authority (part of Bank of England) and Financial Conduct Authority > issue regulations

UK tradition of strong “arms-length”, independent institutions

December 2022: HMG announces Edinburgh Reforms

1. Reforms to Ring-Fencing Regime
2. Implementation of Post-Brexit Financial Regulatory Framework
3. Growth and Competitiveness Remit for U.K. Regulators
4. Reforms to Wholesale Markets
5. Faster Settlement
6. Senior Manager's and Certification Regime
7. Changes to Promote Investment and Growth in Financial Services
8. Sustainable Finance
9. FinTech and Digital Assets
10. Consumer Credit

Source: Shearman & Sterling, "UK Government Publishes Edinburgh Reforms for Financial Services", December 20, 2022.

Scott James and Lucia Quaglia… continued

DE-EUROPEANISATION	OUTCOME	EXAMPLES
Intentional	UK divergence	Capital markets, fintech (less stringent) Bank capital (more stringent)
Passive	EU divergence	Crypto assets (more stringent)
Failed	Limited divergence	Solvency 2, Listings regime
None	Alignment	Derivatives clearing

Central Counterparties: The Big Battle

- Exchanges of standardized derivatives – very important since GFC
- €100 trillion market (Reuters 27/5/21)
- LCH (London Clearing House) 90% of clearing in euro interest rate swaps
- EMIR 2.2 – tier 2 CCPs of systemic importance

The UK wants to preserve this business. The EU would like to bring it into the Eurozone. But economies of scale are important, and there are some risks to financial stability involved. Large EU operators are also likely wanting cheaper services that come form the large London market.

The Commission has granted access to the London CCPs (for EU based companies) until the end of June 2022.