

## **Brexit and the financial services**

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April 12, 2018. Dublin City University

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The state of play of the negotiations:

- The first phase concluded in December, but a clear solution for the Northern Ireland problem is not yet solved
- The second phase was opened in March, and must be concluded in six months from now
- Three different chapters: the “withdrawal agreement”; the transition ; and the framework for the future relationship
- “Nothing is agreed until everything is agreed”

The UK original “red lines” have started to fade. But a lot of uncertainty still remains. The EU “red lines” -non divisibility of the four freedoms, the leaving member cannot be better-off- stay firm.

And I don’t see real possibilities to go backwards and reverse Brexit before March 2019.

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Where we are when it comes to the future regime for financial services?

The solution is to be found. Right now, is yet unknown. Only the transition is established.

From the EU point of view, as the UK decided not to be part of the Single market after Brexit – to be precise, at the end of the transition period post-Brexit- the providers of financial services established in the UK will not benefit anymore of the “passport” allowing them to operate in the EU-27 territory.

The 27 support unanimously that the “passport system” will not be prolonged beyond the end of the transitional period. Instead of a progressive harmonisation of rules, regulatory divergence can exist. And outside the single market, “mutual recognition “ cannot exist.

I don’t expect that the EU-27 will change this position an embark in “political choices”, blurring their “red lines” and accepting “cherry picking”.

Indeed, this is not the UK’s position. The Chancellor of the Exchequer made it very clear in his March speech: according to him, financial services must be part of the future FTA, “regulatory equivalence” has to be “managed” through cooperation between the UK and the EU. Mrs. May called it “the second basket”, but the EU-27 rejected it.

The argument that never an FTA was signed to regulate divergence from the EU framework is not valid, in my view.

The Chancellor's request is not acceptable by the EU-27. The EU regulations for the single market will never be submitted to a negotiation with a third country.

In the case of the members of the EEA ("the Norwegian case"), they accept the single market rules, are "rule takers".

And I don't think the UK can accept this position, beyond the transitional period.

Therefore, the "equivalence system" will apply.

What it means? I quote Karel Lanoo, CEO of CEPS and expert on EU financial services regulations.

*Equivalence means that "in certain cases the EU may recognize that a foreign legal, regulatory and/or supervisory regime is equivalent to the corresponding EU framework".*

*It allows the EU authorities to rely on the compliance of foreign entities with the equivalent foreign framework, stating that "equivalence decisions may apply to the entire (regulatory) framework of a third country or to some of its authorities only". (...)*

"Equivalence" is decided unilaterally by the EU, and the decisions are prepared on the advice of the European Supervisory Authorities.

Every "Equivalence" decision is revocable at any time.

How this possibility will be managed will depend over time of the degree of regulatory divergence in the UK.

Of course, the EU will immediately react to any sign of a "race to the bottom" in the regulatory stance of the UK.

Nowadays, there are around 40 different "equivalence requirements", covering implementation of CRD IV (Basel III), Mifid II, Investment funds and asset managers, CCP's (Clearing houses), Rating agencies, Insurers, ...

The way this equivalence regime will affect financial entities and market players will depend on many aspects: their organizational structure, the evolution of regulations both in the EU and the UK, ...

The precise regime for the future UK's "status quo" will be set up in the future FTA. It is not clear yet the extent to which financial services will receive a very different treatment than the other services. So far, the EU has announced that the equivalence system needs to be "reviewed and improved" (in a more strict sense?)

So far, there are no precedents of the integration of financial services in the FTA's agreed by the EU. What we know is that "mutual recognition" has never been the way the EU established its relations with third countries, within or outside an FTA.

The specific annex for the treatment of financial services to the 28 March Guidelines for the withdrawal agreement and the transition has not been made public. According to the FT information, the draft talks about the need to make sure "appropriate access" for the UK financial services providers to the EU-27 market. But is not clear what it will mean.

There is a common interest to reach an arrangement, nobody will benefit of Brexit. Brexit is not a zero-sum game, neither in general nor in this particular area. Therefore, costs will have to be assumed. The question is how to distribute them.

After Brexit there will be less presence of UK financial activities in the continent, and less EU financial activities in the City. There is an open discussion about the consequences: fragmentation of financial markets, higher costs, loss of efficiencies and synergies, legal certainty regarding existing contracts, relocation of activities and jobs, difficulties to attract new talent, ....

It seems to me quite obvious that the main victims will be the City of London and the British economy, whose financial sector accounts for about 10% of the total UK GDP. The importance of the EU-27 for the British financial system cannot be underestimated: 23% of the total UK banking resources, 10% in the case on insurers and re-insurers, one third of the asset management business and 50% of the clearing activities. Almost 1/3 of the UK external surplus in services comes from the EU-27.

On the EU-27 side, the losses will probably also exceed the profits. The ECB- as well as regulators such as the Single Resolution Mechanism of the euro zone- are sending messages warning the financial sector to prepare contingency plans for the worst scenario.

On their side, the BoE and other British financial authorities are sending messages trying to seduce EU financial operators to stay in the UK. Let's see if those promises are kept once the final position of the EU is known. Apparently, they will be maintained only during the transition period.

The estimates of the potential losses varies, among other reasons because we still don't know what will be the regime that will apply to the British financial services when they will operate in the EU-27, and vice versa.

But the EU cannot go beyond the limits imposed by the need to differentiate those players being part of the single market from those that decide to be out of it. The treatment to the British financial service providers in the EU territory will be, by definition, not as favourable as it is before Brexit.

In parallel to the advance of the negotiations, European capitals – Paris, Frankfurt, Dublin, Amsterdam, ... are competing with each other to attract new financial activities, and the consequent jobs.

Apart the need to move EBA from London to the continent, ESMA will need to be reinforced, and not only because will have to cope with the challenge to reinforce the supervision of the clearing activities.

I also expect advances in the Banking Union, and in the Capital Markets Union strategy.

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To sum up:

- The final result of the negotiations concerning the financial services is still up in the air
- The UK will not be better-off after Brexit. And financial services will not be an exception to this rule.
- The British “red lines”, as much as they are still valid, goes counter the interests of the British financial sector. The success of the City was due, in part, to the EU membership of the UK. And to the EU regulations building the single market with its four freedoms.
- The EU will not be a big beneficiary, but has more possibilities to minimise the damages.
- Clarification of the “steady state” must take place as soon as possible. I heard several times in the recent weeks that “a transition period losses its value every day” if it is not possible to clarify the final status.
- But, will Mrs. May prefer to be ambiguous in the Withdrawal agreement, letting the details for the FTA negotiations during the transition period?
- There is a risk of not reaching an agreement before the final deadline.