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The European Union's post-Brexit reckoning with financial markets

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Executive summary

IN THE NEGOTIATIONS between the European Union and the United Kingdom over their future relationship, we see a high probability of a weak contractual outcome, given the dominance of politics over considerations of market efficiency. The EU will thus face a great deal of readjustment and regulatory realignment of its market for financial and other services.

THE FUTURE RELATIONSHIP will start out with closely aligned regulations which will allow equivalence, and therefore seamless transactions, to continue in many sectors for a number of years. As regulatory autonomy has been one of the main Brexit rationales, we expect divergence to increase after a couple of years. The UK will become a third country for financial service transactions, dependent on temporary equivalence rulings, whereas in the past it could do business under a comprehensive regulatory passport.

LONDON WILL REMAIN a global financial hub, even as EU companies move operations out of the UK, set up additional licences and distribute activities across the EU. This will result in duplication and thus higher costs in both the UK and the EU as market participants strive to adjust to a future structure that will remain highly uncertain for years to come.

IN THE EU-UK negotiations on financial services, the aims should be to seek an agreement to provide stability for a defined, though limited, time period; a plan for how to manage divergences and the regulatory barriers that may result; and an EU reckoning with what kind of financial market it wants. This would ensure a stable transition to what we assume will be a structurally very different link than existed when the UK was part of the EU.

THE UK HAS historically been both a business centre and policy leader in the financial sector. In its absence, the EU will need to decide how prominent a role finance should play and where regulatory and supervisory responsibilities should be located.

BREXIT CAN ACT as a catalyst for the EU to address what its capital markets should look like and how to get them there. The challenges of restructuring and recovery in the wake of COVID-19, of ensuring confidence in the euro and of preserving pensions systems all require highly integrated, functional and fair financial and capital markets, as public budgets are highly under stress. These integrated markets do not exist in the EU. Action now is of the essence.

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1 Introduction

Brexit is now a reality. The future relationship between the United Kingdom and the European Union remains open and will be decided in negotiations taking place during 2020. These talks can be extended, just as previous deadlines were lengthened in response to political and logistical considerations. The COVID-19 pandemic suggests that these negotiations will take longer than some might have hoped.

In the early phases of the UK's withdrawal from the EU, the financial sector was an area of significant concern. It seemed increasingly unlikely that the UK could remain part of the internal market while leaving the EU, because of the need for regulatory alignment and ongoing European judicial oversight. This in turn raised questions about financial stability, given fears that contracts and economic actors would have to deal with an unanticipated disruption. Competition to lure companies and EU institutions from the UK to within the EU distracted policymakers from assessing what the economic consequences of increased financial fragmentation would be.

Brexit has caused much less volatility than forecast; a European Commission assessment of financial services preparations concluded that no additional contingency measures were required

But Brexit has caused much less volatility than was widely forecast. The European Commission in 2019 assessed financial services preparations and concluded that no additional contingency measures were required (European Commission, 2019)[1], while pledging to monitor conditions and adjust as needed.

Up to now the UK has benefitted from 'passporting,' which allows free and permanent operations throughout the whole EU for financial services companies based in one member state. Passporting rights are permanent for all countries in the single market and span a range of activities from deposit taking to investment services and fund management (European Parliament, 2017). As the UK transitions to the status of third country, or one that is not under the legal regime of the EU treaties, it will no longer be eligible for such smooth cross-border acceptance. Instead it will need to establish other relationships, which will necessarily be more limited. The EU already provides for regulatory 'equivalence' with non-members. This essentially means that as long as both parties regard each other's regulations as being equivalent, trade can flow more freely than would otherwise be the case in designated areas. This sort of arrangement is established on a case-by-case basis for specific sectors. Most importantly, it can be withdrawn unilaterally at relatively short notice. Because there is no clear global definition of equivalence, governments have wide latitude to act as they see fit.

The UK has a robust financial rulebook that, at the point the Brexit transition period ends, will be fully aligned with the EU. This means that equivalence will be readily available at the beginning. It seems highly unlikely that the new agreement between the EU and the UK, still foreseen to be concluded by the end of 2020, will be able to regulate in detail how the financial sectors of the EU and the UK would interact with each other at the regulatory and supervisory level. We expect it will take three to five years for political, technical and transitional work to lead to a new equilibrium in financial-sector relations between the UK and the EU, taking into account possible negotiating extensions, 'technical details' left to be resolved after the main agreement is concluded and sector-specific transition timelines. While it would be nice for the process to work faster and more efficiently, realistically markets and politicians tend to ease into new equilibrium rather than creating a new system overnight.

In the EU-UK negotiations on the future relationship, much of the rhetoric may focus on the drama of what extensions are needed and by when they must be requested, coupled with fears or warnings of a new 'no-deal' situation. Despite all the political rhetoric we have little doubt that ultimately there will be an agreement, also on financial services, preventing a cliff edge.

1 See European Commission communications of June 2019 and September 2019 on Brexit preparations.

The eventual agreement will, however, have to set the scene for a divergence of regulation between the UK and the EU. It will need to address the issues of:

- Determination of regulatory equivalence at the start of the new relationship between the UK and the EU;
- Mutual recognition of financial regulatory and supervisory frameworks; and
- Establishment of mechanisms for granting and reviewing such determinations.

Granting equivalence is not an across-the-board solution for a new relationship between the two partners for the financial sector as a whole. It will need to be established sector by sector, regulation by regulation.

Over time, as indicated already by UK politicians, there will be changes to UK legislation and/or regulatory decisions that will deviate from EU standards and rules. At that point, whether for technical, substantive or political reasons, equivalence will therefore in all probability expire or be withdrawn in the sectors or areas where divergence has opened up.

London, which has been the hub of EU capital markets, will not be the same, but neither will it wither. The EU will have to decide how much of what historically has been done in London should be duplicated inside its borders, and how much it is willing to outsource to the UK or other third-country jurisdictions, such as New York. We expect a slow but inevitable shift to the EU of a certain part of financial services activity that for now is still conducted from London. This will reinforce the relocations that have taken place over the last two years or so. The think tank New Financial identified 332 firms that have relocated at least part of their financial business away from London (Hamre and Wright, 2019), with Dublin being the most popular destination and target of 28 percent of the moves. Paris, Frankfurt, Amsterdam and Luxembourg have also seen inflows, with a number of other cities in the EU also benefitting from the changes. Financial companies want to keep their operational options open.

Historically, most European politicians have seemed to want to keep finance at arm's length, with London's dominance providing the EU with an efficient centre for financial and capital markets. As the EU now loses this convenience, policymakers will need to confront longstanding questions about how to make EU markets more efficient and stable, and how to ensure that cross-border flows of finance work to the benefit of member countries.

Brexit offers an opportunity to reshape EU financial infrastructure for the better. If policymakers take up the challenge, the EU may emerge with a more unified and functional financial market that enhances confidence in the euro area and will better serve the EU economy. Otherwise, the markets – and the broader economy – may sputter along without living up to their potential.

The EU's priorities in the coming decades include tackling climate change, ensuring the viability of pensions, and dealing with the financial turbulence induced by COVID-19. Without a fully integrated and single financial and capital market, the EU will not be able to meet these challenges and mitigate the negative fallout of the crisis. Public finances, under severe strain in many EU countries for the foreseeable future, will need to work closely with the private sector as they will not be able to shoulder these multiple burdens and challenges by themselves. The time to take political decisions on these financial market issues is therefore now.

To make these decisions, the EU will have to transcend what we have seen over the past 20 years, namely attempts by national politicians, regulators and supervisors to retain as much market segmentation as possible. When it comes to financial services, the EU faces the additional challenge of how to push forward on something that is important but not urgent.

In 2020, the immediacy of the COVID-19 pandemic makes structural financial regulation feel even more abstract, and it thus becomes harder to prepare for the future. The EU will need to overcome this inertia to build the finance sector it needs.

2 The negotiation period

With the UK out of the Union, EU and British officials have started debating what the future relationship between the two countries will look like once the transition period ends. At time of writing, this is set for the end of 2020, with extensions of the status quo pre-arranged in some areas of financial services where operational continuity is a priority.

Assuming that the uncertainties associated with COVID-19 abate over the year then negotiations will go on. But there will be no solution to financial services until the very end. Additionally, initial debate may focus on procedural issues such as interim deadlines by when various extensions need to be requested, rather than on the substance of the future arrangement.

During this time, there is little likelihood of significant market volatility associated with Brexit, as most of the contingencies and possibilities have been known for quite some time. Firms have taken their precautionary measures, and fallback solutions are in place. In the years between the referendum and the UK's departure, financial firms made the necessary preparations to brace for a hard Brexit (ECB, 2020; European Commission, 2019). Those preparations can be called on to the extent the future arrangement is not fully worked out when the UK takes on true third-country status.

London will not lose its important global position, but it is seeing changes in its position in relation to Europe

London will not lose its important global position, but it is seeing changes in its position in relation to Europe. The scale of the broader financial industry is enormous. The UK is home to nearly €11 trillion in banking assets. EU clients account for roughly 20 percent of total UK banking revenue, suggesting that up to 20 percent of these assets could be on track to relocate, while the rest, related to UK and non-EU clients, might stay in London (Calò and Herzberg, 2019). Beyond banking, Brexit could also ultimately lead to a reallocation of as much as 40 percent of turnover in interest rate derivatives and 14 percent of other financial intermediary assets. Calò and Herzberg concluded these shifts will have a bigger impact on the recipient cities than they will on London, increasing fragmentation risks while also possibly easing concentration risks across the industry.

The scale of such a shift also raises the question of whether this will affect the global importance of London itself. It appears likely that London will keep its importance at the global level, while weakening as a single point of concentration for European markets as firms distribute themselves into and across the single market.

The future for EU financial markets is therefore more decentralised. There is no single financial centre rising up to replace London. Instead, companies are spreading out across Europe to cities that specialise in specific lines of business or offer other benefits. The industry will lose some of the one-stop-shop advantages of having its financial market workforce all in one place, and it may become more dependent on communications and travel infrastructure. But diversification also has its advantages. Just as banks learned to keep their headquarters and back-up facilities in separate physical locations, they may now see advantages in terms of function and human capital in splitting up their operations. These shifts are well underway and will continue in parallel to the official track of the EU-UK negotiations.

3 What will the EU-UK agreement look like?

The European Commission's negotiating mandate, published on 3 February 2020, makes clear that equivalence is "*the key instrument*" that each side will use to regulate financial interactions. The Commission calls for supervisors to cooperate and communicate, while essentially leaving all doors open in terms of what the final outcome will be: "*The envisaged partnership should reaffirm the Parties' commitment to preserving financial stability, market integrity, investor and consumer protection and fair competition, while respecting the Parties'*

regulatory and decision-making autonomy, and their ability to take equivalence decisions in their own interest. This is without prejudice to the Parties' ability to adopt or maintain any measure for prudential reasons" (European Commission, 2020). In plainer English, stability is good, and being able to act unilaterally in the name of stability is better.

The final deal will keep both of those objectives in mind. It may well result in something that goes beyond piecemeal equivalence for individual rules and market segments. Politics matter, so there will be a need for trade-offs between otherwise unrelated dossiers. The outcome will depend on the political priorities of both sides. For example, the EU might seek a favourable agreement on access to fishing waters by offering a more stable contractual relationship on financial services for a certain period of time, compared to mere equivalence.

One possibility for a more favourable agreement could be to give full and unequivocal financial-sector equivalence for at least five years, which could only be withdrawn in the case of serious divergences by one of the partners. There has been some hope that financial services could be put on a separate track, but we think it is unlikely that political negotiators will allow it to become delinked from other important sectors (for example, see *The Guardian*, 2020).

Equivalence is not a single state, but a patchwork of arrangements that replace only some of the things that are dealt with by passporting

Equivalence is not a single state, but rather a patchwork of arrangements that replace only some of the things that are dealt with by passporting within the EU. The industry views selective and time-limited equivalence decisions as the most likely outcome, with a tail risk that political conflict will mean that no such arrangements can be worked out (Asimakopoulos and Wright, 2020).

'Permanent equivalence' was floated in Britain's opening gambit in the future relationship negotiations (*Financial Times*, 2020a). When the UK published its initial negotiating position at the end of February 2020, it took a more pragmatic line. The future relationship should be legally binding and follow precedents set in the EU's trade agreements with Japan and Canada. At the same time, it "*could include appropriate consultation and structured processes for the withdrawal of equivalence findings*" (UK, 2020).

The EU will have a lot of latitude when deciding how to proceed. As the industry-commissioned Norton Rose (2017) analysis of equivalence noted, there is no international standard for how to determine equivalence or which benchmarks to use. Regulators will not want their cross-border reach to be limited only to areas where such standards exist, however. As Klaus Löber, head of the European Central Bank's oversight division for payments and infrastructure has pointed out, authorities can sometimes justify applying their rules in an extraterritorial fashion if they feel cooperation is lacking. Pressure to do this is magnified in industries seen as too important to rely exclusively on deference (Löber, 2019).

To be effective, the new EU-UK agreement will need an arbitration process that produces rapid results. Ideally this process would require demonstration of economic cause for such a withdrawal of equivalence, and will take advantage of independent expertise.

The EU has a better track record of looking at economics and expertise when granting equivalence than when withdrawing it, when technical and diplomatic factors can come into play. For example, in the period leading up to Brexit, the EU chose not to focus on technical solutions while the political backdrop was still so much in flux. Neither the EU nor British negotiators wanted to give away the end game any earlier than was necessary. Political constraints have therefore limited technocratic problem-solving, and we expect that this will continue while the bulk of the future arrangement is still undefined.

In 2019, the European Commission put the world on notice that equivalence is not guaranteed. First, it allowed some provisions in relation to Switzerland to lapse on 1 July 2019 as part of a broader stalemate in renewing a series of trade agreements. Later in July, the Commission moved to withdraw equivalence for Argentina, Australia, Brazil, Canada and Singapore in the specific field of credit rating agencies. The UK will have to join the rest of the world in undergoing equivalence evaluations. These take time: the Commission works in consultation with supervisory agencies to assess whether the rules applied in the country under consideration are equivalent to those applied in the EU, and to verify that they are

legally binding, ensure effective supervision and achieve the same results as the EU rules.

The decision to let Swiss equivalence expire created headlines because of Switzerland's finance ties to the EU and the natural questions about what would happen and what this would imply for the UK. The particular provisions most affected were those that prevented stocks traded in the European Union being traded on stock exchanges of third countries that are not recognised as having prudential and business conduct requirements equivalent to those in the EU (Baltensperger, 2019). In a worst-case scenario, Swiss stocks that traded in the EU could have been banned from trading on their home exchange. In fact, not much happened. Swiss regulators ordered their companies to trade only on Swiss exchanges, thus removing the requirements related to trading on EU exchanges. Relationships were established for middlemen and associated fees (*Financial Times*, 2019), and trading on Swiss exchanges was broadly unchanged. That was about it. Given the numbers and volumes of EU and UK equities respectively, this benign outcome might be difficult, if not impossible, in the case of a withdrawal of equivalence between the two. Other market segments might face even higher hurdles, depending on the sector.

This suggests that many prospective regulatory barriers could be overcome with additional paperwork and money on the part of firms and clients. Equivalence, passporting and the single market were designed to reduce costs and administrative burdens, however. Thus cross-border activity may become permanently more expensive, which may hurt the growth prospects of the broader economy.

4 Longer-term outlook

Ongoing equivalence matters in terms of stabilising expectations over time, not only in terms of trading conditions at a certain point in time. The point of Brexit, as often argued, is legal and constitutional independence. This only makes sense if you want to exercise it, which we assume will be the case, especially given the messaging from the Bank of England and the Johnson government (*Financial Times*, 2020; UK, 2020). Given that, sectors profiting today from equivalence may lose their privileges, possibly incrementally, once agreement is in place and the future relationship is underway.

Different financial sectors will be affected differently. In some cases, such as credit ratings agencies, firms will need EU-registered entities for their ratings to be recognized in the EU. The European Securities and Markets Authority was required to withdraw recognition of UK ratings companies on the date of Brexit, so the necessary workarounds have already been put in place.

The UK has put in place two types of transition period for financial services firms for when the current passporting regime ends at the end of the main Brexit transition period (foreseen at the end of 2020). For European companies planning to wind down their British business after Brexit, existing contracts will automatically be covered by the Financial Services Contracts Regime, which applies for a maximum of 15 years for insurance contracts and five years for all other contracts. For firms that wish to continue doing UK business after losing the EU passport, the UK has also established a temporary permissions regime to apply after the transition period ends (FCA, 2020). The UK Financial Conduct Authority asked firms to notify it of their plans to use this temporary permissions window before Brexit took place, and said it would consider whether and how to reopen the notifications window later.

One way for the EU to improve its financial market oversight would be to reinforce the European Securities and Markets Authority (ESMA), which was created in 2011 and already has direct supervisory duties in some market segments. A broadening of the scope of ESMA's authority requires reform of its governance and funding, which currently limit its independence and capacity (Sapir *et al*, 2017). Many national politicians, financial services companies and interest groups thrive on market segmentation, and would resist strongly the establishment of a supervisory system for capital markets similar to that now in place

for banking, even though it would make for fairer competition, increase legal and economic convergence and move the EU towards a genuine capital markets union.

Adjustment might prove to be challenging for providers whose services are closely linked to finance, such as accounting and the legal profession

Adjustment might prove to be more of a challenge for those service providers that are not financial, but whose services are closely linked to financial products, such as accounting and the legal profession. In the run-up to Brexit, UK law firms actively applied for licences in EU jurisdictions, such as Ireland, in order to have more options in terms of maintaining client relationships (Law Society of Ireland, 2019). EU institutions and European international financial institutions will need to work with EU service providers. The European Stability Mechanism, for example, has shifted its contracts from UK law to Luxembourg law. If a wave of companies follows suit, firms that operate in the UK and in the EU will need to make sure they can manage all of the extra complexity from using multiple systems.

The legal industry faces considerable shifts to make sure it has the capacity to handle all of the new cross-border contracts and technical changes that will result from the UK's change in European status. Under some scenarios, this transition could greatly complicate working relationships, especially for London-based clients. Will they continue to be able to use a London-based lawyer to manage their EU affairs, or will they need to switch to partners in Brussels or Dublin to make sure everything works smoothly? In the past, Europe has been willing to travel to London, but now Londoners might need to make the journey in reverse. Courts could also see an increase in legal battles over which jurisdiction has precedence, and whatever substantive matters may be disputed, once the UK is no longer automatically bound by the EU Court of Justice.

International firms could face additional hurdles managing their human capital because the final EU-UK deal is unlikely to include full freedom of movement. This means workers who are posted from one jurisdiction to the other will need visas and other administrative support that was previously unnecessary, increasing costs and giving companies incentives to consolidate in new financial hubs, to the extent that EU cities can establish knowledge centres and standardise professional qualifications.

One reason this transition is difficult to navigate is that many of the services the UK has provided were done cross border efficiently and well. London has been a home in particular to non-bank financing channels. This is the area in which cross-border relations will require the most attention. Brexit thus forces Europe to consider what else its financial sector needs to have. The EU has already been grappling with dependence on bank financing and a general situation in which there are too many banks and too few capital market options (Pagano *et al*, 2014). After Brexit, the question of how to encourage and support capital markets activity will take on new resonance.

It is too simple to say that the UK is home to 'more finance' and the EU has a preference for 'less finance'. The financial sector and the real economy are intertwined to a great extent. Europe might have a general distrust of 'speculation', but it has long counted on cross-border finance to be one of the single market's strongest enablers. The EU's economic success thus depends crucially on how the EU organises itself without the UK. The less progress there is towards a more efficient and integrated capital market in the EU, the greater the negative effects on the EU will be.

To move ahead, the EU should take action in the following areas:

- Clear-eyed analysis of where Europe's financial stability requires certain functions to remain in-house, and where the EU would be weaker if it fences itself off from global financial channels. Ringfencing is not new with the debate on the EU-UK relationship, but it will take on new resonance.
- Vigilance on operational risks, particularly settlement snags that could arise because of unexpected blockages in the financial plumbing.
- Recognition of the current tension between home and host countries, particularly in the context of cross-border issues including resolution planning, capital set-asides and operational risk management. This will require a balance between consistent pan-European

rules and a fair framework for a multipolar union. A functional system will require a fair degree of flexibility to be workable, but it must not have so much leeway that it becomes effectively unaccountable. If the aim is to have a smoothly functioning internal market and capital market, it will be necessary to move towards more centralised oversight in a number of financial sectors, including equity trading and issuance.

- Completion of the euro-area banking union, including full deposit insurance across the currency union. Brexit might not affect this debate directly, but it should offer a new momentum to address existing weaknesses in the current system. Current vulnerabilities will take on a new prominence as the EU financial system reshapes itself: the bank-sovereign link that the euro area has tried so hard to break could inadvertently strengthen if national champion banks in bigger EU countries take up a larger proportion of the EU financial sector. Deposit insurance would build worldwide confidence in the euro, while continued fragmentation will hold back the currency's global role.
- Data-sharing policies that are practical, effective and adequately protective. Data-transfer questions will be a particular point of contention, as they cut across multiple sectors and industries. To the extent that new barriers inhibit information exchange, regulators will be more likely to require industry retrenchment. Furthermore, the EU has a strong tactical incentive to withhold data adequacy recognition for the UK in this area, given its usefulness as a bargaining chip.
- Renewed consideration of whether non-euro countries will join the banking union. There would be considerable operational constraints for countries outside the Eurosystem to shift financial supervision to the European Central Bank, so the hesitation of countries such as Denmark and Sweden is understandable.
- Action to increase trust among EU nations. It is hard to imagine how Europe can emerge from Brexit stronger than before if it continues on its current course of setting up self-protective national barriers alongside new cross-border supervisory structures. COVID-19 underscores and amplifies these concerns.
- Renewed focus on anti-money laundering initiatives. Once again, the change to the financial system arising from Brexit could be an opportunity to strengthen the EU financial system across the board, not just by absorbing business from London.
- Consider emerging sectors such as financial technology (FinTech) and sustainable finance, where regulatory divergence might have a broader impact because markets are evolving quickly, and weigh how much regulatory competition to allow within the EU.

As discussions on the future EU-UK relationship continue, uncertainty remains a central policy issue. At a minimum, financial firms face extra legal and administrative costs to make preparations and continually review them to avoid unpleasant surprises. At worst, a neglected part of the financial infrastructure could break down and set off a shock that unravels much of the careful work that went before. As of this writing, operational risk and settlement risk seem to have been thoroughly vetted by lawyers and financial managers. But the nature of crisis is that it often comes from unexpected directions. Political considerations require policy technicians to leave many loose ends, in order to allow negotiations to take their course.

Financial sector risks in the wake of COVID-19 will become greater. This will in itself bring about change to the structure of all sectors concerned, and will require further changes in supervision, regulation and international cooperation.

The adjustments will force the EU to confront longstanding questions about how member states work together. Historically, European politicians have been able to keep finance at arm's length, because of London's dominance as a market centre. The EU now loses this shield. But the EU also has an opportunity to reshape its financial infrastructure for the better. If policymakers take up the challenge, the EU may emerge with a more unified and functional financial market, which enhances confidence in the euro area and will better serve the EU economy.

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