Brexit
Special Supplement

Financial Services, the EU, and Brexit: An Uncertain Future for the City?

Niamh Moloney
London School of Economics and Political Science, Law Department
[N.Moloney@lse.ac.uk]

The financial services industry is of central importance to the UK economy. It represents some 7% of GDP. It also generates major exports for the UK - in the region of one-third of UK financial services are exported to the EU.[1] News reports in the immediate aftermath of the referendum result included the sharp drop in banking stocks; the overtures being made to attract UK financial business away from the City to other EU centres; and plans by leading financial institutions to move some operations away from the City. Vivid illustrations all of the importance of the Brexit vote for the City and the UK financial services industry.

The financial services sector is one of the most heavily regulated sectors of the modern economy, reflecting the need to protect the public interest in a strong and stable financial sector. The EU has, up to now, provided the framework within which UK regulation of the financial sector has been designed, applied, and supervised.

The nature of the UK's relationship with the EU following its exit from the EU has yet to be determined. But the consequences of the extraction of the UK from EU financial governance are likely to be disruptive in nature and long term in duration. This short note highlights some of the many implications from a regulatory perspective.

The UK and the International Financial Market

The arguments posed in favour of a 'Leave' vote often referenced the possibility of lower levels of financial regulation. The UK's exit from the EU is very unlikely to bring any significant change to the nature of UK financial regulation. This is because financial regulation is global in nature. Much of it derives from the standards set by the International Standard Setting Bodies (ISSBs) - for example, the Financial Stability Board, the Basel Committee on Banking Supervision, the International Organization of Securities

[1] HM Treasury, *The Long Term Economic Impact of EU Membership and the Alternatives* (April 2016).

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Commissions, and the International Association of Insurance Supervisors - and is shaped politically by the G20.

On exit from the EU, the UK's ability to influence and impose its preferences on these international standards will be severely diminished. At present, the UK has four channels through which it can protect its interests in financial regulation. First, as a member of the major ISSBs, it can directly advocate for UK interests – as it did during the Basel Committee negotiations on the pivotal crisis-era 'Basel III' banking regulation reforms. Second, the EU acts as collective bloc on these ISSBs where a common position can be constructed (the Commission typically sits on the ISSBs, whether directly or in an observer capacity) - collective EU interests also shaped the Basel III reforms. Third, as international standards are implemented in the EU through the adoption of related EU Directives and Regulations, the UK, through the legislative process, can protect UK interests by influencing how Member States implement the standards. The adoption of the behemoth Capital Requirements Directive IV/Capital Requirements Regulation 2013 (CRD IV/CRR) – which acts as the EU's banking rulebook and which implements Basel III - saw the UK achieve a number of negotiating successes designed to ensure the implementation process would not undermine UK interests. Finally, the EU's European Supervisory Authorities, established in 2011 as part of the EU's crisis-era institutional governance settlement and on which all the EU Member States are represented, play a key role in implementing international standards - the European Banking Authority, for example, has been a major institutional player in the design of the detailed technical rules required to implement CRD IV/CRR/Basel III. On an EU exit, the UK will lose three of these four channels for influence. But it will remain obliged to implement internationals standards.

Other international consequences follow. As has been well charted in the literature, the EU has, in the wake of the financial crisis, become one of the 'great powers' in international financial regulation. Part of the EU's related regulatory capacity (or ability to shape outcomes) internationally derives from the EU's ability to impose 'equivalence' requirements on third country access to the single market in financial services. The UK will no longer benefit from this regulatory capacity which has been used by the EU to negotiate access by EU firms to third country markets. For example, the removal by the US of the costly 'reconciliation' requirement imposed on EU firms (to reconcile their financial accounts to US GAAP – the US accounting standard) was agreed because the EU adopted, as a bloc, International Financial Reporting Standards: the US agreed accordingly to accept accounts following International Financial Reporting Standards. A technical issue, certainly, but one of great practical significance for the many large UK firms listed on US stock exchanges.

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The UK and the Single Market

On an exit from the EU, the financial services industry will no longer have access to the massive single market in financial services on the basis of current arrangements. There is no clarity at the moment on the nature of the UK's potential access arrangements. But a number of comments can be made with a reasonable degree of certainty.

The financial services 'passport' – through which UK financial institutions access the single market - will not be available in its current form. The passport is based on the 'home' country of a financial institution (where that firm is registered) supervising that firm and applying the EU's 'single rulebook.' The passport allows a firm to provide services cross-border and to use branches without being subject to duplicate regulation or supervision. For this reason, international banks and financial institutions have established subsidiaries in the UK so that, as UK home-regulated firms, they can access the single market and avoid the complexities, opacities, and uncertainties of third country access arrangements. The passport depends on mutual trust between national supervisors and is, accordingly, dependent on harmonized regulation and on coordinated supervision of financial firms. The financial crisis led to a political and institutional consensus in the EU on the need for a harmonized single rulebook that would protect the single market against cross-border risk transmission, support pan-EU financial stability, facilitate cross-border market access – and also meet the EU's G20 commitments with respect to financial regulation reform. This single rulebook is of massive scale and depth, being composed of 'level 1' legislative rules, 'level 2' technical delegated rules adopted by the Commission, and 'level 3' soft guidelines and other measures adopted by the European Supervisory Authorities. It runs to thousands of pages of text and its adoption has required a monumental effort by the EU's rule-making institutions, by regulated actors, and by a wide range of stakeholders. The UK has implemented most of these rules and will be required to continue with the implementation process until it leaves the EU. In all likelihood most if not all of these rules would have been adopted by the UK without an EU imperative, as they reflect the G20's reform agenda, the requirements imposed by the international standard setters, and the changed post-crisis global consensus on how regulation should be designed and applied.

On an exit, the UK will no longer have access to the financial services passport. Under the European Economic Area/Norway model, it would have access to the single market but would be required to apply the single rulebook - and would not be involved in the negotiations on and the development of this rulebook. This matters as the single rulebook is highly dynamic. For example, the EU's current major regulatory project for financial services is Capital Markets Union (CMU), which was launched by the Commission in September 2015. CMU is a liberalization project. It is designed to deepen EU capital markets, strengthen market-based finance, and reduce the current dependence on bank

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financing in order to support pan-EU growth. Its importance to the City – the major capital market centre in the EU - was immense. On exit, and under an EEA model, the UK will not be able to influence CMU-related negotiations, despite their acute importance for the City. The UK will also lose the ability to shape refinements to the single rulebook which could protect its interests. EU financial regulation is currently being reviewed - the massive crisis-era single rulebook contains a number of automatic 'review clauses' which are now being activated. On exit, the UK will be outside this review process and unable to influence it to protect UK interests. To take one example, the famous 'bankers' pay bonus cap', which was fiercely resisted by the UK, is now being reconsidered, particularly with respect to whether new rules governing the proportionality with which the cap applies are required. The UK will have no voice in these discussions should they not be completed prior to a UK exit. And in the interim, it is difficult to see how the UK will be able to exert any form of influence in ongoing Council negotiations on financial regulation – not least as a euro area qualified majority is now in place in the Council and there will be few incentives for euro area Member States to coalesce with the UK: the interests of those Member States with large financial centres - notably France, Germany, the Netherlands, Luxembourg, and Ireland - can be expected to dominate. Previously, the UK has been an influential and effective influence on financial regulation negotiations. For example, many of the exemptions and calibrations contained in the massive Markets in Financial Instruments Directive II/Markets in Financial Instruments Regulation 2014 (MiFID II/MiFIR), which will govern EU investment firms, markets, and infrastructures from 2017, and which are designed to ensure the new rules are calibrated to reflect different market sectors, are a product of UK negotiation successes.

Beyond the EEA model, any other access model would, given the highly regulated nature of financial services (both in the EU and globally) involve some sort of 'equivalence' arrangement, with the UK seeking access as a 'third country' to the single market. The rules governing third country equivalence and related access to the single financial market are different across different EU financial regulation measures. Sometimes the equivalence decision is held at EU level (with the Commission), more often it is held at Member State level. Equivalence decisions are not automatic and it is hard to see how any equivalence negotiations with the UK – whether by the EU or individual Member States - would not become highly political given how competitive the global financial market is. As the UK has adopted the single rulebook, and as it would likely keep it if it was seeking some form of single market access, formal regulatory equivalence would not pose a major problem. But significant challenges for the UK could be generated by any new rules which the UK would be required to follow, or at least to adopt in such a way that the equivalence assessment was met, and which it had not been able to influence. New EU rules are on the horizon. These include rules governing investment fund regulation which would be of significant importance to the UK asset management sector. In addition, much of the single rulebook, with which the UK would have to show equivalence, takes the form of highly detailed

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technical rules which are proposed by the European Supervisory Authorities. The UK will not have a seat or vote on these Authorities on Brexit and will not be able to influence the new technical rules that will be proposed by these Authorities.

But equivalence under current EU financial law is not simply a matter of regulatory equivalence. It also involves an assessment of supervisory/enforcement equivalence, and here the difficulties could be considerable given the highly elusive nature of equivalence determinations with respect to supervision and enforcement. The UK might, for example, come under pressure to adopt a tougher approach to enforcement or to change its approach to supervision. At present, no such pressure can be applied within the single market.

Finally, and assuming it was operating outside an EEA arrangement, the UK would lose the EU Treaty guarantees relating to single market access. At present, the right of UK firms to choose the form in which they access other Member State markets (whether service provision, branches, or subsidiaries) is protected as a matter of EU law. This guarantee would no longer be available and UK financial institutions would accordingly become vulnerable to requirements to, for example, establish costly subsidiaries.

The UK and the Euro Area

It is very unlikely that, politically, the euro area will be neutral or disinterested with respect to the UK remaining the major centre for euro-denominated trading in the EU (as it currently is). Prior to June 23, there were significant tensions relating to euro area interests and influence, particularly as the euro area can now form a qualified majority voting bloc in the Council and so shape EU/single market decision-making more generally, and as Banking Union has created new incentives and opportunities for euro area interests to be pursued. The UK's efforts to minimize the dangers of euro area caucusing and of any potential discrimination against single market Member States who do not form part of the euro area have had traction. Notable outcomes include the successful action by the UK against the ECB's 'location policy' for central clearing counterparties – a critical part of financial market infrastructure - which the UK claimed discriminated against non-euro-area central clearing counterparties by requiring euro area location.[2] Similarly, the 'double lock' voting arrangement which applies to the European Banking Authority's Board of Supervisors, and which requires a double majority of Banking Union Board members and of non-Banking-Union Board members, were driven by the UK. Most recently, the February 2016 New Settlement on the relationship between the UK and the EU was designed to give legal, but

[2] Case T-496/11, *European Central Bank v UK.* The case was decided on an issue relating to the scope of the ECB's powers.

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more importantly political, protection to the UK (and the single market) against euro area caucusing risks and was the European Council's response to the UK's call for legally binding principles that safeguarded the operation of the Union for all 28 Member States and protected the single market.[3]

The New Settlement is now null and void. On an exit, and assuming a non-EEA arrangement, the legal protections against discrimination within the EU on currency grounds, both in the Treaty and in specific EU financial services measures, will fall away. Even within the EEA, the UK will no longer have a seat or vote on the European Banking Authority – it will have only observer status. The consequences could be severe for euro-denominated trading and financial services. Location requirements, for example, could be imposed on the UK's access, as a third country, to the single market. Such location requirements could require certain euro-denominated business/trading to be carried out in the euro area. This is a particularly likely outcome with respect to critical market infrastructures, such as stock exchanges and central clearing counterparties, in relation to which rescue/resolution responses involving ECB/euro area liquidity support might be needed. These requirements are all the more likely to follow given the political and institutional support in some quarters for a more integrated 'Financial Union,' based on Banking Union but which would also include more intense institutional integration with respect to capital markets.[4] Operating outside the EU Treaties and their guarantees, the UK would have little protection against a Financial Union which sought to repatriate certain euro-denominated trading through regulatory means. Network effects may also follow. If euro area business shrinks, the UK market might become less liquid and lose business more generally.

The UK and the Domestic Market

Finally, for those UK firms that do not trade with the EU, an exit from the EU will also generate costs and uncertainties. This is because of the changes which will be required to the legal operating environment for financial services in the UK.

Much of UK financial legislation is in the form of EU Regulations which apply directly in the UK. These rules will cease to have legal effect on an EU exit. They must be replaced if a

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[3] Decision of the Heads of State or Government Meeting Within the European Council, "Concerning a New Settlement for the United Kingdom with the European Union," European Council Meeting, 18 and 19 February 2016 (EUCO 1/16), Annex 1. *See* N. Moloney, *Capital Markets Union: "Ever Closer Union" For the EU Financial System?*, 41 EUROPEAN LAW REVIEW (2016) 307.

[4] *Completing Europe's Economic and Monetary Union*. Report by Jean-Claude Juncker, in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi, and Martin Schulz (June 2015).

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regulatory vacuum, in an area of the economy which demands high levels of regulation if the public interest is to be protected, is to be avoided. During this replacement process, and aside from any consideration of equivalence-related obligations which may arise, the UK will also have to decide which of the obligations it has implemented through Directives it will keep 'on the books'. This will be a mammoth task given the vast scale, breadth, and complexity of the EU financial regulation rulebook and the great depths at which it is embedded in national regulatory systems. The UK will also have to decide what to do with the vast array of guidelines, templates, FAQs, and so on which have been adopted by the European Supervisory Authorities. Although in the form of soft law, these measures have become part of the regulatory fabric supporting the UK financial sector and protecting the public interest in stable markets, and have also shaped the business and operating models adopted by financial firms.

The unpicking from the macro EU financial regulation order, and in a manner which brings minimum disruption to the financial services sector and its users, of a coherent and stable micro UK financial regulation order - which protects investors and supports financial stability - is a task which confounds the search for a metaphor which illustrates the immense complexity engaged. It can only be hoped that UK regulators and policy makers – and the UK financial services industry - are not, at the same time, required to grapple with dislocation in the financial markets.

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