Brexit Conference

Centre for Commercial Law Studies, University of Stockholm, 16 November 2017

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This presentation addresses some of the main regulatory policy and legal issues for the financial services sector arising from the 23 June 2016 Brexit referendum. The extent to which Brexit may restrict the access of the UK financial services sector to the EU 27 market is of acute economic relevance. The EU 27 market accounts for some 25% of UK financial services business – a business which is one of the motors of the UK economy given its importance to tax revenues. The ability of insurers, asset managers and pension providers to fund their liabilities and manage their risks, on which household finances increasingly depend, is in large part a function of their access to the EU single market in financial services – the second largest financial services market in the world after the US. This access is currently based on the UK's membership of the single market and the related 'passporting' privileges which follow for financial firms: once a firm is regulated in one EU Member State in accordance with the EU's vast and densely harmonised 'single rulebook' it has (more or less) legally frictionless access to the EU single market. When the UK leaves the EU, this passport will no longer be available and UK financial firms, in the absence of an appropriate EU/UK trade agreement, could face onerous regulatory costs and barriers. Similar challenges arise for the EU. Some 35% of all financial services activity in the EU takes place in the UK, which specialises in the highly sophisticated risk management techniques necessary to drive and protect the modern capital market. Any obstruction to this pipeline of critical services could cause serious disruption to the EU financial services sector and potentially to the EU economy.

While the UK and EU are committed to developing a new trading arrangement which is, variously, deep, comprehensive, close, extensive, special, and/or strong, these intentions may founder on the rocks of political interests and technical complexity. For the financial services sector is among the most valuable but also the most heavily regulated sectors of the modern economy, reflecting the scale of the public interest in stable financial markets. States internationally rarely if ever cede access to their markets without demanding – to some extent – compliance with their regulatory requirements. The EU's single financial market has no parallels internationally in the extent to which it liberalises access to domestic financial markets; but this access is predicated on compliance with the EU single rulebook and on the coordination of supervision through the European System of Financial Supervision, as well as on the wider disciplines which govern the single market, including the totemic 'four freedoms' and dispute resolution through the Court of Justice of the EU. One of the most powerful impulses driving the 23 June 2016 referendum, however, was the need to 'take back control' which presupposes a (large) degree of regulatory autonomy and independence from EU institutional structures. How then to ensure UK access to the highly regulated EU financial market, and vice versa, without subjecting firms to EU or UK regulatory norms and institutional structures, particularly when competitive interests are acute given the value at stake? Might there be solutions elsewhere? The classic suite of solutions includes membership of the European Economic Area (EEA), which would lead to the UK being an EU 'rule-taker' – benefiting from the passport but not having a role in the adoption of EU regulatory norms; a Free Trade Agreement (FTA), perhaps within the European Free Trade Association (EFTA), which would provide for market access based on some form of device for assuring regulatory parity – whether in the form of 'substitute compliance,' 'equivalence,' 'comparable compliance' or some other mechanism; or, as a last resort, default reliance on World Trade Organization/General Agreement on Trade in Services (WTO/GATS) rules. All these models have some promise, but they all generate different challenges and complexities.

The questions and conundrums generated by Brexit for financial services are not limited to market access by regulated actors. How is the highly skilled workforce on which the UK financial services sector depends, and which is in part drawn from the large and fluid EU 27 labour market, to be sustained after the UK's withdrawal? And what about the intra-EU implications? After a period of acute instability over the financial and euro-area crises (2008–2012), followed by a period of large-scale reform, EU financial governance has been more or less stable in recent years. Might Brexit unleash new forces for change, driving the EU to seek greater integration and leading to further reforms, including new centralised financial supervisors?

My presentation identifies the core issue for the EU/UK financial services negotiations as finding agreement on a governing standard for testing regulatory parity; regulatory parity can then unlock market access. The EU operates an 'equivalence' system for access by 'third countries', which is based on access being dependent on parity with EU regulation. Acceptance of EU regulatory norms is, however, antithetical to the impulses which drove the referendum result. Accordingly, a bespoke model should be considered which would respond to the mutual interests of the UK and EU in enabling continued reciprocal access through some form of regulatory/supervisory deference. It is suggested that a hybrid standard for regulatory parity offers the most promise. This would rely on the international standards adopted by the International Standard Setting Bodies (such as the Basel Committee) where appropriate. While such standards are not always fit for purpose as benchmarks for parity, they offer a workable solution for the regulation and oversight of cross-border bank branches. Elsewhere, EU standards are likely to provide the most efficient means for assessing parity. However, this calls for a more nuanced EU approach to the assessment of equivalence and for a focus on outcomes rather than on formal compliance. The success of this model is, however, dependent on bespoke EU/UK institutional arrangements for supervisory coordination and dispute resolution and may require a softening of the UK's posture in relation to supranational EU-level dispute resolution.

Another possibility for EU equivalence, and the potential for regulatory parity, is demonstrated by the EEA/EFTA trading and institutional arrangements. The organisational design and institutional setting of the European Economic Area (the ÉEA or 'Norway model') exemplifies the challenges which cross-border market access generates. It is respectfully submitted that the EEA does not provide a solution for the UK as it requires acceptance of EU regulatory norms and institutional structures, but may serve as a short-term fix during an interim period of the single market while a final trading arrangement is negotiated.

Beyond the EEA, the European Free Trade Association (EFTA) has historically been based on its members entering into FTAs with the EU. The example of Switzerland as an EFTA member is salient. Under the so-called 'Swiss model,' Switzerland has negotiated only one FTA with the EU on financial services (the 1989 insurance agreement) which, in effect, requires parity with EU regulation in a narrow area of the provision of insurance services. Since then, Switzerland has struggled to conclude a broader FTA on wider access for financial intermediaries, in part because of EU concern as to Swiss quotas on EU migration.

As a result, Switzerland is increasingly coming to rely on the EU's third country/equivalence rules and related WTO rules, for ensuring access to the EU market, and not on the FTA model.

The Swiss experience with the EU equivalence rules has been successful in certain areas (equivalence under Solvency II, but incomplete negotiations under MiFIR/MiFID II). Swiss financial policy has been impacted by the political, procedural and regulatory challenges posed by the extent to which the EU retains discretion over equivalence decisions.

As a financial policy matter, Switzerland has come to embrace equivalence as the most important means by which Swiss financial firms can gain enhanced access to the EU market, but there are challenges and policy concerns associated with the procedural complexities and contingencies of the equivalence process.

Finally, the Swiss model (EFTA/equivalence) has limitations for the UK, particularly as Switzerland is seeking more economic convergence and integration and regulatory coordination with the EU, while the UK seems to be moving in the opposite direction.

Prime Minister May's 22 September 2017 Florence Speech had been credited with bringing a warmer tone to the UK/EU negotiations but the negotiations have yet to proceed beyond the first 'divorce' phase and on to the second phase and the trade/market access negotiations. Much hope is being pinned on the December 2017 European Council opening the way for the trade negotiations in early 2018. These negotiations, once they start, will be politically challenging and technically complex. It should also be recognised, however, that with political will and technical imagination much can be achieved. The EU, with the UK a key voice, has a long history of finding pragmatic, innovative and purposeful solutions to problems of financial governance previously thought to be intractable. By examining the different implications of Brexit for financial services, EU/UK negotiators should focus on the subtleties and complexities and exposing the potential models for new forms of EU/UK interaction. Only by taking this more principled and nuanced approach can negotiators avoid a hard Brexit scenario and instead propel the most important debate on the organisation of financial regulation for a generation on to a more positive and mutually beneficial level for all of Europe.