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Post Brexit Regulation of Financial Services: Some Perspectives

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1. Introduction: a focal point, the post Brexit era

This paper assumes as a focal point the concept that the "post Brexit" may represent a change of era for European and global financial service and particularly for capital market sector.

The point is underlined in the official "White Paper" issued by UK Governments *The United Kingdom's exit from and new partnership with the European Union*: [1]

> *"The UK's financial services sector is a hub for money, trading and investments from all over the world and is one of only two global, full service financial center and the only one in Europe."*

As to capital market sector:

> *"Over 75 percent of the EU 27's capital market business is conducted through the UK. The UK industry manages £1.2 trillion of pensions and other assets on behalf of European clients. The UK is also responsible for 37 percent of all initial public offering, while the UK receives more than one third of all venture capital invested in the EU".*

Assets under management, i.p.o., venture capital are all - at the present time - under European complex governance and regulation system in which fragmentation and unification are some way intertwined.

The change of era produces new "*global systemic interrelation*" in which financial globalization, governance and regulation will give place to new, largely unknown, complexities.

The paper critically reviews the most significant changes that will be required in the financial system as effect of UK leaving EU, in order to verify an initial assumption: Brexit is the signal of an incoming change of era for capital market and financial governance.

To this purpose the study investigates, from a theoretical perspective, two objectives of research: i) the current status of EU financial governance ii) the interrelations between UK as financial centre and EU regulatory framework. As a result, the study aims to provide a greater understanding of the impacts that might

[1] Presented to Parliament by the Prime Minister, February 2017, https://www.gov.uk.

follow from the UK exit from EU not only on the reciprocal relations, but for the international financial governance as such.

It is implied that the need for an understanding of these impacts will be, along the time, always more essential for a future empirical research.

The structure of the paper is as follows: section 2 is dedicated to a literature review on Brexit impact on financial markets; section 3 defines the current framework of the european financial governance; section 4 examines the post Brexit implications with regard to EU financial regulation; section 5 opens to the perspective global UK financial role. Finally, section 6 concludes by summarizing the main features of a "*change of era*" in financial regulatory approach.

2. Economic Literature Review on Brexit impact on capital and financial markets

Although the topic is very recent, there is already quite extensive Brexit literature. A first line of research tries to quantify the economic and financial impacts of Brexit on the UK economy, in terms of (possible) recession, due to loss of EU passporting rights and job losses in finance-related sectors.

The evidence raised from the study conducted by Belke *et al.* (2016)[2] show that Brexit-induced policy uncertainty will continue to cause instability in key financial markets and has the potential to damage the real economy in both the UK and other European countries, even in the medium run. The main losers outside the UK are the 'GIIPS' economies: Greece, Ireland, Italy, Portugal and Spain.

Similarly, the analysis conducted by the *Policy Department* on *Economic and Scientific Policies* for the European Parliament's *Committee on Internal Market and Consumer Protection* (2017)[3] assesses the likely impact of Brexit on EU27 together with some scenarios for the terms of the UK's secession. For the EU 27, the losses are found to be virtually insignificant and hardly noticed in the aggregate. By contrast, for the UK, the losses could be highly significant, over ten times greater as a share of GDP. Impacts on various Member States – in particular Ireland – and sectors in the EU27 could be more pronounced.

The attention of scholars and field experts has also been directed toward risks and opportunities, in general terms, for the British and EU financial markets. According to Baldwin (2016)[4], Brexit will bring considerable operational risk and impose substantial costs. According to Danielsson *et al.* (2017)[5], on balance, Brexit seems unlikely to increase systemic risk, being possible to contrast them however costly this would be in economic terms.

However, another set of studies appear more relevant to the present analysis, i. e. studies that investigate the UK's position in relation to the cross-border provision of financial services, to and from the EU. A recent report developed by the *International*

[2] Belke, A., I. Dubova, and T. Osowski, *Policy Uncertainty and International Financial Markets: The Case of Brexit*, CEPS Working Document, No. 429, November, 2016.
[3] Directorate General for Internal Policies, Policy Department A: Economic and Scientific Policy, *An Assessment of the Economic Impact of Brexit on the EU27*, March 2017.
[4] Baldwin, R., *Brexit Beckons: Thinking ahead by leading economists*, VoxEU Book, 2016.
[5] Danielsson, J., R. Macrae and E. Micheler, *Brexit and systemic risk*, available at http://voxeu.org, 31 May 2017.

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Regulatory Strategy Group (2017a)[6], contains a factual matrix which provides details of the scope of the existing "third country" regimes, i. e. which areas of financial services are covered by third country regimes and which are not. The analysis shows the conditions that both the UK and UK-based financial services providers would need to satisfy in order to make use of the third country regimes. In most cases, the availability of those regimes depend upon the UK's own regulatory regime being determined by the EU authorities to be 'equivalent' to the EU regime. Finally, the report concludes that the UK should be looking to reach a bespoke agreement with the EU, allowing wider, mutual rights of market access, to reflect the unique position of the UK in relation to the EU and reflecting their integrated and interdependent markets.

In a further study (*International Regulatory Strategy Group*, 2017b)[7] it is underlined that as the UK and EU already have matching regulatory and supervisory frameworks and standards, a broad agreement for mutual access can be based on mutual recognition of each other's regulatory frameworks and standards. This will require a mechanism for regulatory alignment to be set down in the financial services chapter of a wider *Free Trade Agreement*. In particular, the Report identifies some issues as being key factors to agreeing a broad bespoke arrangement for mutual access (clear and transparent criteria which provide the basis for mutual access to each other's markets and formal mechanisms for consultation and co-operation between the respective regulatory authorities of the UK and EU, in order to ensure ongoing alignment, particularly in the context of change).

The analysis conducted by Batsaikhan *et al* (2017) [8] moves from the assumption that London is the Europe's financial hub, providing corporate and investment banking services to the European Union's 28 member countries and beyond. When the United Kingdom will leave the EU and its single market, UK-based financial firms will lose their "passport" to do direct business with EU27 clients. Brexit thus leads to a partial migration of financial firms from London to the EU27 so that they could continue to serve their customers there.

Sapir *et al* (2017)[9] discuss the policy challenges the EU27 faces in building an integrated wholesale market: the study estimates that about 35 percent of current wholesale market activities might move from London to the EU27. The United Kingdom's exit from the European Union creates an opportunity for the remaining EU27 to accelerate the development of its financial markets and to increase its resilience against shocks. Equally, Brexit involves risks for market integrity and stability, because EU including the UK has been crucially dependent on the Bank of England and on the UK *Financial Conduct Authority* (FCA) for oversight of its wholesale markets. Without the UK, the EU27 must swiftly upgrade its capacity to ensure market integrity and financial stability. Furthermore, losing even partial access

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[6] International Regulatory Strategy Group (IRSG), *The Eu's Third Country Regimes And Alternatives To Passporting*, 2017.

[7] International Regulatory Strategy Group (IRSG), *Mutual Recognition – A Basis for Market Access After Brexit*, 2017.

[8] Batsaikhan, U., R. Kalcik and D. Schoenmaker, *Brexit and the European financial system: mapping markets, players and jobs*, Policy Contribution, Bruegel, Issue n 4, 2017.

[9] Sapir, A., D. Schoenmaker and N. Véron, *Making the Best of Brexit for the EU27 Financial System*, Bruegel Policy Brief n. 01, 2017.

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to the efficient London financial centre could entail a loss of efficiency for the EU27 economy, especially if financial developments inside the EU27 remain limited and uneven.

Moloney (2016)[10] argues that the EU pattern of relationship with international financial governance is changing and that the EU's ability to impose its preferences internationally is significant. The proposed approach uses the *European Securities and Markets Authority* (ESMA) - which is the most active *European Supervisory Authorities* (ESAs) internationally - as a case study for examining the availability of an administrative channel through which the EU can engage with international financial governance. Accordingly, the implications of Brexit decision may act to reinforce the role of the ESAs as international actors.

3. The European Financial Governance: the framework

As it is known, on EU side, financial governance is part of a process that in the last years has witnessed an increase in the predominance of the executive power at the EU level. National executives took the lead acquiring an even more central role in economic reform and governance. But it is not only national executives that have gained in power as a result of the crisis.

Within the EU framework, the predominance of national executives has resulted in the European Council adopting a more central role in economic governance - aided by the Commission - in an implementing capacity resorting to the adoption of the so called *intergovernmentalism* method.

> *"The label is commonly used to refer to a kind of decision-making where there is a predominance of the executive, and a lack of some or all of the features of supranationalism or the Community method. In its purest form, decisions are adopted by the Member States by unanimity and without the involvement of supranational institutions, and the decision-making process results in decisions that lack the supranational features of EU law*"[11].

The coordination of *economic* and *financial policies* was the most obvious expression of the resurgence of intergovernmentalism, based on international agreements, outside the EU legal framework.

There are several cases on which a closer integration has been pursued through international agreements: so was for the *Treaty on Stability, Coordination and Governance* (TSCG), as well as *European Stability Mechanism* (ESM) that is therefore an international organization (not an EU agency). A similar mechanism was previously used to create the *European Financial Stability Facility* (EFSF), the predecessor of the

[10] Moloney, N., *International financial governance, the EU, and Brexit: the 'agencification' of EU financial governance and the implications*, European Business Organization Law Review (EBOR), 17 (4), 2017.

[11] Hinarejos, A., *The Euro Area Crisis in Constitutional Perspective,* Oxford University Press, Oxford, 87, 2015.

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ESM, through the signature of an executive international agreement and the creation of a private company set up under Luxembourg law.

Finally, an international Agreement was adopted to regulate certain aspects of the *Single Resolution Fund* (SRF). The Agreement establishes the conditions under which participating Member States will levy the financial contributions from banks and will transfer these resources to the Fund.

In general, the different interests and immediate priorities of euro and non-euro countries, coupled with a need for prompt and, at times, politically sensitive action, have had the result of a greater *fragmentation* or a *differentiated integration* in EU governance in the financial sector.

4. Post Brexit implications with regard to EU financial regulation

On this assumption, we may say that the post Brexit scenario is in some way preceded by a series of "fractures" in European governance. In fact no one of the aforementioned Agreements has been signed by UK.

- The TSGS was framed in an international Agreement because UK did not consent to the allocation of tasks to EU institutions. An amendment to the EU Treaties was blocked by UK;
- The EFSF and than ESM were created outside the EU framework because greater resources were needed than those available from the EU budget, and the non-euro countries were not interested to fund these mechanisms, aimed at safeguarding, either directly or indirectly, the stability of the euro area.
- The more recent Agreement on SRF directly concerning the financial and banking area, so sensitive for the interests of the City of London, was not signed by UK government.

The last point is particularly significant for the future framework of global financial governance.

It was in fact one of the main result of the formal "*Settlement*" that concluded the negotiation pre-referendum between UK and EU[12], whose aim was perfectly synthesized by the title ("*The Best of Both Worlds*") of a Report published immediately after the Settlement[13]. Actually, while being out of European Monetary Union (EMU) concerned the UK influence in monetary and economic policies, the choice concerning the SRF has had a strong impact - even before Brexit - on capital market.

In the context of issues concerning financial and banking and in the perspective of the new relationship, the point is not only that UK hosts Europe's largest financial center, playing itself an outsize role in the British economy, that financial and insurance services generate persistent and large export surpluses, or that the banking sector owns assets about five times Britain's annual GDP. Rather, in the post Brexit scenario, two implications of monetary union are under this regard particularly important: the existence of a large *market of financial products denominated in the single currency* and related to counterparts whose home is a euro member state; and the *evolution of*

[12] House of Commons, *EU Referendum: summary and analysis of the new Settlement for the UK in the EU*, 8 March 2016, www.parliament.uk/commons-library.
[13] Gov. UK, *The best of both worlds: the United Kingdom's special status in a reformed European Union,* February 2016.

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unified rules, regulations and supervisory authorities for the eurozone as a whole: both the implications have a relevant potential impact on the new horizons of *European financial governance*.

On this basis, a regulatory impact will concern *euro-denominated financial activity* as euro derivatives: currently LCH (London Clearing House), owned by London Stock Exchange, deals almost the entire global clearing business for interest rate and foreign exchange swaps. In the EU context, regulators consider oversight in this area as an essential aspect in *monitoring risks* for the financial system.

Yet, as mentioned above (§1), the direct effect of the post-Brexit era is that UK regulated financial entities will need "*passporting*" across the EU single market. For this reason, all the major entities have country branches in one or more member States where they operate under passporting rules. As things stand, today from one of the remaining EU27 member States it is possible to ask the regulator the authorization to expand the activity: the scenario, in the change of era, is that UK asset manager could not be able to sell their funds in EU following Britain's departure from the economic block.

This is the case for the *Alternative Investment Fund Managers Directive* (AIFMD), on which basis nearly 300 companies have received the AIFMD passport from the UK regulator since the Directive was implemented in 2013 and around three-quarters of those received the passport to enable them to sell alternative funds around the EU.

If UK asset managers are no longer able to use the passport, they will have to rely on various *national private placement* regimes to sell their products in the EU. This will add complexity and cost as the private placement rules vary from one EU country to the next.

The issue involves still other aspects of the fund industry. So, under the UCITS (*Undertakings for Collective Investments in Transferable Securities*) regime, almost overall the EU's assets under management are dealt - in terms of investment decisions - in London, although the Funds are formally based in other EU countries: an additional matter of regulatory interest for ESMA, on one side, and FCA on the other.

The biggest risk for the asset management industry is the potential loss of the passport under the set of European rules concerning investment services: MiFID, (*Market in Financial Instruments Directive*). A second iteration of the MiFID directive (MiFID II rules), which impose stricter rule around how asset managers distribute funds and pay for research, is going to come into force in January 2018.

Today UK fund companies need a MiFID license - which also governs segregated mandates - from the UK regulator: potentially, any *MiFID license* that has been granted by the UK regulator *may become void.*

5. Financial services between global and European governance

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According to Bank of England "*London has a pretty unique* [financial] *ecosystem. If one fragments that ecosystem, than that is equivalent to put up the cost of financial service on both UK and EU - 27*"[14].

The points related to the immediate effect of the UK withdrawal was already clear in a Government "White Paper" issued in a pre-referendum period and concerning the exit procedure. Accordingly, when the UK will leave the EU:

> *"the UK government would need to disentangle the regulatory framework from EU law for the financial sector. Regardless of the exit negotiations outcome this would be a large and complex task.*
>
> *For most types of financial services, EU law amounts to the substantial majority of the UK's legislative framework, whether directly applicable or EU Directives transposed into UK law. EU Directives and Regulations govern the regulation - both prudential and conduct of business - of all major sectors, including banking, insurance, wholesale and retail investments provision of market infrastructure, payment clearing and settlement systems and a host of other activities"*[15].

A "*free trade agreement*" between UK and EU would cover - accordingly - "*sectors crucial to our linked economies such as financial services and network industries*."[16]

Accordingly to the previously aforementioned White Paper:

> *"In our new strategic partnership agreement we will be aiming for the freest possible trade in financial services between the UK and EU Member States.*
>
> *In highly integrated sectors such as financial services there will be a legitimate interest in mutual cooperation arrangements that recognize the interconnectedness of markets, as so clearly demonstrated by the financial crisis. Since that time, the EU has taken a number of steps to strengthen collective oversight of the sector. As the UK leaves the EU, we will seek to establish strong cooperative oversight arrangements with the EU and will continue to support and implement international standards to continue to safely serve the UK, European and global economy".*

The implementation of international standards to "*safely serve UK, European and global economy"* impacts on the complex context of European Authorities. Basically the complex governance is centered on the *European Banking Authority* (EBA) whose headquarter is established in London (and it will have now to move, to Frankfurt or any other EU city or, probably, merged with some other ESA) and the ESMA. The two institutions also develop draft regulatory technical standards and implement technical standards in their respective areas.

In the banking area, the central role under the regulatory is performed by EBA:

[14] Jon Cunliffe, Deputy Governor of the Bank of England for financial stability, giving evidence to the House of Lords EU Financial Affairs Sub-Committee,12 October 2016.

[15] H.M. Government, The *process of withdrawing from the European Union,* Presented to Parliament by the Secretary of State for Foreign and Commonwealth Affairs, February 2016, 18.

[16] Letter to President Tusk by Prime Minister T. May, 29 March 2017 www.gov.uk.

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> *"EBA is in charge of achieving a consistent level of prudential regulation and supervision across the banking sector in the EU (credit institutions, financial conglomerates, investment firms, and payment services). Under the Banking Union, the role of EBA is to achieve greater efficiency and harmonization of supervisory and regulatory practices and its application across the EU countries. One of the main tasks is the creation of the European Single Rule Book in banking providing a set of harmonized prudential rules for financial institutions, giving better protection to investors and depositors, and creating a single level playing field for the entire EU banking system*"[17].

The EBA is also in charge of monitoring the capital instruments issued by financial institutions and risk assessment in the EU banking sector by implementing the European stress tests.

One of the most consequential effects of the current European financial system is actually - as suggested by Moloney (*supra* § 1) - that this is likely to strengthen the EU's ability to impose its preferences to international financial governance.

Suggestions that ESMA and the other ESAs have the potential to become *significant actors in the international financial governance* is in fact strongly supported in recent literature: *"The EU has grown more visible and influential in global financial"*. Among the factors underpinning this trend are mentioned:

> *"the emergence and growing coherence of a truly European capital market aided by the single currency"* and *"the further concentration of regulatory capacity in supranational hands"*[18].

International regulatory politics in finance is no longer about harmonization but about *cross-border rule compatibility and market access*.

As market segments grew (such as stock trading on the continent) or evolved into truly European markets (such as those for sovereign sector wholesale lending), EU regulatory capacity increased.

So, the financial EU regulatory system gives place to an intertwined and mixed (somewhat confused) but unique regulatory supervisory framework of the most important financial center in Europe.

But the fact that UK is not participating in the Banking Union, already in a pre-Brexit time, opens a further theme concerning regulatory approaches: UK outside Banking Union *"may hamper its effectiveness given that large European banks have important parts of their operation in London"* (Vives, 2016).

On the other side, the *cultural foundations* of the UK current regulatory approach based on the *Financial Conduct Authority* and the *Bank of England*may be summarized in the trust of the functioning of a *light regulatory regime* and efficient support services [19]. The focus is - according to this approach - in avoiding that compliance with EU

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[17] Vives, X., *Competition and Stability in Banking,* Princeton University Press, Princeton and Oxford, 2016, p. 191.

[18] Mügge, D. (ed), *Europe and the Governance of Global Finance, Introduction*', Oxford University Press, Oxford, 2014, p. 6.

[19] King, M., *The End of Alchemy*, Abacus, London, 2016.

regulation would peak London with regard to the real London financial centers competitors (New York, Singapore, Shanghai).

It is still unclear what the "*judgment-led approach*" to regulation will actually mean and the extent to which a risk-based model can be reconfigured to avoid the over-confidence of the past[20].

6. Conclusion: The Change of Era in Regulatory Approach

Although there is now a clear institutional architecture (*e.g.* there are two *institutional architectures*) there is no clear lesson to draw from it as to the new regulatory approaches to be taken after UK leaves EU, as effect of the extent to which European-schemes will be repealed.

The main worry for UK and its financial sector was that the euro countries could use their numerical advantage to dominate: the fear being the risk that the UK was *out of the euro but run by the euro*[21] (Stiglitz, 2016). The community of interest forged by their common currency could increasingly mean that euro members systematically find their interests in financial policy aligned, and aligned against UK interests. The eurozone's Banking Union - which lifted some bank supervision and resolution power to the supranational level - reinforced this process. The UK government was highly alert to the risk, which is why it insisted that decisions by the EBA must be passed by a *'double majority'* of both euro and non-euro countries, in a view to secure 'safeguards' for the City of London.

The increasing fear was that euro non-membership could leave the UK's financial industry at the mercy of rules set predominantly by a group with little reason to care about its interests.

The change of era means that, in this process, financial services industry will have to live by rules made overwhelmingly by others, according to a view based on Eurozone (that is on the basis of a collective entity developing those rules differently from the views of a financial center outside the common currency).

Or, alternatively, the UK financial services will still do thriving business EU but, together, with the rest of the world. It could, in other words, become the world's largest offshore financial center, even on the basis of a new tax ruling.

A clear suggestion on this direction is contained in the UK official statement on negotiating objectives for exiting the EU:

> "*we would be free to strike deals across the world and we would have the freedom to set the competitive tax rates and embrace the policies that would attract the world's best companies and biggest investors to Britain*"[22].

As long as Britain remained in the EU, would have been subjected to European majority decisions on its financial business with the rest of the world. Once it leaves the *interaction* between the *international regulatory framework* and the EU *financial governance* will be the object of detailed policy areas in which "Global Britain" approach to post Brexit era will need to be transferred.

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[20] Prosser, T., *The Economic Constitution*, Oxford University Press, Oxford, 2014, p. 177.
[21] Stiglitz, J., *The Euro and its Threat to the Future of Europe*, Allen Lane, 2016, p. 349.
[22] Gov. UK, *The government's negotiating objectives for exiting the EU*, www.gov.uk

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Now that - after the formal opening of negotiations - UK is going to vest the role of *third party country*, the first option remains to look at the *equivalence* regime: the European Commission can extend the passport to a non-EU country if it deems the country has the equivalent level of regulation.

In other words, equivalence determination provides EU authorities with opportunities to assess the quality of *third country regimes* against EU benchmark (and when coupled with reciprocity, to demand concessions in return). *Substituted compliance* as used by US regulators aims in the same direction as the objectives that the EU is pursuing via equivalency.

On the other hand, although equivalence regime exists in theory, in practice it is something entirely new. In fact the Commission does not seem particularly inclined to extend the equivalence regime to a non-EU country. The most developed EU equivalence regime is so far in operation only for financial reporting "standards":

> "*The Generally Accepted Accounting Principles of the US, Japan, China, Canada, South Korea, and (initially on a temporary basis) India have been held to satisfy the equivalence test for the purposes of issuer disclosure requirements under the Prospectus Directive and Transparency Obligations Directive*"[23] (Ferran, 2014).

Any equivalence determination is anyway *discretionary*. It therefore places ESMA, in advising the Commission, at the heart of complex and *politically sensitive* market access determinations associated with a position to exert and strengthen EU influence internationally.

The point is if *equivalence regime* may work in principle as a viable way of dealing with cross-border issues at the *global level*: a challenge for the UK financial industry given by the very rapid development of *supranational rules* for banking and finance.

A challenge echoed by the official positions: "*it is in all our interests that financial services continue to be provided freely across borders, that integrated supply chains are not disrupted and that trade continues in as barrier-free a way as possible. While we will seek the most open possible market with the European Union, we also want to further trade links with the rest of the world*"[24].

The possibility of a second option will be - in this context - depending from the extent that financial regulation become *highly politicized* when member states and EU authorities will have to set the rules for "third country" access to their territories.

It is perhaps unsurprising that the above mentioned UK official statement adds: *"if we were excluded from accessing the single market, we would be free to change the basis of Britain's economic model*". That means that an UK "third country" may conceal to changing the "*country economic model*".

In other words, in the longer term equivalency may be the tool closely associated with real politics and an instrument for "*a battle of ideas*"[25] in the new political arena of *global financial governance*.

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[23] Ferran, E., *Financial Supervision*, in Mügge D. (ed), *European and the Governance of Global Finance,* Oxford University Press, Oxford, 2014, p. 25.

[24] Gov. UK, *Statement on a new partnership with the EU,* 17 jan. 2017, www.gov.uk

[25] Brunnermeier, M., J. Harold and J. P. Landau, *The Euro and the Battles of Ideas,* Princeton University Press, Princeton and Oxford, 2016, p.157.

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