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EU Financial Market Access After Brexit

Brexit means Brexit, or out means out – and that includes the UK's exit from the single financial market. With financial services accounting for about eight per cent of the country's GDP, it is understandable why the UK attaches immense importance to retaining access to the EU's single market. But putting a mutually acceptable regime in place will take years of negotiations, and the final agreement will clearly allow much less access than UK-licensed firms enjoy today. The "equivalence" assessment is the basic tool used under current EU financial services legislation to recognise that a third country's legal, regulatory and/or supervisory regime is equivalent to the corresponding EU framework; however, as will be discussed in greater detail below, it applies only to some measures and to some of the freedoms created by the relevant EU regulations, not across the board. In addition, the equivalence decisions vary and can be revoked by the European Commission at any time. This framework offers a fairly bleak basis on which the City might continue to thrive as a global financial centre in Europe.

The UK, and the City in particular, is an archetypal example of the functioning of the single market, as envisaged at the end of the 1980s. By harmonising basic rules and providing for mutual recognition, firms could sell goods and provide services freely throughout the EU with a single licence. As a consequence, each EU country or region could specialise in those services and products it was good at. For the UK, this was services, and for the City, it was financial services in particular.[1] Many financial services providers concentrated their wholesale financial market activities in the City, from which they covered the entire EU. However, from the moment the UK's withdrawal from the EU is complete, the single passport will cease to exist for UK-licensed firms. The only way that the UK could continue to have a single licence would be through its accession to the European Economic Area (EEA), but this is not compatible with the referendum outcome to leave the EU.

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The single market freedoms for financial services providers are contained in a multiplicity of different EU directives and regulations. They cover basic rules for banking, investment services and insurance, but also investment products and financial infrastructures. Since the start of the single market in 1992, these freedoms have been further elaborated in updates and extensions to the rules. The 2008 financial crisis led to a substantial broadening of the regulatory maze and an extensive deepening, with consensus reached on a "single rulebook" and the far-reaching use of secondary legislation. Prior to the crisis, important elements of the financial system were not regulated at the EU level (nor even at the national level in most cases), including ratings agencies, derivative markets and hedge funds. Many key pieces of legislation, such as those covering banking and investment services, have become

1 D. Gros: The Economics of Brexit: It's not about the Internal Market, CEPS Commentary, September 2016.

far more complex. An example of this complexity is MiFID II, which previously only regulated equity markets. It now also regulates the price transparency in bond and commodity markets and has introduced tight rules for algorithmic trading and data vendors. In addition, the EU created the Banking Union, which led to an important centralisation of the supervisory and resolution functions in the EU, but in which the UK does not participate.

The UK as bridgehead of a mighty financial centre, the City

London has developed over the last quarter century into the wholesale financial centre for the EU, in the same way that Wall Street functions for the US or Hong Kong for China. A wholesale financial centre provides for the refinancing of local financial centres, of which there are many in Europe, as well as financial services for corporations, governments and institutional investors. Back-office functions for these activities are not necessarily all concentrated in London, and in recent years they have moved to other cities in the UK as well.

London hosts some 358 banks, many insurance companies and institutional investors, hedge funds, and specialised finance providers. It is now also spearheading the growth of fintech companies. It is home to the largest stock exchange in the EU, the most developed derivatives market, and related clearing and settlement infrastructures. It also hosts important services for the financial sector. Many law firms have their largest EU offices in London. All three ratings agencies, each one of US parentage, have their head offices for the EU in London. Data vendors have located their most important operations in London, and so have many large auditing and consulting firms. Hence, the contribution of the financial sector to the UK's GDP will be even larger when these related services are included in the calculations.

The growth of the UK's financial sector owes much to the single market, according to the IMF.[2] UK trade in financial services as a percentage of GDP has risen much faster than the OECD average, as has its trade in services with EU members. About one-third of the UK's financial and insurance services exports are to the EU, and the majority of UK banks' investments are in the EU.[3]

The introduction of the single passport for financial services providers was started with the Second Banking Directive in 1992 and the Investment Services Directive in 1994. The facilities provided by these directives have been further developed and extended to other financial services in recent years, especially following the G20's commitment to ensure that all financial services, institutions and markets are responsibly regulated in the wake of the financial crisis.[4]

The key components of the EU's passport for financial services providers

The single market freedoms created for the various forms of financial services have been embedded in a variety of directives. In most cases, the free provision of services (FPS) or "passporting", has become extensive. For basic financial services such as banking, investment services or insurance, this has been the result of an extensive and long process of de- and re-regulation at European level. In other cases, for non-core services or products such as clearing, settlement, financial data and hedge funds, it started much later and/or was largely driven by the experiences and lessons of the financial crisis.

These freedoms also apply in the EEA countries, which implement all these rules, as well as EU regulations, into national law. The EEA recently concluded an agreement with the EU by which they will also become observers in the European Supervisory Authorities and implement secondary legislation.

The FPS framework is accompanied by additional prudential measures. The financial crisis led to an agreement on common rules for resolving banks in the Bank Recovery and Resolution Directive (BRRD). The UK authorities played an important role in the debate for a resolution framework for banks, drawing on their experience with Northern Rock in September 2007 and other banks following the collapse of Lehman Brothers, and adopted their own rules in the 2009 Banking Act. This Act requires banks to have recovery plans readily available and set a framework for the resolution of banks, including inter alia the concept of a "bridge bank". These concepts were later incorporated in the BRRD. Another part of the resolution framework, the rules for deposit insurance, was also harmonised as a result of the financial crisis, in the Deposit Guarantee Schemes Directive of 2014.

Remuneration rules, a particularly sensitive issue for the City, have become standard in most post-crisis updates of EU directives and other new measures (see Table 1). They are now part of many of the FPS rules, covering banking, investment and alternative funds, and rating agencies, but

2 International Monetary Fund: Macroeconomic implications of the United Kingdom leaving the European Union, Country Report, 2016.
3 Ibid.
4 See K. Lannoo: Brexit and the City, CEPS Commentary, 22 January 2016.

Table 1
The various EU financial services and their single passport regime

Financial service	Rule	EU Passport	Start date	Comments	Remuneration rules
Payments and transfers	CRDIV/PSDII/ e-money	Extensive	1992/2007/ 2009	PSD and e-money Directive set rules for wiring services	
Commercial banking	CRDIV	Extensive	1992		Limits on bonuses
Trading	CRDIV/MiFID II	Extensive	1992/1994	Remote access for brokers to trading platforms	Limits on bonuses
Investment banking	CRDIV/MiFID II	Extensive	1992/1994	Universal banking has been the rule since 1992	Limits on bonuses
Insurance	Solvency II	Limited	1997	Unlike banking, Solvency II does not allow a single capital base	
Pension funds	IORP II	Limited	2002	Labour market and tax rules have limited take-off	
Investment funds	UCITS IV-V	Extensive	1985	First single financial product passport	Remuneration rules
Alternative funds	AIFMD	Extensive	2012	Single licence for hedge funds managers	Remuneration policy to be authorised
Securities and derivative markets	MiFID II	Extensive	1994	Remote access and colocation of trading servers in financial centres	Remuneration policy to be authorised
Settlement	CSDR	Extensive	2014	Code of conduct before the crisis	
Clearing	EMIR	Extensive	2015	Not regulated before the crisis	
Rating agencies	CRA	Extensive	2012	Not regulated before the crisis	Compensation to be disclosed and not driven by performance
Financial data providers	MiFID II	Extensive	2018	License from 2018 onwards	

Source: Author's elaboration.

there are substantial differences across the various measures. The tightest and most widely debated are contained in the Capital Requirements Directive (CRD IV), which limits a banker's bonus to a maximum 1:1 ratio of his/her annual salary. The rules were challenged by the UK government before the Court of Justice of the European Union (CJEU) on the grounds that these rules would not make the system safer, but the case was withdrawn. The UK's resistance to implementing EU rules was also later reflected in its refusal to apply the European Banking Authority's implementing rules, because they did not take proportionality into account.

EU financial services measures of greatest concern to the City

Markets in Financial Instruments Directive (MiFID) is an essential measure for the City, as it provides for a single passport for trading platforms and brokers in the EU. The Directive has just gone through a long process of upgrades and adaptations, which will only come into force in early 2018 because of the depth of the review. It now sets rules for trading of non-equity financial instruments and commodity derivatives, regulates algorithmic trading and data vendors, and implements the UK rules of the Retail Distribution Review, which requires the unbundling of investment advice from investment services, at the EU level. As an illustration of the importance of this directive, the UK currently hosts 2,250 firms using the MiFID passport outbound, as compared to 988 from other EU and EEA countries using the passport in the UK.[5]

The Alternative Investment Fund Managers Directive (AIFMD) is another core measure for the City, as it sets EU-wide rules and a single passport for managers of hedge funds and other alternative funds. The rules were heavily criticised by UK-based firms and organisations when proposed, but the lobbying campaign backfired and remuneration rules were added to the Directive in October 2010, the first EU financial services measure to contain such provisions. EU lawmakers argued that a fund's remuneration rules should promote sound and effective risk management and not encourage risk taking, and they need to be authorised by supervisors. The Directive requires the full disclosure of remuneration in the annual report, broken down by staff members. There are 212 firms in the UK

5 See A. Bailey: Letter from Financial Conduct Authority to Committee Chair regarding passports, 17 August 2016, available at http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/.

holding the AIFMD passport, as compared to 45 from other EU and EEA countries.[6]

Credit rating agencies (CRAs) were not regulated before the crisis, but since 2010 they have been subject to a licence and supervised by ESMA. The regulation requires CRAs to be independent and to identify and manage conflicts of interest, also in their compensation policies. Supervisors can monitor the methodologies and business model of rating agencies. The three largest ratings agencies, which control 94% of the EU market, have located their head offices for Europe in London.[7]

The European Markets Infrastructures Regulation (EMIR) sets rules for the obligatory clearing of OTC derivatives and for the functioning and governance of central counterparties (CCPs), which clear such instruments. The UK is home to a very large part of derivatives turnover, both OTC and on exchange, in the EU.[8] EMIR establishes that CCPs can offer clearing services throughout the EU. The passporting of CCPs in all EU member states was the subject of a CJEU case between the UK and the ECB, in which the latter argued that euro-denominated clearing could only occur within the eurozone. The Court ruled against the ECB, finding that clearing services were a single market freedom.

Financial institutions can have several passports under one roof, depending on the services they provide and the number of EU countries in which they are active. This fact explains the huge number of passports that UK-based firms possess, according to the Financial Conduct Authority.[9]

Third-country access to the single market

Leaving the EU means that third-country rules will apply to firms based in the UK for access to the single market, unless another agreement is found. The basis is the equivalence assessment, which determines that a third country's regulatory and supervisory framework should achieve the same results as the corresponding provisions in EU law, provided that it is incorporated in relevant rules. Brexit led many groups to argue that this should not be a problem, as the UK applied the same rules as the EU until secession. The situation is not that straightforward, however.

The debate on third-country access provisions is as old as the single market. Foreign banks in the City led the charge in the early 1990s, when reciprocity provisions were contained in the Second Banking Directive (today called the Capital Adequacy Directive). It was argued that market access in the EU should be "reciprocal" to that given in other jurisdictions, which raised fears that the EU would become a "fortress". The provision was never applied, however. Later on, in the measures adopted under the Financial Services Action Plan (FSAP), the term "reciprocity" was replaced with "not more favourable treatment", enabling the EU to start negotiations with third countries seeking to obtain the same treatment as that given in EU member states. The financial crisis changed this more lenient regime, as the conviction emerged that much stricter supervision was required, and the post-crisis term became "equivalence".

According to the European Commission, equivalence means that "in certain cases the EU may recognise that a foreign legal, regulatory and/or supervisory regime is equivalent to the corresponding EU framework".[10] It allows the EU authorities to rely on the compliance of foreign entities with the equivalent foreign framework, stating that "equivalence decisions may apply to the entire (regulatory) framework of a third country or to some of its authorities only".[11] Equivalence decisions are taken unilaterally by the Commission, but can be revoked at any time. They are prepared on the advice of the European Supervisory Authorities. The recent equivalence decision on CCPs under EMIR, for example, states that a review of the decision can be undertaken at any time and that "such re-assessment could lead to the repeal of this Decision".[12]

A comparison of the third-country regime provisions of the different EU FPS measures presents a highly complex puzzle. In certain cases, such as the AIFMD, the third-country regime is quite developed, whereas in other cases, it is brief and restricted to certain provisions or is very specific.[13] In still other cases, it is not provided for at all. Table 2 provides an overview of the key items of the third-country regime for banking, investment services, investment funds, trading venues, and clearing and rating agents.

6 Ibid.
7 K. Lannoo: The Great Financial Plumbing: From Northern Rock to Banking Union, London 2015, Rowman and Littlefield International.
8 See e.g. J. Miethe, D. Pothier: Brexit: What's at stake for the financial sector, Economic Bulletin, DIW, August 2016.
9 L. Noonan, J. Brunsden: Banks fear chill wind of "passport" freeze, Financial Times, 21 September 2016.
10 See European Commission: Equivalence with EU rules and supervision, available at http://ec.europa.eu/finance/general-policy/global/equivalence/index_en.htm.
11 Ibid.
12 European Commission: Commission Implementing Decision (EU) 2016/377 of 15 March 2016 on the equivalence of the regulatory framework of the United States of America for central counterparties that are authorised and supervised by the Commodity Futures Trading Commission to the requirements of Regulation (EU) No 648/2012 of the European Parliament and of the Council, Recital 23, Official Journal of the European Union, 16 March 2016.
13 M. de Manuel: Third Country Rules for Alternative Investments: Passport flexibility comes at a price, ECMI Commentary, 16 December 2010.

Table 2
Main features of the third-country regimes under the most important free provision of financial services measures

Measure	Third-country regime
CRD IV (Basel III)	• Branches of third countries cannot enjoy more favourable treatment than those from EU countries (Art. 27)
	• EU may conclude agreements with third countries for "analogous" treatment of branches throughout the EU
	• No free provision of services for third-country branches (Recital 23)
	• Equivalence assessment of third countries' supervisory and regulatory arrangements (Art. 47), consolidated supervision (Art. 127) and specific measures
MiFID II (brokers and trading venues)	• Commission to adopt equivalence assessment, but limited to eligible counterparties and professional clients
	• ESMA to register third-country firms (from equivalent jurisdiction)
	• ESMA to establish cooperation arrangements
	• Member states can "opt up" a third-country service provider but only within their territory; no FPS in the Single Market
	• Equivalence assessment of third-country markets (Art. 25.4)
UCITS (investment funds)	• No specific third-country regime
	• Equivalence assessment for third countries' supervisory systems of management companies of UCITS
AIFMD (managers of non-UCITS funds)	• Since 2016, EU passports co-exist with national passports
	• Until 2018, non-EEA manager has to be authorised as a manager in the EEA by the EEA regulator in its "member state of reference"
	• After 2018, only EU passports will be authorised
EMIR (CCPs)	• Equivalence of third-country supervisory regime, subject to Commission Implementing Act
	• Third-country CCP can provide clearing services after equivalence assessment by ESMA (Art. 25)
	• Cooperation arrangements between supervisors
CRA (rating agencies)	• Commission to adopt equivalence decision for CRA regime in a third country
	• Credit ratings issued in a third country can only be used if they are not of systemic importance to the EU's financial stability (CRA I, Art. 5.1)
	• A local endorsement of ratings of EU importance produced outside EU is required
	• Cooperation arrangements between supervisors to be coordinated by ESMA

Source: Author's elaboration.

What emerges from the above enumeration of the main features of third-country regimes is that there is no full access to the single market for third countries. Member states, however, can individually authorise bank branches, investment firms and funds to provide services, but only within their own territory. Access to the EU's single market is governed by equivalence assessments of the third country's regulatory regime, which are carried out by the European Commission. For banks, the equivalence assessment is focused on the third country's prudential regime. For third-country investment firms, the access is limited to eligible counterparties and professional clients and to trading venues.

For UK-based financial institutions, this means that future access to the EU's single market will be very limited compared to what is available today. The UK could start negotiating a trade agreement with the EU as soon as Art. 50 is triggered, but this will certainly not provide for the free provision of financial services. In line with international trade conventions, it could provide for most favoured nation treatment. In the area of financial services trade, this would require a local establishment for firms, but with a "prudential carve-out", meaning that access could be denied on prudential grounds. For trading venues and clearing services, an equivalence assessment would be required. In the meantime, the UK will need a transitional agreement, which will provisionally grandfather some existing single-market conditions, but possibly in a broader manner than what is foreseen under the various rules today.

Either route entails important drawbacks. A trade agreement takes years to conclude, is difficult to sell to public opinion and may have to be ratified by all EU member states. A transitional equivalence agreement should effectively prepare for the best, but may only cover what is foreseen in the different measures governing the single market in financial services. To highlight how political such a decision may become, the remuneration rules could also be part of a future equivalence assessment of the UK's regulatory regime; this is where it could already get stuck, in the event that the UK regime deviates from EU rules. The UK could also choose to adopt a lighter touch and more flexibility in financial regulation, which would increase its attractiveness globally but would reduce the likelihood that such measures would be recognised in the EU as equivalent. It is also unlikely that the UK would follow such a path in the aftermath of the financial crisis and in light of the monitoring by the Financial Stability Board of the steps taken in compliance with the country's G20 commitments.

The UK's withdrawal will also be a setback for continental European financial institutions. EU-authorised exchanges will no longer have access to colocation services for their servers in the City, and traders from the City will have restricted access to exchanges within the EU. The intermediation effects of a large financial centre on foreign direct investment in the EU will decrease. The refinancing of local banks in the EU by large City-based institutions will become more difficult. Finally, the networking and conglomeration effects currently accruing to the City due to its role as a large financial centre will disappear.

Conclusion

In the area of financial services, the UK has much to lose and little to gain from leaving the EU. Those that will be most severely hit are large integrated financial institutions using multiple passports under one roof and specialised investment firms and asset managers with a single passport. They will need to disentangle their operations, split up their capital base, and create separately capitalised and licensed operations within the EU. There is an urgent need therefore to give careful thought to the content and shape that a new deal with the EU might take.

Inspiration could be taken from the relationship that the EU has formed with other trading partners. As with Switzerland in insurance, the UK could strive to negotiate a bilateral agreement for market access with the EU on financial services, pending a more comprehensive trade deal, similar to the arrangements the EU has with many other jurisdictions. The British government, however, will have to overcome the animosity that prevails in the EU towards a special deal with the UK, certainly in the domain of financial services. It will therefore have to start a long and difficult process of persuading the EU that it is important to the European economy that London be allowed to remain a global financial centre.