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Evidence to the European Affairs Committee on the UK-EU relationship in financial services

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This submission addresses the following two issues of the inquiry: (1) The future of cross-border UK-EU financial services trade and (2) the impact of regulatory divergence on the international competitiveness of the UK. In the submission we seek to clarify certain legal aspects of financial regulation which are bound to shape the future UK and EU trade relationship in financial services.

Summary

1. Deregulation and regulatory divergence are likely to undermine rather than strengthen the international competitiveness of the City of London as a world leading financial centre.
2. The UK will probably end up having less flexibility 'to do as it pleases' because the loss of direct access to EU decision-making will diminish its sphere and scope of influence.
3. Brexit has changed the framework for formal cross-border cooperation in matters of financial regulation, supervision and resolution in ways that have increased complexity, uncertainty and transactional costs. According to the recently concluded IMF FSAP for the UK of April 2022: "The effectiveness of crisis-management arrangements has not been tested in times of stress."
4. Convergence with international soft law emanating from the FSB and other standard setters cannot serve as a substitute for passporting rights.
5. The argument that EU liquidity will continue to be pooled in London because of the fragmented and comparably small size of the market landscape in mainland Europe is not persuasive because it downplays the EU's commitment to attain strategic autonomy in the long term. Market fragmentation has already occurred.
6. Neither subsidiarisation nor equivalence provide credible alternatives to passporting.
7. While there is a pressing need to set up a permanent and comprehensive arrangement for facilitating cross-border trade in financial services, the UK proposed model of mutual recognition is unlikely to provide a credible basis for negotiations between the UK and the EU.
8. The retention of EU law as part of the domestic law of the UK (onshoring) may be strategically justifiable but it has created a separate source of legal uncertainty and risk which will take years to ameliorate it. The MoU between HMT and the EC establishing regulatory cooperation on financial services is yet to be finalised. This also creates legal uncertainty.

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Transnational networks of governance and their impact on the future position of the City of London as world-leading financial centre

Contrary to what is often thought, Brexit will not liberate the UK from the EU's regulatory reach.1 Market interconnectedness and interdependence will not disappear. Furthermore, both the EU and the UK will continue to influence and be influenced by the workings of international standard setters like the Basel Committee on Banking Supervision (BCBS), the Financial Stability Board (FSB), the International Organisation of Securities Supervisors (IOSCO) and the International Association of Insurance Supervisors (IAIS). As a member of the EU, the UK used to have access to and conspicuous influence in the above-mentioned international networks of financial markets governance as well as in regional networks -specifically, the European Supervisory Authorities. Participation in each one of them was instrumental to the City of London becoming the leading financial centre globally and regionally as an onshore financial centre in the EU single market and as a competitive offshore centre for the rest of the world. One of the outcomes of the UK's withdrawal from the EU is the City becoming an onshore centre for the UK only and an offshore for the EU. This suggests that the City of London now occupies a less powerful position because of its smaller size, lack of direct influence in regional networks of governance and because of its anticipated diminishing ability to continue to attract foreign investment as it did in the past as a cost-efficient gateway to the EU single financial market. 2

1 A Georgosouli, 'The transnational governance of bank resolution and the treatment of national regulatory variation in the EU' (2021) 80(1) *Cambridge Law Journal* 74-100 at 86.

2 "The UK is a central node for global finance and international capital markets (…). Financial and related professional services contribute to around 10% of the United Kingdom's economic output and generates the

When the UK was an EU member state, the European Supervisory Authorities (ESAs) served as regional mechanisms of "credible commitment" under the auspices of the European System of Financial Supervision (ESFS). With the withdrawal of the UK from the EU, such mechanisms are now absent. Currently, there is no mechanism under international soft law standards to permit cross-border market access. Even if such mechanism becomes available in the future, its soft law nature means that it will not generate any legally binding obligations between the relevant parties. For the same reason, convergence with international soft law standards between the EU and the UK will have little if any positive effect on the Commission's future unilateral and highly discretionary decision to grant equivalence to the UK let alone secure the preservation of equivalence status in the long term.

The impact of harmonised EU law will not be confined with the EU. The EU model is already transforming the domestic legislation of neighbouring third countries ("Brussels effect") –typically, as a result of accession preparations (e.g., Serbia) or trade agreements (e.g., Ukraine).. 3 To be sure, things are different in the case of the UK. Being a former EU member state, the UK is in the unique position of having in place a legal framework which is fully compliant with EU law, but this may change in the future as the UK refrained from undertaking the commitment to ensure regulatory convergence between the UK and the EU legal frameworks.

Though the City of London still keeps EU liquidity pooled, there is no guarantee that this will continue in the future. Once the temporary equivalence decisions expire in June 2022, the cost of derivatives clearing will increase as a result of market fragmentation.4 The claim that the City will remain more efficient compared to other alternative locations also ignores the fact that the Commission is unlikely to have the incentive to grant equivalence status in the long term. Continuing EU dependence on the UK does not serve the strategic autonomy of the EU. On the one hand, it would be a source of risk to the financial stability of the EU financial markets as there is no reason to think that in the event of a crisis the UK would prioritise the protection of vital EU interests (See, Icelandic crisis of 2008, when Reykjavik protected domestic depositors but not foreign ones). On the other hand, the EU has every reason to intensify and speed up market integration through the completion of the Capital Markets Union precisely because leading financial centres in the EU (notably, Amsterdam, Frankfurt, Luxemburg, Paris and Ireland) stand to gain. The Commission has

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largest surplus in U.K. cross-border trade." 'United Kingdom: Financial Sector Assessment Program-Financial Stability and Managing Institutional, Technology, and Market Transitions' (IMF Country Report No. 22/107; April 2022) (henceforth 'IMF UK FSAP 2022) para 11 available at <https://www.imf.org/en/Publications/CR/Issues/2022/04/07/United-Kingdom-Financial-Sector-Assessment-Program-Financial-Stability-and-Managing-516279>.

3 A Bradford, *The Brussels Effect: How the European Union Rules the World* (Oxford 2020).

4 The IMF also points out in its April 2022 FSAP that "The degree of this fragmentation could affect market access or lead to an increase in costs, inefficiencies, further optimization, and possibly a migration of some financial services businesses to other third-country financial centers." 'IMF UK FSAP 2022 at para 5.

recognised that market fragmentation is a barrier to the creation of a concentrated financial centre in the EU even before Brexit.5

What is the problem with subsidiarisation and equivalence?

(a) Introductory remarks

Financial firms authorised in any of the Members States of the EU and the European Economic Area (EEA) benefit from passporting rights in that they are allowed to carry on activities in another EU or EEA member state on the basis of their home state authorisation ('single authorisation'). Specifically, they are permitted to conduct their activities by opening up a branch in one or more host member states or provide their services on a cross-border basis. Passporting rights are available to EU authorised firms under several key EU legal instruments. Notable examples include the CRD IV, MiFID II, Solvency II, IDD, and the UCITS Directive.

Pre-Brexit, UK authorised financial firms used to take advantage of passporting rights to access the entire EU single market for financial services. UK based financial firms no longer enjoy such rights, but they may seek to benefit from the so-called 'third-country regimes' (TCRs) currently available under EU law.6 TCRs provide a limited range of rights to third country financial firms (e.g., the right to carry on specific regulated activities without the need to obtain authorisation in any of the member states of the EU) when certain conditions are fulfilled. These rights fall short of passporting. Subsidiarisation and equivalence are two notable examples of TCRs. We examine them in turn to explain why they are not substitutes of the lost passporting rights bearing in mind that the optimal option for the UK would be to secure long-term sustainable access to the entire EU single market for financial services.

(b) Subsidiarisation and its limitations

To benefit from passporting rights, an UK financial firm can seek to establish a subsidiary in the EU and apply for it to be authorised by the regulator of an EU member state. Once authorised, the subsidiary would then be able to use passporting rights to access the entire EU single market. Subsidiarisation is not an appealing proposition for UK-based financial firms wishing to continue their operations in the EU single market. It comes with administrative costs and

5 European Commission, 'Green Paper: Building a Capital Markets Union' (Brussels, 18.2.2015) COM(2015) 63final <https://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf>; A Sapir, D Schoenmaker, & N Véron, N (2017), 'Making the Best of Brexit in Finance: The EU27 Side' Bruegel Policy Brief (8 February 2017) at 4 et seq at < https://www.bruegel.org/wp-content/uploads/2017/02/Bruegel_Policy_Brief-2017_01-090217.pdf>.

6 For a general overview see IRSG Report on the EU's Third Country Regimes and Alternatives to Passporting Published (23 Jan 2017) at <https://www.irsg.co.uk/assets/the-eus-third-country-regimes-and-alternatives-to-passporting-executive-summary.pdf>.

bureaucratic hurdles. The process of obtaining authorisation is time consuming causing delays to the commencement of operations.7 The possibility of outsourcing arrangements back to the UK as a third country is also quite uncertain. As it has been communicated by the European Supervisory Authorities (ESAs) and the European Central Bank, in the aftermath of Brexit, subsidiaries are expected to be operationally independent from the rest of their group, while key personnel is to be based in the EU.8 Furthermore, subsidiaries are to be scrutinised closely to ensure that they do not simply act as empty shells.

(c) Equivalence and its limitations

Equivalence is an important tool but as the IMF notes, "it is unclear whether it constitutes a stable enough basis for markets that have been—and remain—deeply connected at so many levels."9 Specifically, equivalence is a decision-making process through which the EU makes an assessment of the regulatory framework of a third country to determine whether it is compatible with EU standards. Equivalence allows third-country financial firms to provide specific financial services in the EU single market and comes with three advantages. It reduces unnecessary overlaps. It allows for the application of a less burdensome prudential regime. It enables EU based market actors to access a wider range of financial services and instruments.10 Third countries neither have a right to obtain equivalence status, nor indeed a right to receive a positive determination let alone challenge an unfavourable decision in courts.

The Commission makes determinations about the granting of equivalence on the technical advice of the European Supervisory Authorities or external consultants and according to a set of parameters of equivalence as these are laid down in relevant EU legislation. The majority of EU laws on financial regulation make provision for equivalence decisions. The determinations of the Commission are unilateral, discretionary and cover only specific aspects of financial services.

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7 IMF UK FSAP 2022 at para 32 noting that "[p]ost-Brexit access is more complex compared to passporting".
8 Opinion of the European Banking Authority on issues related to the departure of the United Kingdom from the European Union (EBA/Op/2017/12) (October 2017) at <https://eba.europa.eu/documents/10180/1756362/EBA+Opinion+on+Brexit+Issues+%28EBA-Op-2017-12%29.pdf>; Opinion: General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union (ESMA42-110-433) (May 2017) at <https://www.esma.europa.eu/sites/default/files/library/esma42-110-433_general_principles_to_support_supervisory_convergence_in_the_context_of_the_uk_withdrawing_from_the_eu.pdf>; Opinion on supervisory convergence in light of the United Kingdom withdrawing from the European Union (EIOPA-BoS-17/141) (July 2017) at <https://www.eiopa.europa.eu/sites/default/files/publications/opinions/eiopa-bos-17-141_opinion_supervisory_convergence.pdf>; ECB 'Relocating to the euro area' (January 2021) <https://www.bankingsupervision.europa.eu/banking/relocating/html/index.en.html>.
9 IMF UK FSAP 2022 para 30 (further noting that equivalence "covers only specific elements of financial services, its granting and revocation is unilateral by the issuing party, can be conditional, and may involve political aspects").
10 European Commission 'Equivalence of non-EU financial frameworks' at <https://ec.europa.eu/info/business-economy-euro/banking-and-finance/international-relations/equivalence-non-eu-financial-frameworks_en>.

Furthermore, the Commission is not required to engage with negotiations with the third country in question. The European Parliament is involved in three respects. It adopts (jointly with the Council) Directives which delegate power to the Commission to assess equivalence. It is invited as an observer to the Commission's decision-making. Since the decisions of the Commission are subject to judicial review at the Court of Justice of the European Union (CJEU), the European Parliament may initiate judicial review proceedings. Judicial review proceedings are not available to third countries like the UK.

While the obtaining of equivalence status is often thought of as an alternative option to passporting, its perceived benefits for the UK should not be blown out of proportion. As a third country, the UK may express an interest in being considered for equivalence, but it is not entitled to receive a positive determination even when all necessary requirements obtain. The outcome of such determination depends entirely on the discretion of the European Commission. More generally, equivalence is a privilege, not a right. The relevant Implementing Act may grant equivalence in full or in part, on a temporary or more long-term basis or subject to certain conditions. Equivalence may be later adjusted or may be even withdrawn or terminated at a short notice. This entails significant risks for third-country financial firms because the legal basis for their activities might be pulled out at short notice and with little or even no warning.

The argument that the EU will be compelled to grant equivalence to the UK because of the reliance of EU liquidity on the City of London is not persuasive.11 In fact, the Commission has set out to reduce its dependence on the City of London now that it has become an offshore financial centre,12 and it is already taking steps for a stronger and deeper Economic and Monetary Union, the completion of the Banking Union and the development of the Capital Markets Union. Furthermore, the Commission has emphasised the importance of shielding its financial sector and critical financial-market infrastructure (e.g., stock exchanges, CCPs etc) against interference from abroad as a key priority. The reluctance of the Commission to grant equivalence may appear at odds with the fact that almost all of the UK financial regulation stems from existing EU legal instruments but, it is fully consistent with the EU's future plans to become strategically autonomous and to increase its own international competitiveness. Problems may also come up due to low confidence as to the genuineness of the commitment of third-country authorities to cross-border cooperation or when equivalence cannot provide a relatively stable framework for cross-border supervision and regulation due to frequent reviews.13 The fact that the UK has declined to commit to keeping UK law aligned with EU law in the years to come considering instead the case for divergence and deregulation is set to exacerbate the problem.

11 N Veron, 'After orderly Brexit, a new European financial landscape starts to emerge' (Peterson Institute of International Economics Blog; March 19, 2021) at <https://www.piie.com/blogs/realtime-economic-issues-watch/after-orderly-brexit-new-european-financial-landscape-starts>.
12 European Commission 'Questions and Answers: Fostering the openness, strength and resilience of Europe's economic and financial system' at <https://ec.europa.eu/commission/presscorner/detail/cs/qanda_21_109>.
13 IMF UK FSAP 2022 at para 26 (underscoring the role of trust in the context of equivalence).

What is the problem with the UK proposed model of mutual recognition?

In view of the shortcomings of TCR's like subsidiarisation and equivalence, it is in the interests of the UK to seek a long-term solution namely one that can be based on a legally binding international agreement between the UK and the EU like the one that it has been put forward by the UK. The current Trade and Cooperation Agreement (TCA) contains only limited provisions on the trade in financial services between the UK and the EU.14 Alongside the TCA, the UK and the EU also published a Joint Declaration on Financial Services Regulatory Cooperation between the European Union and the United Kingdom committing themselves to agree a Memorandum of Understanding (MOU).15 Technical negotiations on the MOU concluded in March 2021 but the MOU has not been formally signed or entered into force.

Being broadly in line with the WTO rules on financial services liberalisation, the envisaged framework of cross-border cooperation could be instrumental to a stable and durable UK and EU relationship in that it would facilitate dialogue while enabling both parties to retain their regulatory autonomy. That being said, the framework is not under the sole control of the UK and it is unlikely to provide a viable long-term solution, unless it is mutually appealing to both parties. In this regard, a significant point of contention between the UK and the EU is likely to be the proposed trade arbitration body which is one of the main tenets of the UK proposed model of mutual recognition. To be sure, the model is cast in vague terms16, however, the plan seems to be to set up a trade arbitration body which will be endowed with wide interpretive discretion to settle disputes between the UK and the EU in the light of generic projections about "regulatory outcomes over time".17 While its decisions will not set aside or strike down domestic

14 UK/EU and EAEC: Trade and Cooperation Agreement at <https://www.gov.uk/government/publications/ukeu-and-eaec-trade-and-cooperation-agreement-ts-no82021>; European Commission 'ANNEX to the Proposal for a Council Decision on the signing, on behalf of the Union, and on provisional application of the Trade and Cooperation Agreement between the European Union and the European Atomic Energy Community, of the one part, and the United Kingdom of Great Britain and Northern Ireland, of the other part, and of the Agreement between the European Union and the United Kingdom of Great Britain and Northern Ireland concerning security procedures for exchanging and protecting classified information' COM(2020) 855 final (Brussels, 25.12.2020) at <https://ec.europa.eu/info/sites/default/files/brexit_files/info_site/com_2020_855_final_annexe3_v1.pdf>.

15 Joint Declaration on Financial Services Regulatory Cooperation between the European Union and the United Kingdom at <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/948105/EU-UK_Declarations_24.12.2020.pdf>.

16 A Tarrant, P Holmes and R D Kelemen, 'Equivalence, mutual recognition in financial services and the UK negotiating position' UK Trade Policy Observatory Briefing Paper 27 (January 2019) at <https://blogs.sussex.ac.uk/uktpo/publications/equivalence-in-financial-services/#guidelines27>; PM speech on our future economic partnership with the European Union (2 March 2018) at <https://www.gov.uk/government/speeches/pm-speech-on-our-future-economic-partnership-with-the-european-union>.

17 Prime Minister Theresa May's speech on our future economic partnership with the European Union (2 March 2018) at <https://www.gov.uk/government/speeches/pm-speech-on-our-future-economic-partnership-

legislation directly, in practice, they could become a powerful weapon in the hands of the UK.

On the one hand, the UK would be able to press the EU to revise its standards; on the other hand, the regulatory divergence between the UK and the EU would create an opportunity for financial firms to bypass regulatory requirements (e.g., regarding bonuses or onerous capital and solvency requirements) by locating their business in the City of London and without sacrificing access in the EU single market. In short, the UK would end up having greater decision-making powers and influence in the EU than an EU Member State would have. It would be unprecedented for the EU to accept this arrangement for a third country.18 Equally problematic is the narrow focus on access to financial market in that its stands at odds with the CJEU jurisprudence which takes into account wider socio-economic implications as these are enshrined in Article 3 of Treaty of the European Union (TEU) including the preservation of the social market economy and employment. To conclude, the proposed dispute resolution body is likely to be seen by the EU as undermining Treaty objectives and threatening the coherence of the EU legal order. Taken together, these concerns make the proposed mutual recognition model too unappealing in the eyes of the EU to count as a realistic basis for negotiations in the first place.

Legal uncertainty and lack of predictability will take years to ameliorate

Even though Brexit has changed the framework for formal cross-border cooperation between the UK and the EU, a huge volume of EU law remains operative into the UK domestic law. The 2018 Withdrawal Act converts this body of existing EU law into a new category of law -the so-called "Retained EU law".19 In addition, it empowers Ministers to amend retained law as necessary to deal with any deficiencies arising from the UK's withdrawal from the EU ('onshoring' process). The Withdrawal Act further stipulates that retained EU law is to be interpreted in line with retained case law, as far as it is unmodified at the end of the Transition Period. More recently, the 2020 Withdrawal Act designates inter alia the UK Supreme Court, the High Court of the Judiciary and the Court of Appeal as having the ability to depart from retained EU case law.20 The creation of this new category of law raises a number of uncertainties.21 While retained EU law seems familiar, given the long adherence in the UK with EU legislation, the context in which it now applies and the rules and principles governing its interpretation will be new and untested.22 A further issue of concern is the lack of clarity as regards determinations of the exact and currently applicable provisions of English law, given the complexity of the overlaid onshoring

with-the-european-union>.

18 A Tarrant et al, above note 16.

19 The European Union (Withdrawal) Act 2018.

20 The European Union (Withdrawal Agreement) Act 2020.

21 IMF UK FSAP para 17.

22 Cross-border financial crisis management arrangements is a case in point as their effectiveness has not been tested in times of stress. IMF UK FSAP para 6.

statutory instruments. The ensuing legal uncertainty is bound to increase transaction costs for the financial industry.23 Bearing in mind that the relevant jurisprudence will take years to develop, the problem of legal uncertainty will not go away any time soon.

Should the future UK financial regulation converge or diverge with EU financial regulation?

Approaching the UK's international competitiveness from the perspective of what would be appealing for international investors is unhelpful and potentially dangerous in practice. International investors do not form a homogeneous group. Their interests are diverse, incommensurable while certain of them may be incompatible with what is in the best interest of the UK in the medium and long term. As different international investors look for different things, it is imperative for the UK to opt for a model of financial regulation that secures the country's longstanding sustainable economic growth. The latter would be hard to attain without having in place some sort of a relatively stable arrangement for the management of cross-border financial services between the EU and the UK. Accordingly, if soft law international standards of financial regulation are to play a more prominent role now that the UK is the 'third country' vis a vis the EU, the UK and the EU financial regulation of the future should converge in principle (adhering to soft law international standards of financial regulation) as well as in some detail at least in relation in those areas or issues for which the UK will seek to obtain EU equivalence status or other similar arrangement. Areas of regulation where the legal framework is less well developed in both the EU and the UK seem to provide greater scope for the UK to diverge.24 Notable examples include fintech, data digitalisation, green and sustainable finance, however, this may change in the near future. The commitment of the EU to catch up with or even exceed the UKs' current progress in these fields in the years to come should not be underestimated because, in the aftermath of Brexit, strategic autonomy has become an imperative for the global competitiveness of the EU.25

23 IMF UK FSAP paras 46 and 53.

24 See Evidence of Miles Celic (Chief Executive at The CityUK), 'House of Lords, Europeans Affairs Committee Corrected Oral Evidence: UK financial services' (8 February 2022) at 13 at <https://committees.parliament.uk/event/7089>.

25 See e.g., Making the EU a role model for a society empowered by data' at <https://ec.europa.eu/info/strategy/priorities-2019-2024/europe-fit-digital-age/european-data-strategy_en> For an insightful commentary see, Andrea Renda, 'The Data Act: six impossible things before breakfast?' (CEPS; 2 March 2022) (characterising the relevant regulatory proposals "most ambitious, complex and controversial") at https://www.ceps.eu/the-data-act-six-impossible-things-before-breakfast/?mc_cid=32c6745a37&mc_eid=96d530f814