Dr Miranda Brawn – Written evidence (FTS0053)

How will the arrangements in the EU-UK Trade and Cooperation Agreement (TCA) shape UK-EU trade in financial services?

A significant component of the Agreement is on free trade, ensuring that no tariffs or quotas are put in place for the cross-border trade of rule-compliant goods. The Agreement also puts in place a framework for cooperation on energy, transport, social security and standard-setting including in respect to climate change, labour rights and tax transparency. One area where the Agreement is noticeably light on detail is in respect to financial services. As widely anticipated by the industry, the Agreement does not extend to banks, insurers and other financial services firms authorised in the UK an automatic right to access EU markets.

Under a variety of European Directives and Regulations, UK financial services firms have been able to undertake regulated business in the EU (and vice versa) using so-called European financial services passports. Provided firms were appropriately licensed and regulated in their home country, these firms could use either a services or branch passport to undertake their business across EU markets under the supervision of local EU Member State regulators without the need for a local presence and/or licence.

Financial services are expressly excluded in the Agreement from the most-favoured nation clause in terms of any future trade deal with a third country. Financial services are also excluded from the provisions in the Agreement on services more generally and are also excluded from the requirement to review trade in services and investment relations in the future.

The agreement will make trade between the U.K. and the EU more complicated however it is better than no trade deal being struck at all. The U.K. and EU will be locked in trade talks for the foreseeable future.

As for financial services, the first area detailed in the declarations, this is not covered comprehensively in the full trade agreement. Instead, the declarations include an agreement to try and reach a memorandum of understanding by March 2021 that might mean the two sides agree to recognise each other's rules, a process known as "equivalence," which would allow the finance industry to trade across the U.K. and EU border. There will need to be transparency and appropriate dialogue in the process of adoption, suspension and withdrawal of equivalence decisions. Financial services are a rare area where the U.K. has a clear competitive advantage over the EU. Meanwhile, the EU is seeking to onshore far more of its financial services activity, particularly in terms of bond trading and with contracts tied to the euro.

Equivalence decisions granted by the EU can be withdrawn at short notice. This is off-putting for investors who will want legal certainty about the status of cross-border contracts. It is also somewhat impractical or at least challenging for financial stability, given the volume of outstanding contracts between the two parties.

What little detail there is on financial services in the full trade agreement shows that there will be a great deal of segmentation and complexity for this sector. If a UK based company wants to serve customers in an EU member country by setting up an office there, for example, its market access and regulation will vary from country to country.

As with lots of trade deals, there are frequent references to so-called "reservations" — areas with so-called mixed competencies, where some power lies with member states and some with the European Commission. Market access and regulation therefore need to be determined member state by member state. For instance, anyone who does not speak French or German will need a legal translation on implications for financial services from national reservations there. The same principle also applies in fields such as criminal records.

UK and EU regulators already have a range of memorandums of understanding. For example, the Financial Conduct Authority has a memorandum of understanding in place with the European Securities and Markets Authority (ESMA) as well as national EU regulators covering supervisory cooperation, enforcement and information exchange. The Agreement's proposed Memorandum of Understanding should build on the existing good work of EU and UK regulators in terms of fostering cooperation. The Agreement commitment to a Memorandum of Understanding does fall short, however, of the provisions of other such free trade agreements. For example, the free trade agreement between the EU and Japan expressly put in place regulatory cooperation measures in the free trade agreement itself.

Financial services are regulated by a range of laws across the EU with few containing substantive equivalence regimes which enable third country firms to provide services to local customers / counterparties without local authorisation. The ability of UK firms to operate in the EU under equivalency decisions and vice versa is much more limited than the soon-to-end passporting arrangements. Importantly, equivalency decisions may also be withdrawn unilaterally on very short notice. It remains possible, however, that EU concerns about the UK loosening regulations to its competitive advantage will result in the EU seeing the prospect of a unilateral withdrawal of equivalency decisions as an effective method of keeping the UK harmonised with the EU legal and regulatory framework.

The failure to replicate market access arrangements under passporting in the Agreement does not come as a surprise or shock to the financial services industry. UK and EU firms, as well as national and pan-EU regulators, have been putting in place contingency measures to allow cross-border business to continue in the event that no agreement is reached.

In the UK, these measures have primarily consisted of a temporary permissions regime which allows EU firms to continue doing business in the UK without local authorisation for a period of time. No pan-EU temporary permissions regime exists for UK firms seeking continuity of business. Instead, UK firms have

proceeded to either scale back their EU business, subsidiarise and seek EU Member State authorisation and access to passporting, or else to rely on local EU27 national measures (such as overseas persons regimes, which exist in certain countries) and/or on conducting business with EU customers on a reverse solicitation basis.

As the transitional period ended on 31 December 2020, it appears highly likely that friction in cross-border financial services will occur. The extent of that friction continues to depend on the willingness of regulators and governments to act on equivalence decisions, regulatory cooperation and the acknowledged shared interest in a vibrant financial services sector.

Financial services is an export success for the UK and has developed significant EU export markets on the back of passporting arrangements (around 40% of the sector's exports go to the EU). In order to continue to access the single market without passporting, UK based financial services firms will either have to comply with the different requirements of individual member states or rely on equivalence decisions. Neither is a like for like replacement for the EU wide common access facilitated through passporting. Seeking permissions on a state-by-state basis would add complexity and hence costs for financial services firms.

Meanwhile equivalence does not cover the same range of financial services activities. Core banking services such as lending, payments and deposit taking are excluded, for example. Neither do they guarantee permanent access rights. The EU can withdraw equivalence determinations with 30 day's notice.

The European Commission explicitly identifies future equivalence decisions in financial services as one of the potential unilateral measures that the EU can adopt within a wider set of 'pillars of cooperation' with the EU. A general commitment to regulatory cooperation is no replacement for certainty regarding single market access for UK financial services firms. Many have already planned for this eventuality by moving parts of their operations to cities such as Paris, Frankfurt, Amsterdam and Dublin. The TCA also creates further uncertainty for UK financial services.

The measures designed to promote openness between the UK and international markets are threefold:

i. Overseas funds regime. The Financial Services Bill ("The Bill") introduces a new equivalence regime for retail investment funds and money market funds, which will simplify the process for investment funds that are domiciled overseas to market to UK consumers.
ii. Gibraltar Authorisation Regime. The measures in the Bill will deliver long-term market access between the UK and Gibraltar for financial services firms on the basis of alignment and cooperation, now that the UK and Gibraltar have left the EU.
iii. Markets in Financial Instruments Regulation (MiFIR). The Bill updates the regime which regulates the services and activities of third-country firms in the UK, following an equivalence decision. This will ensure the FCA has an

appropriate degree of oversight over firms that could register under the regime.

The City of London is the predominant financial centre in Europe. It does six times more financial services business with the EU than the EU does with the UK. More financial services business is done in Canary Wharf than in the whole of the EU combined. London accounts for 40% of Europe's assets under management (and 85% of hedge fund assets), 60% of its capital markets business, 78% of its foreign exchange trading, and 74% of its derivatives trading. The UK securities market is the biggest in Europe, the UK banking sector is the biggest source of cross-border lending to EU banks and corporates with more than £1tn of loans outstanding, and the UK is by far the largest market in Europe for 'alternative finance'. Exports of UK financial and insurance services are around £82bn, of which £33bn or 40% go to the EU.

Under current EU rules, the UK financial sector can only access the single market if the EU determines that the UK financial regulatory system is deemed to be 'equivalent' to that of the EU, meaning that it achieves the same outcomes as its own rules, as well as preserving financial stability, investor protection, market integrity and a level playing field in the EU single market.

This is not a sustainable long-term position for the UK to operate a £30bn+ business in the EU which can be stopped on a whim with 30 days' notice. There is also the question of costs because equivalency is not just about access. It is about the cost of doing business. A lack of equivalence decisions would increase the cost of doing business for financial services firms and the clients they serve.

While the UK has granted a temporary permissions regime to a large number of EU companies, allowing them to continue to do business in London and to allow UK firms to use venues in the EU, the EU has refused to reciprocate and has banned EU companies from trading swaps and other derivatives on platforms in London. The euro-denominated derivatives market in London is worth €78trn.

There are two additional important issues of concern and these are movement of people and data. While the TCA permits visa-free travelling for 90 days in any 6-month period to attend meetings, conferences and conducting research, any sale of goods or services to the public will require a visa. In terms of data, financial services firms need to ensure they comply with EU data sharing rules, which covers client paperwork and personal data under GDPR.

Regulations will need to be accepted as being sufficiently similar, but without actually being identical. Mutual equivalence for the financial services regulation and supervision in the UK and EU should be sufficiently aligned in the future. Regulatory monitoring by a joint committee to ensure regulatory alignment is a potential option. This would be a good way to avoid disruption for market participants and avoid fragmentation of liquidity in products like derivatives (i.e. swaps), reducing costs for investors.

In addition, it is common for financial regulators to permit the ‘delegation’ of certain financial services to entities regulated in other jurisdictions. This is typical of portfolio management, where fund managers frequently operate a portfolio management hub, enabling economies of scale and other efficiencies. In Europe, this hub is London. Two key questions are whether the EU will: a) allow EU fund managers to continue to use London as their European portfolio management hub and b) allow UK portfolio managers to enter into arrangements with a third-party ‘host’ EU fund manager, subject to complying with EU delegation rules.

The regulations must not restrict growth in financial services, not encourage regulatory arbitrage, not prevent sections of the economy from accessing capital or other financial products, help to develop safe but competitive markets, and facilitate the growth of new and small businesses.

London will remain one of the world’s leading financial centres and an attractive place to do business. It has a diverse pool of talent, a reputation for innovation and a business friendly regulatory and legal environment. Many financial institutions have long factored Brexit into their plans.

Financial services were one of the first industries to prepare for Brexit, because of the importance of having the right licence to operate, and it moved quickly to set up new operations to continue operating in the EU. Many financial institutions are stepping back now and considering how they conduct business across Europe, and where efficiencies can still be made. An evolving regulatory environment in the UK could spark innovation, attract new talent and push UK financial institutions to consider new areas of growth, like investing in clean technologies and sustainable investing.

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