A post-Brexit future for UK financial services in the EU

Paul Edmondson, Partner, and Victoria Hewson, Counsel to the Legatum Institute and Senior Associate, at CMS Cameron McKenna LLP summarise the issues concerning regulation of the financial services market post-Brexit, and introduce their recent report which contains proposals for a possible way forward for this intensively cross-border industry

Financial services have been at the forefront of concerns about the consequences of the UK leaving the EU, but the debate about Brexit and financial services has been confusing for the public and practitioners. Much of the jargon in use means different things to different people.

Joint report

Law firm CMS and the Legatum Institute Special Trade Commission have produced a joint report (the 'report' - see www.pdpjournals.com/docs/99015) entitled "A new UK/EU relationship in financial services – A bilateral regulatory partnership" which looks at how a new UK/EU partnership might work in the field of financial services. We have aimed to move away from binary and simplistic discussion (such as 'passporting' versus 'equivalence') and to contribute to the development of a more informed consensus.

The Prime Minister's speech on 17 January 2017 and the White Paper on 2 February 2017 made clear that the UK will not be seeking to retain single market membership or participation. This means that if cross-border financial services business is to continue in its present state of integration, or something close to it, there needs to be a new construct for cross-border regulatory coordination between the EU and the UK. A joined-up approach will be required, combining the practice and terminology of trade negotiation on one side, and the world of financial services regulation on the other.

In preparing the report, we went back to the basic principles of regulation of cross-border supply of financial services. When financial services firms seek to provide services from their home state into another country (the host state) or from within the host state, they face substantial barriers from the host state regulatory regime ("DR barriers"). In some cases, these barriers preclude cross-border modes of supply altogether. A firm may require host state authorisation which is only possible if it establishes a local branch; a host state may refuse to authorise a branch and may require a local subsidiary to be used. In other cases, regulatory requirements may conflict, making cross-border supply or international infrastructure impractical.

Additional DR barriers are a mix of financial barriers (ineffective use of capital and resources), operational difficulties (maintaining multiple entities, licences and compliance operations) and associated cost.

Dual regulation co-ordination

This specific nature of the market means that 'market access' (in WTO/FTA terminology) is not the real or immediate priority for financial services firms. Rather, an agreement on dual regulation co-ordination ("DRC Agreement") is required, whereby UK financial services providers can continue to do business in the EU on the basis of their regulation and oversight in the UK – and vice versa.

Our report sets out how this might be achieved, within the parameters of trade policy, regulatory policy and prudential objectives in terms of consumer and market protection and financial stability, and the ultimate goals of competitive markets in financial services promoting wealth creation and economic growth.

There are lots of examples in operation across the globe by which DRC has been achieved in different sectors and markets. We have explored these and the structures and dispute settlement fora that underpin them.

The DRC options are far from binary – there is a broad spectrum of possibilities (in terms of what may be proposed and what may be agreed in a DRC agreement). For example, EU legislation gives various powers in relation to bilateral accords – by way of illustration, the Swiss/EU treaty above and the 2016 European Commission/CFTC accord on central counterparty regulation. The latter arose under the auspices of the G20/Financial Stability Board review, and was implemented by equivalence findings by the EU under the European Market Infrastructure Regulation (EMIR), and comparability findings by the US under Dodd-Frank respectively.

Equivalence of UK regulation

However, the UK should not expect to rely upon unilateral EU findings of UK 'equivalence' for recognition and coordination. If the UK were to leave the EU without any bespoke agreement, UK firms in some lines of business and for certain modes of supply would be assisted by the EU determining (on a unilateral basis) prior to Brexit, that relevant UK regulation was 'equivalent' and thereby activating, for the benefit of UK firms, the EU's existing external DRC measures.

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This, however, would not prevent the re-introduction of most of the many substantial DR barriers which have been eliminated between EEA states (because of the limited scope of EU external DRC).

The unilateral basis of these equivalence measures would mean that they could be withdrawn at a later stage without recourse.

Divergence of UK regulations post-Brexit

There is a strong economic case – for both the EU and UK - for transposing full DRC (as it currently applies within the single market) at the outset, at least as an interim measure. There is unparalleled regulatory homogeneity between the UK and the 27 EU member states. Thereafter, regulatory divergence between the UK and the EU should be permitted.

Under our proposed DRC agreement, neither side will have a veto over the regulatory rules of the other side - the UK, as a third country with a substantial financial services sector, cannot be bound in perpetuity to all EU financial services legislation as it emerges.

A permanent EEA style model of 'follow all EU measures', as accepted by Norway, Iceland and Liechtenstein, would not be practical or desirable for the UK. Divergence is therefore a possibility which must be catered for in the DRC agreement, and represents the opportunity for the UK to move its regulatory environment in a more pro-competitive direction. Unless the DRC agreement prohibits outright divergence, which would threaten the continued co-ordination and recognition of regulation and which we also think is neither practical nor desirable, the agreement must cater for the possibility of DRC withdrawal if either side diverges from standards that give the other the confidence to accept its prudential regulation and oversight.

Post-Brexit freedom to move away from EU harmonisation, as carried into domestic law for Brexit, may not therefore be exercised to a significant extent in the short to medium term.

Development of future rules, however, may be a greater source of divergence, but DRC should not be sacrificed unless and until substantial divergence poses real and unacceptable risk. This should not be based on narrow concepts of matching or equivalent rules but on a substantive assessment of regulatory outcomes and whether the host state would be exposed to unacceptable risk by relying on less effective regulation in the home state.

The report refers to these as the principles of sufficiency and proportionality – i.e. that the assessment is relative to the risks involved. The agreement must also be flexible enough to include increased/new DRC measures.

A framework such as the one we have outlined would enable the UK to maximise opportunities to improve regulations domestically, as well as to reach into emerging overseas markets, whilst maintaining stability and consumer confidence.

As law makers review the acquis, risk and compliance professionals who implement and operate within these regulations in practice are ideally placed to participate in the process and make recommendations as to the future direction of financial services regulation.

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