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Very limited regulatory cooperation—and market access—likely on financial services

- With a UK-EU trade deal in place for goods, discussions between the two sides are now turning to services, with a memorandum of understanding (MoU) due to be concluded in March.
- Although many observers expect this process to conclude with a deal on “equivalence” for financial services, we think that is highly unlikely; instead, the MoU will establish a process and framework for regulatory cooperation between the two sides.
- Initially, this framework will be narrow and not create a more strategic, in-depth dialogue about regulatory changes each side is likely to make in the future; however, as the politics of the new UK-EU relationship mature, so will regulatory cooperation, possibly making it easier for the EU to grant equivalence over the medium term.

Now that a trade deal on goods between the UK and EU has been struck, political, policy and investor attention is turning to services—especially financial services—and what level of regulatory co-operation, in exchange for market access, can be achieved on this front.

A memorandum of understanding (MoU), due to be concluded between the two sides by March, will provide the first indication of how both see their relationship for this critical sector evolving over time.

Our view is that while the MoU will seek to strengthen UK-EU co-operation and dialogue, it will also recognise that both sides will want to develop their own rules—and go their own way in some areas. Equivalence is not a single “all or nothing” decision but patchwork of arrangements formed by separate decisions in different parts of the market. Indeed, the rhetoric of ministers since 1 January hints at a more distant relationship with the EU on financial services than “equivalence”—the already minimalistic framework used by

the EU for third countries to determine what level of access their financial service providers can gain to the Single Market.

The unwillingness of the UK to align and follow EU rules in the area of goods is likely to foreshadow its approach to financial services. Chancellor Rishi Sunak is even raising the prospect of a “Big Bang 2.0” for the City of London like Margaret Thatcher’s 1986 deregulatory shake-up. Sunak wants London to use its new freedom from EU rules to become a global leader in financial technology and sustainable or green finance.

Boris Johnson has ordered a review of all regulations affecting business with the aim of cutting red tape inherited from the EU. Ministers know that raising the spectre of Singapore spooks the EU; indeed, it was a major reason why the EU demanded level playing field (LPF) provisions on goods in the trade deal and such language could make agreement on equivalence harder to reach.

Moreover, ministers point out that the City has survived many upheavals and always proved creative and flexible enough to adapt to new conditions; they are convinced it will find ways to prosper and retain its status as a world leader post-Brexit. They envisage a pivot away from the EU to Asia, in line with UK trade policy.

The Treasury and Bank of England are therefore assuming no equivalence, not because they necessarily see this as the most likely outcome, but so they are prepared for a “worst case outcome.” The Bank’s view is that equivalence is not the “be all and end all,” and that if the EU demands the UK be a “rule-taker” which must adopt the same rules as it does in future, that would be too high a price to pay.

For its part, the EU thinks the idea of UK rule taking is a “straw man.” First, senior EU officials argue that it is the EU that is at risk of becoming a rule taker from the UK, given its dependence on some activities in London, such as clearing. “We have a great deal of financial risk located outside our jurisdiction. We don’t have national infrastructures to provide us with alternatives if things go wrong,” says one senior EU official.

Moreover, EU officials point to the equivalence discussions that the EU has with the US. The objective there, as it would be for the UK, is to get to a level of regulatory convergence between two sides that are equivalent so that the EU can open up its markets and not import “stability risks.” This makes a deal with the UK difficult to strike—as in order to grant equivalence and open up the Single Market, the European Commission will want a sense that relations between the two sides are stable and that Brussels has a sense of the evolutionary changes the UK would like to make in the future.

Put differently: trust is an essential component of equivalence and that is currently lacking between the two sides, not least given the government’s manoeuvres on the Internal Market Bill. The recent political rhetoric in Westminster has also created some concern that the UK wants to change and deregulate in more radical ways. As one senior EU official says: “We are not asking the UK to never change its rules. But we cannot sign equivalence and then allow the UK to do whatever it wants.”

This problem—the need for the EU to satisfy themselves about the UK’s future regulatory plans—is the most difficult part of the equation. This is not least because Number 10, the Treasury and Bank’s view is that “open markets” is the top priority. The recent decision to allow Swiss share trading, previously banned by the EU, is but one example.

Similarly, the EU’s ability to withdraw equivalence at 30 days’ notice is seen by some ministers as a “one-way street” giving the EU all the power. UK officials say more stability should be built into the system so that withdrawal is a “last resort.” The suspicion in London is that some EU members, particularly France, see Brexit as an opportunity to develop their own financial sectors—such as capital markets and derivatives—a goal of the Eurozone since the 2008 financial crisis. The Commission and MEPs want to increase the euro’s strength on international markets, to reduce dependency on London. EU officials insist that they have awarded over 260 decisions and withdrawn only 4, which were announced 2 years in advance and so reject the UK argument that equivalence is

a political weapon. However, senior EU officials argue that for equivalence to provide “a stable basis for cross border trade, the equivalence relationship must be stable, which means our understanding with London must be stable”—which it obviously currently is not.

There are countervailing pressures on the UK government. Any perception of lighter touch regulation would risk political controversy, reviving memories of the 2008 financial crisis. Officials insist the UK has signed up to the same global standards as the EU and that in practice these will likely shape future regulation in both the UK and EU. Despite ministers’ rhetoric, there appears little appetite in the City for a “bonfire of regulations.”

Political criticism of the UK-EU deal has focused on the virtual absence of the services sector which account for 80% of the UK economy. Johnson’s critics on this point include Theresa May, his predecessor. MPs in all parties would view the absence of equivalence as another failure which posed a threat to UK jobs. About 7,000 have migrated to the EU since the 2016 referendum as UK firms moved operations; although this was far less than the 50,000 predicted, a “no equivalence” scenario would likely see more jobs lost in the UK.

Nonetheless, senior officials on both sides agree that the MoU will not deliver a “deal” on equivalence for financial services. In general, when equivalences are not in operation, the two sides of the relevant transaction will need to be located and regulated within the same legal territory—creating the risk that more UK business will migrate to the EU.

At this stage, the process is about setting up a framework for co-operation. What that will be exactly at this point is uncertain, but on the narrower end, the MoU could be very mundane, simply setting out the conditions by which regulators would talk to each other. At the other end of the spectrum would be something more strategic—say an in-depth dialogue about change on either side. For now, the less ambitious outcome is more likely. That said, over the longer term, a productive discussion on regulatory co-operation could make it easier for the Commission to determine equivalence in the future.

Happy to discuss

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