

Brexit and the Single European Financial Market^{*}

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Introduction

The outcome of the British referendum on continuing membership of the European Union (EU) represents a turning point in the relationship between the United Kingdom (UK) and the EU. The economic and political effects of Brexit will be far reaching for both the UK and the EU. Although the events are still unfolding, Brexit raises a set of important questions with reference to the Single Market, especially in financial services. What are the implications of Brexit for the UK and its financial industry; and what are the implications of Brexit for the EU and the single financial market? This topic is examined in four consecutive steps. We first discuss the UK’s influence in the development of the single financial market, including EU financial regulation, over the past two decades — and thus both prior to, and after, the international financial crisis. This overview is necessary in order to grasp the potential implications of Brexit for the UK, the EU and their financial industries — examined in the second step. We then examine the so-called safeguards secured by the UK government from

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the EU in the run up to the Brexit referendum and the position of the UK's financial industry during the Brexit campaign and after the referendum. Finally, we review the post Brexit options available to manage the relationship between the UK and the EU, specifically with regard to finance.

It is argued that that the UK has been a key player in the development of the single financial market, especially prior to the international financial crisis, and has greatly benefited from it. The — at times considerable — British influence made EU financial regulation more market-friendly and open to third countries than it would have been otherwise. Post-crisis, British policy-makers and the financial industry were — at least temporarily — on their back foot. The EU-UK agreement signed prior to the Brexit referendum contained several clauses concerning economic governance, including non-discrimination provisions for the financial industry based in the UK. However, these provisions mainly reflected the status quo and re-stated existing commitments. The City of London and British financial industry were mostly in the pro-Remain camp during the referendum campaign — albeit there were some noteworthy financial sector supporters of Brexit. Following the June referendum, the City unsuccessfully mobilised in order to retain full access to the single financial market — the alternative options were considerably less appealing for the UK financial industry.

I. The UK, the single financial market and EU financial regulation

The further integration of the Single Market in financial services, which regained momentum with the Financial Services Action Plan in 1999, was characterised by the presence of two competing coalitions: the 'market-making' one, which was led by the UK, and included Ireland, the Netherlands, Luxembourg and the Scandinavian member states; and the 'market-shaping' one, which focused upon re-regulating the market at the EU level and which

included France, Germany, Italy, Belgium and the other Mediterranean countries. The UK (Posner and Véron, 2010), the City of London and the most competitive part of the financial industry on the continent (Mügge, 2010) were the main driving forces for further financial market integration because they were the interests that would mostly benefit from it. Hence, pre-crisis EU financial regulation was strongly influenced by the UK — as suggested by the prevailing market-making content of the four so-called Lamfalussy directives, the Solvency II directive and the Payment Systems directive — even if certain provisions of these pieces of legislation could be described as market-shaping.

What accounts for the UK's influence on financial market integration and pre-crisis EU financial regulation? First, the UK was the second or third largest EU member state in terms of GDP. Second, the UK had voting power: under QMV voting rules in the Council, the four largest member states (Germany, France, the UK and Italy), together with any other EU member state, had sufficient votes to block any proposed pieces of legislation on finance. Most importantly though, the UK financial sector was by far the largest in the EU and the City of London was the largest financial centre in Europe and the second largest in the world. Given the size of the financial sector — in particular when compared to the rest of the economy (Macartney, 2009 — British authorities had considerable subject-specific expertise on matters related to finance and were regarded by many policy makers and stakeholders as providing state-of-the-art regulation (Mügge, 2010). Moreover, British policy-makers invested a considerable amount of technical and human resources in order to shape the regulatory debate in the EU (Posner and Véron, 2010; Quaglia, 2010). In addition, the UK hosted large banks, including large US banks, that had the resources to lobby policy makers both domestically and at the EU-level (Baker, 2010; Helleiner, 2010).

In the wake of the international financial crisis, the UK's influence on EU financial governance waned somewhat, at least in the short term. A host of new financial legislation was issued by the EU in the aftermath of the crisis. The vast majority of these measures regulated activities or entities that were previously unregulated (or subject to self-regulation) in the EU and its member states (including credit rating agencies) (Quaglia, 2010); or at the EU level (such as hedge funds and bank resolution) (Buckley and Howarth, 2011); or at the national, EU and international level (over the counter derivatives) (Pagliari, 2011). In other instances, legislation imposed heavier, more prescriptive and more burdensome requirements on financial entities that were already regulated prior to the crisis — as in the case of higher capital requirements for banks and new liquidity management rules (the Capital Requirements Directive IV) (Howarth and Quaglia, 2016) — or they set in place more substantial protection for depositors (the revised Deposit Guarantee Scheme Directive) (Howarth and Quaglia, 2016). The reform of the financial services architecture following the de Larosière Report (2009) was designed to strengthen financial supervision at the EU level and to foster macro-prudential supervision in the EU (Hennessy, 2014).

Unlike the period prior to the international financial crisis, most EU regulation adopted from 2009 to 2016 was market-shaping rather than market-making. Hence, the UK was often a foot-dragger, for example concerning the legislation on hedge funds, rating agencies and the Financial Transaction Tax. These pieces of legislation were resisted by the UK by Labour and Conservative-led governments on the grounds that they would impose unnecessary costs, damage the competitiveness of the financial industry in Europe and reduce the attractiveness of European financial centres as a result of regulatory arbitrage. The concern about international 'regulatory arbitrage' has traditionally been at the forefront of policy-makers' minds in Britain, given the fact that London hosts many non-British-owned financial

institutions and successfully competes with other financial centres worldwide to attract business (Quaglia, 2010).

Indeed, the British government's influence on the content of EU post-crisis financial regulation proved to be important in order to maintain the single financial market open to third countries (Pagliari, 2013; Quaglia, 2015). Equivalence rules were the cornerstone of the post-crisis regulatory approach of the EU towards third countries in finance. All the main pieces of financial markets legislation adopted from 2009 — namely the Regulation on Credit Rating Agencies (CRAs) (2009), the Directive on Alternative Investment Fund Managers (AIFMs) (2011), the European Market Infrastructure Regulation (EMIR) (2012) and the revision of the Markets in Financial Instruments Directive (MiFID II) — contained 'equivalence clauses'. These clauses stipulate that unless third country rules are equivalent to EU rules, foreign firms providing services in the EU or doing business with EU counterparts will be subject to EU regulation in addition to their home country regulation. Without equivalence, foreign firms failing to respect EU regulations would be blocked from accessing the Single Market.

For policy-makers in countries such as France and Germany, which embraced a 'market-shaping' regulatory paradigm, the equivalence clauses were first and foremost intended to prevent the 'import' into the EU of financial instability from third countries. These clauses were also seen as instrumental in seeking to align third country rules with EU rules. By contrast, British policy-makers, who traditionally supported a 'market-making' regulatory approach, worried about the potential risk of closing the EU market to third country entities and products as well as the detrimental effects that the new EU equivalence rules could have on the competitiveness of the financial sector in the EU. For British policy-makers, loose

equivalence rules were needed above all to ensure the access of third country financial entities and products managed from London to the EU market.

The UK was by and large supportive of Banking Union and specifically the Single Supervisory Mechanism (SSM) for euro area member states, notably as a way to tackle the sovereign debt crisis distressing the euro area periphery and to ensure financial stability therein.¹ However, the British government had no intention of participating in Banking Union because of domestic political and political economy considerations. Banking Union implied a considerable pooling of power at the EU / Banking Union level — first and foremost the supranationalisation of banking supervision — which was politically unacceptable in the UK. Moreover, the institutional and decision-making framework of Banking Union was primarily designed for euro area members. While designed to be open to the participation (through ‘close cooperation’ provisions) of non-euro area countries, none to date has yet to join Banking Union. As for its domestic political economy, the British banking system was — and by a large margin — the most ‘Europeanized’ of the largest six EU member state banking systems in terms of the holdings of other EU-headquartered banks in the UK (as both a percentage and in total terms) as well as British bank holdings elsewhere in the EU (in total terms). The British banking system was also by far the most internationalized in terms of non-EU headquartered banks active in the UK and the activities of British banks abroad (Howarth and Quaglia, 2016). The UK was most exposed to the potential instability of globally systemic banks, which affected the British banking system more in relative terms than others in Europe (Howarth and Quaglia, 2016). British banks by and large supported the creation of the SSM, but none sought British participation (BBA, 2012).

¹ See, for example, *The Telegraph*, 13 December 2012, 19 December 2012.

During the negotiations on Banking Union, British policy-makers feared that a euro area majority would be able to impose its rules on non-euro area members in the European Banking Authority (EBA) — the body of national bank supervisors which sets supervisory standards for the entire EU.² Hence, the British demanded an EBA voting reform, whereby any decision by the Authority had to be approved by a ‘double majority’ of member states inside and outside Banking Union, thus effectively giving veto power to a small number of non-euro area member states. Some euro area member states, notably France and Germany, resisted British requests but eventually an agreement was reached on the creation of a double majority system until the number of non- Banking Union member states dwindled to less than four (Howarth and Quaglia, 2016). The end of the UK’s membership of the EU is likely to weaken the bargaining position within the EBA of those supervisors from member states outside of Banking Union.

Finally, the UK was a pace-setter on Capital Markets Union (CMU) very much in the same way it had been on financial market integration over the previous two decades (Quaglia *et al.*, 2016). First, a British national, Jonathan Hill was chosen to lead the CMU project at the European Commission and was appointed as Commissioner ‘for Financial Stability, Financial Services and Capital Markets Union’. Second, UK policy-makers and stakeholders engaged extensively in the agenda setting process on CMU. Third, the areas prioritised for action by the Commission — securitization (banking), Solvency II (insurance) and Prospectus (securities markets company information) — were those that would clearly benefit British interests and, indeed, had been previously set by the UK government as its three top priorities for action on CMU (UK Government, 2015). The call for evidence on the EU regulatory

² *Financial Times*, 13 December 2012.

framework for financial services also chimed well with British concerns regarding EU over-regulation as the reaction to the international financial crisis.

Of all EU Member States, the UK had the most potentially to benefit from the financial liberalisation and diversification promised in the CMU project, given the diversity of its financial sector and, in particular, the high concentration of wholesale market activity, private equity and hedge funds in the City (Véron, 2014). In a speech made to the City of London Corporation Policy Committee, Commissioner Hill (2015) noted that:

[f]rom here investment flows out across the continent: UK banks lend more than \$2 trillion into other European countries.... More than a third of UK private equity funds' investments go to companies elsewhere in the EU. So the success of the City is tied to a successful Europe.

Given the fact that the UK was one of the main cheerleaders of CMU, the UK's departure is likely to have negative implications for this project.

II. The EU-UK agreement prior to the Brexit referendum

In February 2016, the EU Member States engaged in a re-negotiation of the terms of the UK membership of the EU with the aim of reaching an agreement which could aid British Prime Minister David Cameron's efforts to win the referendum by clarifying or resolving certain politically sensitive matters. On 2 February, European Council President, Donald Tusk, presented a proposal for an agreement to address a range of specific concerns raised by Mr. Cameron (Tusk, 2016). After negotiations among the Member States and between officials of the European Council and European Parliament, the agreement was approved by all EU leaders as a 'legally binding and irreversible decision' at the European Council session in Brussels on 18-19 February (European Council, 2016). The changes were to take effect after

the British referendum, if the 'Remain' vote prevailed. The re-negotiation agreement contained five clauses with reference to European economic governance which largely restated the status quo. However, a small number of new 'safeguards' were inserted.

Clause 1: 'Discrimination ... based on the official currency of the Member State ... is prohibited. Legal acts ... directly linked to the functioning of the euro area shall respect the internal market ... and shall not constitute a barrier to or discrimination in trade between Member States. These acts shall respect the competences, rights and obligations of Member States whose currency is not the euro' (European Council, 2016, p. 13).

This clause stated what was already *de jure* and *de facto* the case. The principal concern that this clause addressed was the impact of British non-membership of the euro area upon the UK economy and notably upon financial services. For the British, there was a clear political logic of including this clause because of previous efforts by the European Central Bank (ECB) and some member states seeking to prioritise euro area financial stability over the preservation of the internal market. However, ECJ rulings to date have undermined these efforts.

The notable case was euro clearing. In January 2009, then-French Finance Minister Christine Lagarde referred to the need for 'euro area clearing' of financial products denominated in the single currency,³ a position supported publicly by the Governor of the Bank of France.⁴ In a July 2011 policy paper, the ECB called for legislation requiring clearing houses to be based in the euro area if they handled 'sizeable amounts' of (i.e., more than 5 per cent of the clearer's total business was in) a euro-denominated financial product (ECB, 2011a). This recommendation came in the context of a long-standing debate over the control and

³ *Financial Times*, 19 February 2009.

⁴ *Financial Times*, 19 February 2009; 2 December 2012.

authorisation of clearing houses in the European Markets Infrastructure Regulation (EMIR) on which the British government later won an important concession, prohibiting the discrimination against any Member State as a venue for clearing services.

In September 2011, the British government launched its first lawsuit against the ECB through the European Court of Justice (ECJ) on the grounds that the ECB's policy recommendation on the clearing of euro-denominated financial products would restrict the free movement of capital and infringe upon the right of establishment. The ECB's move would disadvantage financial services in the United Kingdom and could force one of the world's largest clearing houses — LCH.Clearnet, which far exceeded the 5 per cent threshold proposed by the ECB — to move much of its euro operations to the euro area. At the end of 2012, over 40 per cent of euro-denominated transactions took place in London, more than the entire euro area combined. The ECB (2011b) responded to valid British government concerns by a clarification of its clearing house location policy in a November 2011 document against which, in February 2012, the British government launched a second 'technical' legal challenge. The ECJ ruled that the ECB was acting beyond its competence by attempting to direct most clearing of euro-denominated financial products to the euro area.

While the illegality of the ECB's efforts was clarified, the ECJ did not decide on the financial stability versus internal market concerns per se. Thus there remained the possibility that financial stability concerns could trump efforts to preserve the internal market. Furthermore, the ECB's action left a nasty aftertaste and a very real (and very valid) fear that some member states and some EU institutions continued to see the balance between financial stability concerns and the need to respect the internal market very differently than the British government. However, on this issue, the underlying concern of UK-located counterparty

clearers potentially lacking sufficient liquidity in a crisis was resolved through swap arrangements between the ECB and the Bank of England.

More generally, there remained the possibility that pressure from convergence of bank supervisory standards within the Single Supervisory Mechanism (SSM) could shape rules that applied to all EU member states. This was another important British preoccupation and one that definitely was not unwarranted. However, there were already important safeguards in place. Moreover, it is important to note that on nearly all internal market issues (and specifically on financial services) there has been no clear euro area block. The coalitions of EU member states on nearly all matters concerning financial services have cut across euro area / non-euro area membership. Thus, the UK has been regularly joined by the Netherlands, Ireland and Luxembourg — amongst other Member States — in its positions on a range of financial services issues, from the financial transactions tax to the Alternative Investment Fund Managers (AIFM) Directive.

Clause 2. ‘Union law on the banking union ... is applicable only to credit institutions located in Member States whose currency is the euro or in Member States that have concluded with the European Central Bank a close cooperation agreement on prudential supervision [thus participating in Banking Union].... The single rulebook is to be applied by all credit institutions and other financial institutions in order to ensure the level-playing field within the internal market. ... To this end, specific provisions within the single rulebook ... may be necessary for Banking Union members, while preserving the level-playing field and contributing to financial stability’ (European Council, 2016, p. 13).

Clause 2 was also re-statement of both current legal fact and de facto reality. However, the clause appears to exaggerate the singleness of the single rulebook on banking. Even in the SSM, in its direct supervision of the largest euro area banks, the ECB was required to operate supervision according to the rules of the participating member states. The ECB had counted 122 options and national discretions in the application of EU rules on banks and their

supervision. The ECB sought to reduce the scope of these options / discretions but with many this would likely take a long time and with some options / discretions full convergence was very unlikely.

With regard to non-Banking Union member states (including the UK), they were still subject to the Single Rulebook and efforts at convergence and harmonization. However, here the EU (through the EBA) had fewer powers and less suasion than the ECB to bring about convergence in supervisory practice. Another crucial point to make is that the SSM's supervisory manual / and supervisory practice had to conform to the EBA's technical standards — not the other way around. This is because the SSM had to respect the rules of the internal market. The UK had more wiggle room with regard to the transposition / implementation of European standards than did the SSM national competent (supervisory) authorities which were under direct ECB pressure to modify a range of their distinctive national rules on banking and supervisory practices than were British authorities.

The double majority voting rule of the EBA was unique in EU law / policy-making and meant, in effect, that a UK vote on EBA decisions weighed more heavily with regard to supervisory standards in the EU (and thus the SSM) than the vote of individual Banking Union member states, including Germany, France and Italy. In 2016, five out of nine non-euro member states could block EBA decisions, whereas it took ten out of nineteen euro area member states to block decisions. This was egregious because it introduced a de facto qualified majority voting which had no relationship to national population or economy size. Double majority voting in the EBA would remain until the number of member states outside Banking Union dropped to four — a rule which created the potential situation in which three member states (regardless of size) could legally block decisions sought by the other 25.

Clause 3. ‘Emergency and crisis measures designed to safeguard the financial stability of the euro area will not entail budgetary responsibility for Member States whose currency is not the euro, or, as the case may be, for those not participating in the banking union. Appropriate mechanisms to ensure full reimbursement will be established where the general budget of the Union supports costs, other than administrative costs, that derive from the emergency and crisis measures referred to in the first subparagraph’ (European Council, 2016, p. 14).

This clause was, to a very large extent, a re-statement of the legal and de facto reality that existed in 2016. However, this clause also provided one example where the February agreement might have feasibly provided additional safeguards. On this, we can consider principally the design and operation of the European Financial Stability Mechanism (EFSM) which is a EU Commission mechanism created in 2010 to provide financial assistance to Member States. In 2015, the EFSM provided a bridging loan to Greece of €7 billion. The UK voted against the use of EFSM funds but was outvoted in the Council — with all euro area member states voting in favour. This example of the UK being outvoted on the use of EFSM funding was picked up — by the UK government, the softly Eurosceptic think tank Open Europe and various elements of the Brexit campaign — as a good example of Britain losing power to a bloc of euro area member states and being potentially forced to pay out to help euro area member states in trouble (Open Europe, 2016). Unlike the European Stability Mechanism (ESM) (which is the main funding mechanism of the euro area for both sovereigns and banks) the EFSM is a Commission mechanism that can be used to support all the EU member states (and not just the euro area member states). The EFSM can raise up to €60 billion by issuing debt and the reimbursement of this debt is guaranteed by EU budget.

The creation of the EFSM thus entailed a potential budgetary responsibility for Member States outside the euro area, and specifically the UK government. However, the likelihood of

a euro area member state imposing a financial burden on the UK government was exceedingly limited. First, the bulk of European support for euro area member states needing financial assistance came from the European Stability Mechanism (ESM) to which the UK did not contribute capital. Second, the EFSM raised funds on the markets. These funds were guaranteed by the European Commission using the budget of the EU as collateral. Thus, in theory, if a euro area member state failed to pay back the loans from this mechanism (offered at comparatively generous terms) then the EU budget could take a hit. However, the impact would only be on contributions to the EU budget to which MS have already committed themselves. Funds to cover EFSM debt incurred would have to be taken from other parts of the EU budget. The UK government would not be expected to pay more and, at most, the UK net contribution to the EU budget would only increase slightly given the potential decrease of funds allocated to other EU programmes from which the UK also benefitted. Thus, the impact upon the UK government of EFSM financial support was unlikely and the clause added to the agreement on the UK and the EU provided a guarantee that was unlikely ever to be called upon. It is also important to note that the bulk of the EFSM's total funding (€46.8 billion out of a possible €60 billion) had previously been lent to Ireland and Portugal and that these loans had been supported by the UK government.

Clause 4. 'The implementation of measures, including supervision or resolution of financial institutions and markets, and macro-prudential responsibilities, to be taken in view of preserving the financial stability of Member States whose currency is not the euro is ... a matter for their own authorities and own budgetary responsibility, unless such Member States wish to join common mechanisms open to their participation' (European Council, 2016, p. 14).

This clause re-stated the existing situation both *de jure* and *de facto*.

Clause 5. ‘The informal meetings of the ministers of the Member States whose currency is the euro ... shall respect the powers of the Council as an institution upon which the Treaties confer legislative functions and within which Member States coordinate their economic policies. In accordance with the Treaties, all members of the Council participate in its deliberations, even where not all members have the right to vote’ (European Council, 2016, p. 14).

Again, this clause re-stated the existing situation both *de jure* and *de facto*. If anything, it might have even exaggerated the importance of the Euro Group which had no legal decision making powers and operates as an informal decision making body (Puetter, 2013). However, yet again, it is important to insist upon the significant differences among most euro area member states on most policy areas (fiscal policy, etc.) which made it unlikely that important decisions would be taken in Euro Group discussions on internal market matters that also affected the non-euro area member states. In any event, these decisions were subject to subsequent intergovernmental discussion in the Council (Ecofin).

The Quid Pro Quo?

The final point to make on the European Council’s economic governance provisions is that the agreement on the UK could be seen as having potentially reduced British government power in policy making on economic governance. The first clause of these provisions noted that:

‘Member States whose currency is not the euro shall not impede the implementation of legal acts directly linked to the functioning of the euro area and shall refrain from measures which could jeopardise the attainment of the objectives of economic and monetary union’ (European Council, 2016, p. 13).

Again, the wording of the clause largely reflected the status quo. However, the new obligation of having to refrain ‘from measures that could jeopardise the attainment of the objectives of EMU’ might have been significant. The creation of the European Stability

Mechanism (ESM) in 2012 can be taken by way of example. It was necessary to create the ESM through an intergovernmental treaty because the UK government had refused EU treaty change. These new provisions might have been invoked to prevent the UK from blocking the future incorporation of the ESM into the EU treaties.

III. The British financial industry and the Brexit vote

From the late 1980s, the open and competitive UK financial sector greatly benefitted from European financial integration because it was well positioned to take advantage of the removal of financial barriers, passporting rights and the EU-wide harmonisation of financial regulation.⁵ The City more generally benefitted from the free movement of capital and labour within the EU. In turn, the success of the financial sector was a major driving force for the British economy. The EU was the biggest market for UK exports of financial services, generating a trade surplus of £15 billion in 2012, a third of the UK's total trade surplus in financial services, which totalled £46 billion (The CityUK, 2013). The UK's financial services trade surplus with the EU more than doubled over the decade to 2015. About 70 per cent of the EU's foreign-exchange trading and 40 per cent of global trading in euros took place in the UK. The UK hosted 85 per cent of the EU's hedge-fund assets, 42 per cent of EU private-equity funds, half of EU investment bank activity, and half of EU pension assets and international insurance premiums (The CityUK, 2015).

Given this massive interest, the City of London and the UK financial industry more generally were predominantly against Brexit (The CityUK, 2013). However, certain financial services — and notably hedge funds — were pro-Brexit. For example, hedge-fund bosses Crispin

⁵ 'Passporting' is discussed in more detail below.

Odey and Paul Marshall were major contributors to Vote Leave, the main pro-Brexit campaign.⁶

A number of British financial industry associations and large firms mobilized in earnest on the referendum. In 2014, The CityUK sponsored a study that presented the economic benefits of UK's membership of the EU — beyond financial services — and delivered a clear message that 'membership of the EU is essential for the UK's success and for the ability of our businesses to compete in world markets'.⁷ The financial industry also responded *en force* and with a positive outlook to the Balance of Competence review carried out by the UK government from 2012 to 2014. However, the industry also expressed some concerns about the implications of differentiated integration in the EU and, specifically, the potential fragmentation of the single financial market by creating a distinct (euro area) market within the Single Market.

The British Bankers Association (BBA, 2014) submitted one of the most positive contributions in favour of EU membership, arguing that 'the Single Market is a significant factor in the success of the UK as a financial centre and therefore of considerable value to the British economy'. Similarly, the Investment Management Association argued that 'EU rules provide a basically positive framework for not just within the EU but also globally, as well as purely within the UK'.⁸ Moreover, the Association of British Insurers concluded that 'the balance of competences lies in roughly the right place', while warning that '[i]f the UK is to

⁶ *The Economist*, 7 May 2016.

⁷ See: <https://www.thecityuk.com/research/analysing-the-case-for-eu-membership-does-the-economic-evidence-stack-up/>; accessed on 12 March 2017.

⁸ See: <https://www.gov.uk/government/consultations/balance-of-competences-review-single-market-financial-services-and-the-free-movement-of-capital>; accessed on 28 March 2017.

reap the benefits of EU membership, it is essential that the British Government remains fully engaged with its EU partners, participating constructively in the debate'.⁹

During the re-negotiations between the UK and the other EU Member States that led to the February 2016 European Council agreement, the City and the UK financial industry supported British demands for new rules to protect countries outside the euro area against regulation made by those inside the group that could disadvantage them. One provision sought by both British finance and government that was not included in the agreement, would have granted any non-euro area country the power to stall any new regulations for the currency union, by triggering further discussions among EU leaders prior to adoption. Even though the new 'safeguards' of the February agreement were of questionable significance, the financial industry and the UK business community more generally supported the agreement that was seen as instrumental for the 'yes' vote to prevail and for the UK to remain in the EU. In February 2016, a letter calling on the UK to remain in the EU was signed by 200 business leaders, including many financial firms in the City. The letter, which was published in *The Times*, welcomed the re-negotiation deal secured by Prime Minister Cameron in Brussels the previous week.¹⁰

The outcome of the referendum was a rude shock for the British financial industry and its principal response can be described as damage limitation. The priority for the bulk of British finance was to preserve membership of and full access to the single financial market. It soon became clear that a European Economic Area (EEA) style arrangement post-Brexit was not

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See: https://www.abi.org.uk/~/_/media/Files/Documents/Consultation%20papers/2014/01/Balance%20of%20Competences%20review%20Single%20Market%20Financial%20Services%20and%20the%20Free%20Movement%20of%20Capital.pdf; accessed on 28 March 2017.

¹⁰ Available at: <https://www.bba.org.uk/news/bba-brief/p/25/>.

feasible for the UK government because of its commitment to ending free movement of labour. As its main alternative, the City favoured a special deal for finance, which however was not politically feasible for the EU Commission and several Member States which insisted publicly on maintaining all four freedoms of the internal market or none. Hence, the British financial industry called for the preservation of as much market access as possible (The CityUK, 2016a, b; see below).

In August 2016, in its first blueprint for life after Brexit, The CityUK (2016a) called for sustained access to the Single Market and for ‘mechanisms approximating single market passporting’. In September 2016, in its report on ‘Brexit and the financial industry’, The CityUK (2016b) reiterated the priority to preserve ‘access to the Single Market on terms that resemble as closely as possible the access the UK currently enjoys’. In an October 2016 report commissioned by The CityUK to the global management consultancy, Oliver Wyman (2016), analysed Brexit’s potential impact on the UK-based financial services sector, providing a doomsday scenario in the event that the UK moved to a relationship with the EU defined by terms set out under the World Trade Organization and without any regulatory equivalence — a position favoured by some ministers in the UK Conservative government. According to the report: up to 50 per cent of EU-related activity (£20 billion in revenue) and an estimated 35,000 jobs could be at risk, along with £5 billion of tax revenues per annum. Furthermore, the knock-on impact on the broader economic system risked losses of £14-18 billion of revenue, 34-40,000 jobs and £5 billion in tax revenue per annum (Wyman, 2016).

Outside the financial sector, in October 2016, in an open letter to the government, business leaders, including the Confederation of British Industry (CBI) and the International Chambers of Commerce (ICC) wrote to Prime Minister Theresa May, urging her to avoid opting for

hard Brexit. They pointed out the need to ensure ‘barrier free access to the EU's Single Market, which is vital to the health of the UK economy, especially to our manufacturing and service sectors. Uninterrupted access for our financial services sector is also a major priority’ (CBI 2016). The Confederation of British Industry and the British Bankers Association lobbied the offices of both the Prime Minister and the Chancellor of the Exchequer to stress that transition arrangements were needed.¹¹

IV. Three post Brexit options for UK financial services

The impact of the British referendum result upon UK financial services — like the rest of the economy — remained far from clear. Concretely, there are three main options that could be considered for the EU-UK post Brexit relations: Full Brexit, whereby UK-EU relations are regulated by World Trade Organization (WTO) rules; UK joins the European Economic Area (EEA) (the so-called Norwegian model); and UK-EU relations regulated by bilateral relations (the so-called Swiss model).

Full Brexit: UK-EU relations regulated by WTO rules

According to this model, EU-UK relations would be regulated by WTO rules, which prescribe, amongst other things, the ‘most favourite nation’ clause, according to which countries cannot discriminate between their trading partners. Thus, if one country grants another country special conditions (such as a lower customs duty rate for one of their products), it has to do the same for all other WTO members. In the WTO model, some tariff barriers, customs barriers and non-tariff (regulatory) barriers would remain between the EU and the UK, unless the UK adopted EU rules (or UK rules were considered as equivalent to EU rules). UK firms would not have the right of establishment in the EU; and they would not

¹¹ *The Guardian*, 27 November 2016.

be able to passport their services, including financial services, across the EU. However, the freedom of capital movement would be retained. Foreign direct investments into the UK could potentially take a hit because the UK has been an important point of entry into the EU Single Market, especially in finance. In fact, many US-headquartered banks set up branches and subsidiaries in London, and from there they operated throughout the EU. The UK would not be able to access the Court of Justice of the EU, and UK-EU dispute settlement would take place through the WTO. The UK would be free to negotiate new bi and multi-lateral trade agreements and would not have to pay contributions to the EU budget and EU programmes. This was the option most politically palatable for the ‘Leave Campaign’ and pro-Brexit government ministers, but it was also the most potentially expensive from an economic point of view, especially for the UK financial sector.

UK joins the EEA (the so-called Norway option)

If the UK joined the EEA, it would retain membership of and hence unrestrained access to the Single Market, including the passport for financial services. However, the UK would have to comply with EU rules (or UK rules should be considered by the EU as equivalent to EU rules). The four freedoms — of movement of goods, services, labour and capital would remain in place. EEA institutions mirror EU institutions, including the Court for dispute settlement. The UK would be free to negotiate new trade agreements; it would not participate in the EU’s Common Commercial Policy (CCP), nor the Common Agricultural Policy (CAP), the Common Fisheries Policy (CFP), EMU, etc.; it would not pay contributions directly to the EU budget and would not have access to EU Structural Funds. There would be EEA membership fees to be paid to the EU, and the UK would be able to join ad hoc EU programmes (for example, on research). From an economic point of view, this option would have been a good solution for the City and the financial industry, which however would have

to comply with EU financial regulation. However, this option was the most politically costly for ‘Leave’ campaigners given their promises on ending the free movement of labour, and thus the Conservative government.

EU-UK bilateral agreements (the so-called Swiss option)

According to the so-called ‘Swiss model’, the EU-UK relations would be regulated by a set of bilateral sectoral agreements. Hence, access to Single Market would be regulated by ‘bilaterals’, whereby UK exporters would have to comply with EU rules — or UK rules would have to be considered by the EU as equivalent to EU rules. Currently, the bilateral agreements with Switzerland do not include financial services, which are very important for that country. The UK would be able to join ad hoc EU programmes (for example, on research), subject to agreement on the free movement of labour. The UK would be free to negotiate new trade agreements; it would not pay contributions to the EU budget and would not have access to Structural Funds.

Bilaterals are complex and time-consuming, the EU is not keen to replicate the Swiss option with the UK. Indeed, even prior to the Brexit referendum, the EU expressed dissatisfaction with the Swiss deal, questioning the continuation of this arrangement. This option — subject to the details eventually agreed — would not be politically costly for the UK and it was seen as a good potential deal for the City, which indeed advocated a ‘Swiss plus deal’. However, this option would be politically costly for the EU. Any ‘special deal’ for the UK financial services sector would give the UK important benefits of EU membership, but not many of the obligations deriving from it.

The British authorities and the UK financial sector faced a ‘dilemma’ in the upcoming Brexit negotiations. On the one hand, if the UK loses unrestricted access to the single financial market, UK-based financial entities and activities will need to relocate at least some activities to subsidiaries in the EU in order to continue to benefit from passporting across the Single Market (that applies to the full range of financial services). Moreover, the UK will no longer serve as the main point of entry into the EU for third country financial entities and products, which will be more likely therefore to seek to choose to place a range of operations in other EU Member States to secure access to the passport. Finally, the UK will be less able to challenge the efforts of the ECB and a number of Member States to transfer euro clearing to the euro area.

On the other hand, if unrestricted access to the single financial market is retained, the UK will have to continue to comply with EU financial regulation on which it ceases to have a direct say in policy- and law making. In the past, the UK financial sector frequently complained about excessively burdensome EU financial regulation. As this contribution has argued, in several financial policy areas, the UK has yielded considerable influence in ‘calibrating’ (at times, toning down) EU financial rules. Hence, EU financial regulation is likely to be different in the future without the UK’s ‘market-making’ approach — this will make EU rules less suitable for the financial industry based in the City. Moreover, euro area member states will tend to develop specific preferences on binding technical standards on supervision and potentially financial regulation more generally through their cooperation in Banking Union.

The EU also faces a Brexit dilemma. Any ‘special deal’ for the UK financial services sector is politically unpalatable for the EU because it would give the UK important benefits of EU

membership, namely, unrestricted access to the single financial market, including passporting. It would be the kind of ‘pick and choose’ approach that has so far been ruled out by the EU — whereas the UK authorities have tended to speak of a ‘bespoke deal’. There might also be a political trade-off among the four freedoms, in particular the movement of labour (including control of immigration) and the free circulation of financial services and capital. At the same time, the City is by far the main financial centre in Europe, so there are incentives to retain it in the Single Market — and even some press reports that the Commission has been exploring this option.¹² Furthermore, many continental banks, insurers, securities dealers, and so on, operate in London and face potential costs in having to move operations.

Equivalence and passporting

In addition to the choice among the three macro-models described above, two other mechanisms have been examined through which to manage UK-EU relations in finance post Brexit: passporting and equivalence. According to passporting, a firm authorised in an EEA country is entitled to carry on permitted activities in any other EEA country by either exercising the right of establishment (of a branch and / or agents) or by providing cross-border services. The activities that are 'passportable' are set out in the relevant EU Single Market directives, which are: the Capital Requirements Directive; the Markets in Financial Instruments Directive; the Undertaking Collective Investment Scheme Directive; the Alternative Investment Fund Managers Directive; the Solvency II Directive; the Insurance Mediation Directive; the Payment Services Directive; and the Second Electronic Money Directive (Bank of England, 2016).

¹² See, for example, *The Guardian*, 13 January 2017.

Certain pieces of EU financial legislation contain provisions for ‘equivalence’. There are currently nearly 40 equivalence requirements in place in total (Open Europe, 2016). Equivalence stipulates that if third country rules are equivalent to EU rules, foreign firms providing services in the EU or doing business with EU counterparts can continue to be subject to their home country regulation in lieu of EU regulation (see Quaglia, 2015). Equivalence is outcome-based — that is, the regulations of the third country do not need to replicate EU legislation word-by-word as long as they achieve the same objectives — and can bestow passport-like rights in some cases. Equivalence is granted to countries not to individual firms, as in the case, for example, of substitute compliance in the US. The Commission decides on the equivalence of third countries on the basis of advice from the European Supervisory Authorities — the EBA, the ESMA and the EIOPA. However, EU’s equivalence only covers a narrow range of services; it can be withdrawn at any time; and its approval is generally a political rather than a technical process, which does not bode well for a country in trade negotiations with the EU. Furthermore, in November 2016, the *Financial Times* reported that the European Commission was considering tightening up equivalence for non-EU jurisdictions.¹³ Ironically, equivalence was in part a British invention to ensure that the Single Financial Market remained open to third countries.¹⁴

Conclusion

This contribution has focused on a watershed event concerning the EU’s Single Market in finance: Brexit. It has provided an overview of the UK’s central role in the development of this market. It has discussed the significance and potential implications of the provisions on economic governance of the EU-UK re-negotiation agreement of February 2016. This

¹³ *Financial Times*, 6 November 2016.

¹⁴ *Financial Times*, 25 July 2016.

contribution has examined the mobilisation of the financial industry in the run up to the referendum and subsequently. Finally, the various options for EU-UK relations, specifically with regard to the financial sector, have been examined.

As for the effects of Brexit, given the strong internal and external market-making influence exerted by the UK in the past, one could expect that EU financial regulation in the future will become more market-shaping, and less market-friendly. The Single Market in finance is also likely to be somewhat less open to third countries, after the UK's departure. In turn, Brexit represents a major challenge for the UK financial sector and the finance-led model of capitalism in the UK. Brexit will have an impact on the size and profitability of the sector, as well as its contribution to the real economy. The precise impact remains to be seen and will depend largely on the progress of Brexit negotiations starting in 2017.

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