CENTRE FOR EUROPEAN REFORM

On Brexit, TTIP and the City of London

by Sam Lowe

The EU was keen to include financial services in TTIP, the proposed trade agreement with the US. Is its reluctance to do so with the UK mere hypocrisy?

The EU has repeatedly said that, unless the UK changes its red lines and decides to stay in the single market, financial institutions based in the UK should expect to be treated post-Brexit in the same way as those based in any other non-member country. In practice this will mean, at best, operating under the meagre provisions of the EU's equivalence framework, which in certain areas allows for financial services providers to sell into the EU from outside, but which can be unilaterally rescinded by the European Commission with 30 days' notice. Most recently, Michel Barnier asked an audience at the EU-Western Balkans summit in Sofia: "why would the equivalence system, which works well for the US industry, not work for the City?"

In contrast, the UK has put forward a proposal based on mutual recognition, whereby both the UK and the EU would accept each other's rules as equivalent in outcome even if specific provisions were different, and the outcomes were achieved in a different way. That would allow cross-border trade to continue much as it does now. Importantly, revocation of market access would be determined on the basis of consultation and set criteria, thereby giving institutions and investors greater security and confidence. This has been welcomed by many in the City. But just as the UK was always going to propose something to this effect on financial services, the EU was always going to say "no".

Mutual recognition of financial services regulation, as proposed by the UK, goes against the single market framework which increasingly relies on harmonised rules, minimum standards, continual co-operation and overarching supranational oversight and enforcement. This approach gives national regulators the confidence that foreign banks under the purview of other EU member-states are not exposing their financial system to excessive risks or ripping off their consumers. Privileged market access will not be on offer to the UK, which wants to extricate itself from the harmonised rule book and associated oversight.

Furthermore, if the EU were to allow UK-based institutions to operate in its market on the basis of mutual recognition of outcomes, it would run the risk of undermining its rule-making autonomy and the integrity of the single market. Companies trading out of the UK would in effect be able to operate across the single market on the basis of a different rule book, offering opportunities and incentives for the UK to engage in regulatory competition. Under the EU's existing equivalence

regime, rulings are largely confined to types of financial activity that are deemed to pose low systemic and consumer risk.

Some in the UK, including the prime minister, have pointed to the Transatlantic Trade and Investment Partnership (TTIP), the stalled EU-US FTA negotiations, as an example of past EU willingness to include financial services in a trade agreement. It is true that financial services were to be covered in TTIP, just as they are in all EU trade agreements. They will inevitably be in any future EU-UK free trade agreement, too. But the financial services provisions contained in EU FTAs do little more than reaffirm the EU's market access commitments and reservations as already laid out in its WTO General Agreement on Trade in Services schedules, which do not amount to much.

The one area where Michel Barnier has indicated the EU is prepared to up its offer is with regard to the right of establishment. This will further reduce the already low barriers facing UK-based services providers wishing to set up within a member-state in order to service the EU. It will also lock in existing rights of establishment, guarding against future rollback. But this will not give the City access from London and firms will still need to establish subsidiaries in the EU.

TTIP could have potentially gone further on regulatory co-operation in financial services. Officially, the EU proposed a continuing regulatory dialogue that would have ensured consultation between the EU and US prior to new financial regulations; a co-ordinated approach to the implementation of international standards; a joint review of existing rules to try and identify unnecessary barriers to trade; and an ongoing commitment to scope out potential future equivalence rulings. The UK could realistically aspire to something similar, but these arrangements should not be confused with comprehensive mutual recognition.

There is, however, slightly more to the story. Although they have never been published, the EU did table some informal proposals on regulatory co-operation in financial services during the fifth round of the TTIP negotiations, which offered more detail. In its non-paper the EU proposed a process that could eventually lead to 'mutual reliance' of regulations and future rules, although mutual reliance was not fully defined. This does suggest that the EU was, at one point at least, considering something in the context of an FTA that appears similar to mutual recognition. However, other sections of the non-paper muddy the water, such as a section clarifying that any party may rescind equivalence decisions unilaterally, but should consult beforehand.

The UK should not take this non-paper as evidence that the EU will concede to British demands on mutual recognition in financial services post-Brexit. These unpublished proposals were a product of a post-financial crisis era in which regulators were under pressure to increase international co-operation; even so, they are vague about the extent of mutual recognition that the EU would consider. While the non-paper suggests EU sentiment could one day shift back towards being more favourable to mutual recognition, it should not be taken as indicative of where the EU is now in the Brexit negotiations, or will be any time soon.

Behind closed doors, member-state representatives say that comprehensive mutual recognition is not something an FTA can allow in and of itself. It would also require the EU to change many of its laws, which provide certain rights only to financial institutions incorporated within the territories of member-states of the EU and the European Economic Area. In itself, this would not be an impossible hurdle to clear, but it would require the will to offer mutual recognition in the first place, which is currently absent on the continent.

The EU is amenable to suggestions as to how to improve and expand the scope of its equivalence regime. Instead of pushing for the pipe dream of mutual recognition, the UK and the City should engage more readily with the current discussions on this issue, including clearer guidelines concerning the withdrawal of an equivalence ruling and a longer notice period of withdrawal. The UK should also make the case for including an ongoing, structured regulatory dialogue on financial services in the future EU-UK partnership, leaving open the possibility that new opportunities for improved market access may emerge.

Beyond the specifics of the future relationship, in the short-to-medium-term a degree of honesty and humility is warranted. The EU line on financial services is not going to crack, and the member-states do not believe they need the City as much as the City believes they should. If the UK is unwilling to change its Brexit negotiating red lines, and in particular its plan to leave the single market, the only way for a UK-based financial institution to guarantee its continued ability to service EU-27 customers post-Brexit is to establish itself within the EU-27. And the EU is rolling out the red carpet.

Sam Lowe
Research fellow, CER @SamuelMarcLowe