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A trade deal would give the City of London breathing space

by John Springford

The EU's decisions on financial equivalence for the UK are formally separate from the trade deal under negotiation. But in reality, the two are linked.

The British government has marginalised big business during the EU trade negotiations – and none more so than finance. By prioritising sovereignty over close economic ties with Europe, the UK has accepted that trade in financial services will be more difficult once the transition period ends. This is despite the City of London's status as a global financial centre, responsible for a sizeable chunk of British exports and tax revenues. The City is not only a cluster of banks, markets and insurers, but also the accountancy, consulting and law firms that service them.

The trade agreement that the UK and EU are negotiating offers little in practice to the sector. But the City of London is still hoping for a deal: the EU is more likely to grant equivalence in some areas of financial services if a trade deal is struck. Equivalence is a unilateral decision, taken by the European Commission, that a third country's regulation and supervision is similar enough to the EU's. That decision would allow British firms to provide services across the EU. In the event of no deal, access on the basis of equivalence will be limited to areas where the EU is worried about its own financial stability.

The EU has granted the UK equivalence in derivatives clearing until mid-2022, despite the spat over the UK's Internal Market Bill. The European Central Bank (ECB) has always been concerned that ending EU banks' access to clearing houses in London might cause financial instability. After the 2008 financial crisis, regulators tightened regulation on derivatives (such as futures and options) and mandated that some derivatives be 'cleared', so that if one participant in a derivatives contract went bust, the contract would be carried out without harm to the other. If the EU failed to grant equivalence on short notice, there would be a scramble to move derivatives contracts to clearing houses within the EU, which do not yet have the capacity to cope. But equivalence will be temporary, and over time both the Commission and the ECB will press for more derivatives to be cleared within the EU's jurisdiction: neither wants to outsource regulation and supervision of a critical part of the EU's financial system to the UK.

The ECB is not convinced that equivalence decisions in other areas – the trading of shares, advice about mergers and acquisitions, and so forth – are needed in order to protect the

EU's financial system. As a result, the European Commission and the member-states have been more willing to use the equivalence process in these areas for leverage in the trade negotiations. If a trade deal is agreed, and Boris Johnson drops the provisions in the Internal Market Bill that violate the terms of the Withdrawal Agreement, it is more likely that equivalence will be granted by the EU in some of these areas.

But there is one important area in which the Commission said on July 9th that it will not grant equivalence: investment banks that provide investment services to clients in the EU, even to 'professional clients' in other financial institutions. In August, Commission Vice-President Valdis Dombrovskis said that new rules were still being implemented, so the Commission would not be able to grant equivalence to allow UK investment banks to continue to serve EU clients from January 2021. Investment banks headquartered in the UK and seeking to provide cross-border services will have to apply to the national authorities of each member-state they want to operate in.

If the EU does not grant equivalence decisions in other areas, many banks have already set up subsidiaries in the EU that will allow them to continue to provide services, and are ready to move more staff and capital to offices on the continent as needed. Many have done so already, operating on the basis that no deal will happen, in order to minimise risk.

Not all areas of finance are covered by the EU's equivalence regime in any case – especially those where banks and insurers are providing services to ordinary consumers, rather than other financiers. But that does not mean that equivalence decisions would not be helpful. The City may currently be a ghost town, with most people working from home, but once the pandemic is over there will still be benefits to being able to dip into a big pool of skilled financiers in London rather than having workers distributed across Europe. Banks can also use their capital more efficiently if they provide services from one institution, rather than several, each of which will have to be capitalised.

That is why a trade deal is worth having for the City: the EU will take the mostly political decision to allow equivalence if the UK signs up to a state aid regime that is similar to its own, provides the EU with long-term access to its fishing waters, and so forth. The trade deal itself may include provisions for an ongoing dialogue between the regulatory bodies on financial markets, similar to those included in the EU's trade deal with Japan. Those dialogues will be needed to preserve a stable equivalence regime between the EU and the UK.

But in the longer term, it is unclear which of two competing visions for the future of EU financial markets will win out – with important ramifications for the City. The first view sees the EU financial system as a pillar of 'strategic autonomy'. In 10-15 years, there would be a fully-fledged capital markets union. The EU system would be open to London, New York and Asia but would be more developed itself. An EU safe asset, such as the common EU bonds that European leaders recently agreed should finance the recovery fund, would underpin a stronger international role for the euro and the European financial system. The EU would face less exposure to US sanctions, because Europe would be less dependent on the US financial system.

The opposing view sees a more 'independent' European capital market as inevitably more closed: instead, the EU should maximise its involvement in the regulation of global markets. Free-trading national governments in the EU and the financial services lobbies stress that tighter equivalence rules and EU capital market rules that diverge from the global norm will raise the cost of finance for companies and consumers. And the capital markets union has made slow progress so far: centralised supervision of capital markets and a single set of rules for insolvency, stock exchanges, taxation and many other things will be needed to create a single market in this area. The Commission proposed new common supervisory measures on September 24th to try to restart the process.

Which is more likely? The trajectory has undoubtedly been towards the centralisation, albeit slow, of financial regulation at the EU level. The ECB has become the supervisor for the largest banks in the eurozone, and as a result it has sway over the banking regulations that the Commission proposes. Member-states are resisting losing the power to supervise and regulate capital markets, but centralising logic is powerful here, too – a consolidated market would allow the costs of recessions and benefits of upswings to be shared more equally across the continent. A deal would give the City breathing space, but Brexit gives the UK the power to go its own way, and it should not be surprised if the EU does the same over time.

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