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Brexit and European Finance: Prolonged Limbo

ABSTRACT

Following the orderly British exit from the European single market in late 2020, the full impact of Brexit on the financial sector has been delayed by risk aversion in the public and private sector alike, in part related to the Covid-19 pandemic. It will take longer than many had anticipated for the dust to settle on the post-Brexit financial landscape and its respective implications for the EU and the UK.

It is still early to assess the impact of Brexit on the European financial sector, including both the UK and the EU. In sharp contrast to the politics of the bilateral EU-UK treaties negotiation and its aftermath, which have been and will probably remain full of sound and fury, the implementation of the British exit from the European Union and its single market has been carefully prepared and cautiously managed by regulatory authorities and market participants, with additional risk aversion in the Covid-19 pandemic phase since March 2020. While the prudent approach has successfully averted any disorderly developments so far, it also implies that the current status is far from a steady state, as many impactful decisions remain to be made. Just as the initial negotiation has taken significantly longer than initially envisaged, the transition to a truly post-Brexit financial sector in the UK and Europe more generally is turning out to be more protracted than many had anticipated.

SUCCESSFUL TRANSITION

The period of Brexit negotiations lasted nearly four years, from the British government's formal notification of its decision to leave the Union in March 2017 to the signature of the EU-UK Trade and Cooperation Agreement on 30 December 2020. As the memories of the related twists and turns rapidly fade away, it becomes increasingly easy to forget the radical uncertainty and cliff-edges that marked the process at various junctures. At no point, however, did that result in financial turmoil. To some degree, this success has been a consequence of the very high-profile nature of Brexit, a development that captured the attention of a considerable number of participants for a long time. A critical mass of players worked hard at mapping scenarios and planning for Brexit-related contingencies, and that reduced the likelihood of market disruption.

In particular, there is every indication that the principal authorities in charge of financial stability, the European Central Bank and the Bank of England, were able to continuously maintain a high level of mutual information and cooperation throughout the period, in contrast to the toxic politics and abrupt breakdowns in the parallel relationship between the European Commission and the UK government at the same time. While personalities surely mattered, this is also to the credit of the strength and distinctiveness of the central banking community's culture and routines of cross-border coordination.

The political negotiators also deserve credit for a shrewdly designed feature of the Brexit sequence that acted as a check against instability at the point of most tangible change in the financial services sector, namely the moment of British exit from the EU single market. The Withdrawal Agreement, whose final text was published in October 2019 and ratified in January 2020, established a transition period beyond the formal point of UK exit from the EU (on 31 January 2020) during which most aspects of EU law would continue to apply and thus the UK would effectively remain in the single market (and customs union, the latter being of limited or no significance for most financial services). The transition period was set to end on 31 December 2020, but Article 132 of the Withdrawal Agreement allowed for an extension "for up to 1 or 2 years" if jointly agreed (i.e., requested by the UK—there was never much doubt about the EU's willingness to concur) before 1 July 2020. The flipside of that option was that, once the UK government decided as it did not to exercise it in June, there was no longer any uncertainty as to the date of exit from the single market—since changing it would have required amending the Withdrawal Agreement itself, an implausible prospect given the need for separate ratification before the end-2020 deadline in every EU member state. Thus, amid all the uncertainty, market participants knew one thing for certain during the second half of 2020, namely

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that Britain would indeed leave the single market on 31 December 2020, as it did. That allowed for simpler planning than if an option had been left for extension until the end.

The orderliness of the transition in the financial sphere had nothing to do with any softness of the arrangements that were made for it. Compared to the debates immediately before and after the 2016 referendum, the kind of Brexit that has applied to the financial sector has been about the hardest-possible version of "hard Brexit." Not only has Britain exited the single market as well as the EU itself—a choice that was made by the UK government after the referendum, without clear guidance on that from the referendum question itself—but it was almost granted almost no equivalence recognition for its existing financial regulatory framework, a choice made by the EU and more specifically by the European Commission. That decision of not granting any equivalence, except on a temporary basis in the stability-critical areas of securities depositories (for six months, expired since 1 July 2021) and clearing services (until mid-2022), was not to be taken for granted in the early stages of the discussion. UK treasury representatives have acknowledged publicly that it went against UK negotiating objectives.

NEW GEOGRAPHY

Orderly as it happened, the exit from the EU single market has left London and the UK in a fundamentally different position than it had been for nearly half a century. While in the single market, the City was an onshore financial center for the EU as it was for the UK itself, and an offshore center for the rest of the world. Now, it is onshore only for the UK, and has become offshore (or in the EU parlance, a third country) for the entire EU of 27 remaining countries. Even though the share of the EU in the global economy is on a slow decline, this is a major shift.

To be sure, the onshore/offshore dichotomy is somewhat blunted by the imperfect nature of the EU single market for financial services. A number of national regulatory or tax restrictions result in effective intra-EU barriers to the provisions of cross-border services, and the European Commission has not been as proactive as it perhaps should be to fight for their elimination in compliance with European treaty provisions. One stark illustration is the extent to which European banks generally maintain fully capitalized subsidiaries in host EU countries instead of providing their services directly from their home entity or through local branches.

Even so, the UK's loss of the passport status that comes with single market membership will inevitably have structural consequences. All things equal, the single market passport is a commercial advantage: a firm that has it is in a better competitive position than a peer that lacks it. The question then becomes whether the UK's other competitive advantages can more than offset the absence of passporting rights, whereas pre-Brexit, financial firms in the UK could enjoy the passporting rights in addition to the country's other competitive advantages. Since much of UK financial regulation is currently aligned with the EU, and other drivers of national competitiveness such as tax policies are mostly determined at the national rather than EU level, the potential for the UK to be the best place for doing financial business in Europe, as it ostensibly had been from the mid-1980s to the mid-2010s, is inevitably diminished. Correspondingly, the UK will be placed in more direct competition with other offshore (or third-country) financial centers for the provision of financial services to EU-based clients, including Switzerland and, albeit farther away, the United States. Furthermore, an international center as complex as London relies on powerful clustering effects and synergies between services provided onshore and offshore. Through such linkages, the City's loss of competitiveness for services to EU clients may also have an impact, even though it is practically impossible to model and predict, on its competitiveness for services to clients in the rest of the world (and also, conceivably, in the UK itself).

The advantages of London remain considerable. It has unmatched depth and breadth of domestic and international talent that is not immediately mobile. The UK has profoundly anchored traditions of openness and outward orientation, shaped by centuries of history, that even a protracted period of populist or nativist government may be unable to change significantly. London also has excellent physical and service infrastructure for the financial community. At this point, it remains well ahead of any single other European financial center on about any criterion one can think of.

DELAYED IMPACT

In the face of the fundamental shift that is Brexit, the structural impact that has been observed so far appears highly differentiated across market segments, and altogether limited. Even though the counterfactual will of course remain forever unknown, it is probable that the Covid-19 pandemic has been a major cause of this mild evolution so far, as it has led public authorities and market participants alike to generally minimize their short-term risk-taking and to delay long-term decisions. Since the pandemic still seems to be far from over, it is reasonable to project that the same dampening impact will be prolonged for at least several more quarters in a baseline scenario.

Since late 2014, the euro-area banking sector (which represents about nine-tenths of the entire EU or European Economic Area banking sector post-Brexit, measured by assets) has been supervised by a single authority, lodged in the European Central Bank (ECB). The ECB has repeatedly signaled that it expected all its supervised entities to implement a suitable post-Brexit organization that would allow appropriate supervision from Frankfurt of their euro-area activities and the corresponding risks. In the years since 2016 and especially since 2020, major banks have created new legal structures and transferred significant assets from the UK to the euro area, which in April 2021 analysts Elving Friis Hamre and William Wright have estimated at more than a trillion euro (or £900 billion, nearly 10 percent of total assets in the UK banking system). As their report highlighted, however, this is not the endpoint of a process that is still unfolding (Hamre and Wright 2021). Indeed, and even though this is typically not the matter of public communication by either the ECB or the banks, the ECB appears to have allowed a number of supervised entities to delay the full implementation of their post-Brexit organization beyond the December-2020 deadline, and one suspects that several of the corresponding discussions between the ECB and the banks on target arrangements are ongoing. This obviously raises the question of the ECB's next steps: how many more assets may need to migrate, if any; what organizational consequences in terms of the banks' footprint in the euro area; and when. It is practically impossible to assess these points with any specificity from outside the supervisory community.

As for non-banks, to the extent they are publicly supervised—be it for prudential purposes, like insurers, or for conduct of business, like asset managers—the supervisory system remains essentially fragmented across individual member states, even though the European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA) play coordinating roles.[1] In that space, unlike in banking, there appear to exist powerful dynamics of supervisory competition, under which supervisory authorities in some member states offer significantly more flexible conditions than others in terms, for example, of how much activity needs to be located in the country as opposed to how much can remain in London. If so, one can expect most financial firms—at least those headquartered in non-EU countries—to choose to conduct their EU operations from an entity based in one of the more accommodative member states.

It remains to be seen, of course, how stable the landscape thus created will turn out to be. History suggests that regulatory and/or supervisory competition of the kind that exists in most of the EU non-bank financial sector can easily turn to a race to the bottom, eventually leading to future supervisory failures that in turn may prompt at least partial policy reform. In the EU context, such reform is likely to take the form of policy centralization as the simplest antidote against race-to-the-bottom competition. This is precisely what has happened in the past decade with banking prudential supervision, where the revelation of comprehensive undercapitalization of euro-area banks during the crisis of 2007–2017 led to the mid-2012 decision to put the ECB in charge, and with Anti-Money Laundering (AML) supervision, where a string of scandals starting in 2018 led to the 2021 proposal by the European Commission of a new EU AML Authority which appear likely to be enacted shortly. It would certainly make sense to consider such changes on a proactive basis, instead of waiting for failure before acting. Somewhat frustratingly, however, the lack of reform traction associated with the EU rhetoric on "capital markets union" since 2014, which in principle could have provided a favorable environment to integrate market supervision, for example by reforming and reinforcing the role of ESMA, has been sobering in this respect.

As Europe appears to enter a phase of post-Covid-19 recovery, even with high uncertainty about future outlook, a growing number of firms will need to make decisions on where to locate new investments—a dynamic that is likely to have larger impact eventually than any relocation of existing activity that could be directly traced to Brexit causes. It is far too early to have a sense of any corresponding geographical shifts. In a year or two, one may expect a clearer picture to emerge on whether the UK remains the best place in Europe to do financial business.

THE FUTURE EU-UK RELATIONSHIP

In the near term, the EU-UK relationship, as far as it has impact on the financial services sector, appears set to remain at a low-trust equilibrium. No major issues call for immediate negotiation or renegotiation. A process has been set for decision on the possible extension of the clearing equivalence currently set to expire in mid-2022, which may or may not be dominated by technical considerations, with a recommendation expected from ESMA in late 2021. The Joint Financial Regulatory Forum established by memorandum of understanding in March 2021 is a coordination mechanism that can be useful but does not bind either side, little different from what has existed for years between the EU and the United States and other third-country jurisdictions. Besides the unique case of clearing, there is no indication that the EU is considering any new equivalence decision any time soon.

Meanwhile, both sides are updating their financial regulatory frameworks to adapt them to a constantly changing environment. Since there is no commitment or willingness to do so in a joined manner, regulatory divergence will slowly but surely set in. Generally speaking, the UK legislative and regulatory process is nimbler and more attuned to market realities than its EU equivalents; any resulting future differential in

[1] ESMA is also the direct supervisor for comparatively small market segments, such as credit rating agencies and trade repositories. Due disclosure: the author is an independent non-executive director of several trade repository subsidiaries of DTCC, including an EU entity supervised by ESMA and a UK entity supervised by the UK Financial Conduct Authority.

regulatory toughness and/or quality may impact the relative abilities of the EU and the UK to attract financial business. But, at least in the near term, this is unlikely to be a first-order driver of change, not least because the UK also has domestic political constraints that go against scenarios of comprehensive deregulation. The EU also has potential scope to improve its own financial rulemaking practice, for example by improving the governance and funding of EIOPA and especially ESMA to bolster their independence and effectiveness.

Of course, none of this takes place in isolation from what is happening in the wider world. By and large, London in the last two–three decades has been the central hub of financial globalization. On the face of it, the erosion of Hong Kong's position as an international center as a consequence of its growing integration into China may benefit London as a competing venue, but things are unlikely to be that simple. Chancellor Rishi Sunak recently gave a sunny view that the UK "can pursue with confidence an economic relationship with China in a safe, mutually beneficial way without compromising our values or security" (Sunak 2021). Meanwhile, analysts have debated the extent to which the EU's financial regulatory influence on a global scale, referred to as the "Brussels effect," may have been undermined as a consequence of Brexit (Rosca 2020). Unstable global geopolitics is another risk factor that could directly affect the future geography of European financial services.

CONCLUSION

Brexit is unquestionably a tectonic shift for the European financial sector, but one that has triggered no landslide or earthquake yet. The combination of public-sector and private-sector caution in a context shaped by massive Covid-19-related uncertainty since March 2020 has resulted in an undramatic transition so far. It is not yet clear when the full fallout from the end-2020 British exit from the European single market will be observable, and what its eventual magnitude will be. The only thing that is clear is that we are not yet there.

Equally unsure is the future general direction of financial services policy, in the UK and especially in the EU. Until the Brexit referendum of 2016, the UK was disproportionately influential in shaping the EU financial services agenda and provided a policy vision, especially for anything related to wholesale markets. No alternative vision has emerged yet in the UK-less EU—not even an unambiguous intent to reduce the EU's dependence on London as a financial center, be it motivated by economically apt (financial stability-related) arguments or by less compelling (mercantilist) ones. As several member states compete to attract financial firms and activities, the EU's future policy stance need not be less conducive to a dynamic financial sector than it has been pre-Brexit. At the present juncture, however, it remains far from a point of clarity, let alone stability.

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