The Brexit negotiations and the international capital markets

By Paul Richards

Summary

The purpose of this paper is to assess the current state of the Brexit negotiations between the UK and the EU27 from the perspective of the international capital markets, focusing on: the transition period after Brexit; the framework for a future trade agreement; and the implications for international capital market firms operating in the UK and in the EU27.

Introduction

1 Agreement in principle was reached in December 2017 on the first phase of negotiations for the withdrawal of the UK from the EU on 29 March 2019. The agreement in principle covered:

- an agreed method for calculating the divorce bill to be paid by the UK to the EU27;
- an agreement on the rights of EU27 citizens in the UK and UK citizens in the EU27; and
- an agreement on "full alignment" as a fall-back, if no alternative is agreed, to prevent a hard border between Northern Ireland (in the UK) and the Irish Republic.[1]

2 The European Council judged in December that the agreement in principle represented "sufficient progress" to move on to the second phase of the negotiations, covering:

- *a transition period after Brexit:* the UK and the EU27 agreed at the European Council on 23 March 2018 on the terms of a transition period starting on 29 March 2019 and lasting until the end of 2020, when the EU's next multi-annual budget is due to begin;[2] and
- *the framework for a future trade agreement between the UK and the EU27:* only a framework agreement is possible before the UK leaves the EU, as the EU is not legally able to conclude an agreement with the UK as an external partner while the UK is still an EU Member State.[3]

3 In practice, the framework for a future trade agreement needs to be settled by the autumn of 2018 in order to give sufficient time for EU27 Member States, the European Parliament and Parliament in the UK to decide whether to approve the withdrawal agreement or not by the deadline of 29 March 2019. The British Government has promised

1. The European Commission published a draft Article 50 Withdrawal Agreement on 19 March 2018 translating into legal terms the progress achieved during the first stage of the negotiations, and on the transition, and proposing text for outstanding withdrawal issues which are still subject to negotiation between the UK and the EU27.

2. Michel Barnier, Chief EU Negotiator: Brussels, 9 January 2018. The British Government refers to the "transition period" as an "implementation period".

3. David Davis, Secretary of State for Exiting the EU: *Implementation Period: A Bridge to the Future Partnership Between the UK and EU:* Teesport, 26 January 2018.

Parliament a "meaningful vote" on the outcome of the negotiations. There appear to be four possible outcomes:

- The first possible outcome is for all the authorities involved to approve the withdrawal agreement, covering both the first and the second phase of the negotiations, and leading to a transition period after Brexit during which detailed negotiations can take place on a future trade agreement. This is the outcome preferred by the British Government and the EU27.
- The second possible outcome is that the withdrawal agreement is not approved by all the authorities involved. If so, there is a risk that the UK may leave the EU without an agreement. A disorderly withdrawal – over a "cliff edge" – is an outcome which both sides want to avoid.[4]
- A third possible outcome is that, before 29 March 2019, Article 50 could be extended (eg until the end of the transition period). This would require not only the support of the British Government, but also the unanimous support of the EU27. Extending Article 50 would avoid a situation in which the UK, which has participated as a "rule maker" while a member of the EU, would become a "rule taker": ie new EU rules would apply in the UK without the UK having any say in making them. However, extending Article 50 would also mean that the UK would not leave the EU until after the date at which it is publicly committed to leave. It is not clear whether this would be politically acceptable to Parliament in the UK.
- The fourth possible outcome would arise only if the British Government were to change its intention before Brexit and decide to remain in the EU. That could not happen, first of all, unless Article 50 could be revoked. The answer to this question has not been clarified by the European Court of Justice, though in practice President Tusk and President Juncker have both said that the UK could remain in the EU, if it wished to do so.[5] And second, a change of intention would probably require, not only a vote in Parliament on the outcome of the negotiations, but also a general election or a second referendum in the UK on whether to accept the outcome of the negotiations to leave or alternatively to remain. The British Government's view is that the UK is leaving the EU and "there is no question of a second referendum".[6]

The transition period after Brexit

4 Many international capital market firms have made it clear that, if they do not know at least a year in advance of Brexit whether there will be a transition period after Brexit, they will have no choice but to plan on the basis that the UK will leave the EU without an agreement. UK withdrawal without an agreement would create risks in both the UK and the EU27 of a "cliff edge", which they want to avoid. The transition period agreed at the European Council on 23 March helps to address these concerns, but there are still questions relating both to the terms and timing of the transition and also to outstanding legal issues:

(i) Transition terms and timing

5 The first question is whether international capital market firms can rely on the transition agreement for planning purposes. It is conditional on the UK/EU27 withdrawal agreement as a whole: "nothing is agreed until everything is agreed". The UK and the EU27 still need to negotiate the framework for a future trade agreement, and to resolve outstanding issues such as finding a workable solution to avoiding a hard border between Northern Ireland and the Irish Republic. While the agreement on a transition period at the European Council on 23 March is an important step in the right direction for international capital market firms, they may still regard it as prudent to continue to undertake contingency planning in case the transition period does not happen.[7] To help reassure the market, the Bank of England has stated that it "considers it reasonable for firms currently carrying on regulated activities in the UK by means of passporting rights, or the EU framework for central counterparties, to plan that they will be able to continue undertaking these activities during the implementation [ie transition] period in much the same way as now".[8]

6 The second question relates to the terms of the transition agreement. There are three related elements:

- One element is that the proposed transition agreement is

4. Michel Barnier: "On 8 December we reached an agreement with the UK that represents a significant step towards an orderly withdrawal.": Brussels, 9 January 2018. Without a deal, the UK would fall back on trading under the WTO. The WTO does not cover in any detail trade in financial services.

5. President Tusk, President of the European Council: "Our hearts are still open to you."; President Juncker: "If the UK wished to stay in the EU, they should be allowed to do so.": 16 January 2018.

6. British Prime Minister, speech at the Security Conference in Munich, 17 February 2018.

7. See also the statements by the Bank of England, PRA and FCA on 28 March 2018.

8. Bank of England: *Update on the Regulatory Approach to Preparations for EU Withdrawal:* 28 March 2018.

largely on a "standstill" basis: "unless otherwise provided in this Agreement, Union law shall be applicable to and in the UK during the transition period".[9] This should in general mean that international capital market firms need to implement only one set of changes at the end of the transition period, not two (ie one at the beginning as well as one at the end). However, the detailed implications need to be considered. For example, it is understood that the deadline previously set by the ECB for licence applications remains unchanged at the end of June this year.

- A second element is that the UK has agreed to the *status quo:* ie continuing free movement of people between the UK and the EU27; the jurisdiction of the European Court of Justice; and continuing net budgetary contributions from the UK to the EU27. However, the UK is permitted during the transition period to negotiate new trade agreements with countries outside the EU, and sign them, though it cannot implement them until after the end of the transition period.[10]
- A third element is that the UK will no longer be able to participate in EU decision-making after Brexit: ie instead of being a "rule maker", it will become a "rule taker". This has raised political concern in Parliament in the UK that, during the transition period, the UK will effectively become a "vassal state" unless steps are agreed in advance to forestall this. The draft withdrawal agreement provides for limited consultation with the UK by the EU on decisions affecting the UK, but without UK voting rights.[11]

7 The third question is whether a transition period of under two years will be long enough to complete the negotiation of a detailed trade agreement before the transition period comes to an end, and if not whether the transition period will be extended:

- The trade agreement between the EU and Canada (CETA) took seven years to negotiate and ratify. Given the scope and scale of the relationship between the UK and the EU27, a trade agreement between the UK and the EU27 is likely to be much more complex, though (unlike CETA) there will be full regulatory alignment at the start.
- A UK/EU27 agreement would be likely to need to be approved by 38 national and regional Parliaments, which would inevitably take time.
- The transition period was originally envisaged as a period in which international capital market firms were given time to implement plans for the future trade agreement between the EU27 and the UK. But if the future trade agreement cannot be negotiated in any detail until after Brexit, as the EU27 propose, the prospective outcome will not be clear for some time. That will reduce the amount of time during the transition period in which detailed implementation planning can take place, unless the transition period can be extended.

(ii) Legal issues

8 Apart from the terms of the transition, there are also several legal issues arising from Brexit where action may need to be taken by the UK and the EU27, acting together, to maintain financial stability, including three issues in particular:

- First, action may need to be taken to ensure that a wide range of financial contracts across borders between the UK and EU27 counterparts can continue to be serviced, in particular insurance and derivatives contracts, when passporting between the UK and the EU27 ceases.
- Second, action may need to be taken to ensure that EU27 and UK CCPs are not in breach of regulation by providing clearing services in the other's jurisdiction, both in order to maintain existing positions and to take on new positions.
- Third, action may need to be taken by the UK and the EU27 to ensure that holding and sharing each other's data is not in breach of national law.[12]

9 Finally, the EU Withdrawal Bill is intended to take EU law into UK law on Brexit. During the transition period after Brexit, UK law is expected to continue to follow EU law; and the UK needs to continue to participate in the EU's international agreements.[13]

The framework for a future trade agreement

10 The negotiations between the UK and the EU27 on the framework for a future trade agreement are currently

9. *Draft Agreement on the Withdrawal of the UK from the EU*, 19 March 2018: Article 122, Scope of the transition. See also David Davis, Secretary of State for Exiting the EU: "Businesses now have the certainty they asked for about life immediately after Brexit, knowing that they can trade on the same terms as they do today until the end of December 2020.": *Sunday Telegraph,* 25 March 2018.

10. David Davis, Secretary of State for Exiting the EU: "[In this period,] we can start negotiating, signing and ratifying our own trade deals."

11. *Draft Agreement on the Withdrawal of the UK from the EU*, 19 March 2018: Article 123, Institutional arrangements.

12. See Andrew Bailey, CEO, FCA: *The Future of the City,* 5 February 2018.

13. "During the transition period, the UK shall be bound by the obligation stemming from the international agreements concluded by the Union …": Draft Agreement on the withdrawal of the UK from the EU", 19 March 2018: Article 124 on specific arrangements relating to the Union's external action. See also David Davis, Secretary of State for Exiting the EU: "The scores of international agreements we are signed up to as members of the EU should continue to apply during the implementation period." *Sunday Telegraph,* 25 March 2018.

constrained by "red lines" on both sides:

- UK "red lines" consist of: control over EU immigration; freedom to negotiate new trade agreements with the rest of the world; no jurisdiction in the UK for the European Court of Justice; and no further budgetary contributions to the EU (other than for some specific purposes) after the end of the transition period. The British Government is opposed to UK membership of the European Economic Area after Brexit; and it accepts that its "red lines" involve leaving both the EU Single Market and the Customs Union, though the Opposition is in favour of remaining in a Customs Union.[14]
- EU27 "red lines" consist of: the indivisible nature of the four EU freedoms (ie free movement of goods, services, capital and people), with no "cherry picking"; continuing budgetary contributions for market access; and the jurisdiction of the European Court of Justice.
- Both sides "want good access to each other's markets; we want competition between us to be fair and open; and we want reliable, transparent means of verifying we are meeting our commitments and resolving disputes."[15]

11 Taking account of the "red lines" on both sides, what progress can be made towards the framework for a future trade agreement? The Prime Minister set out the British Government's negotiating position in a speech at the Mansion House in London on 2 March. On financial services, the UK is seeking to be "part of a deep and comprehensive partnership" with the EU:

- "We are not looking for passporting because we understand this is intrinsic to the Single Market of which we would no longer be a member. It would also require us to be subject to a single rule book, over which we would have no say."
- "As in other areas of the future economic partnership, our goal should be to establish the ability to access each other's markets, based on the UK and EU maintaining the same regulatory outcomes over time, with a mechanism for determining proportionate consequences where they are not maintained."
- "But given the highly regulated nature of financial services, and our shared desire to manage financial stability risks, we would need a collaborative, objective framework that is reciprocal, mutually agreed, and permanent and therefore reliable for businesses."[16]

12 By contrast, the European Council guidelines of 23 March on the framework for a future free trade agreement with the UK are similar to the agreement between the EU and Canada. The European Council proposes that:

- "Being outside the Customs Union and the Single Market will inevitably lead to frictions in trade. ... A non-member of the Union, that does not live up to the same obligations as a member, cannot have the same rights and enjoy the same benefits as a member."
- "The four freedoms are indivisible and there can be no "cherry picking" through participation in the Single Market based on a sector-by-sector approach, which would undermine the integrity and proper functioning of the Single Market. ... A [free trade agreement] cannot offer the same benefits as membership and cannot amount to participation in the Single Market or parts thereof."
- "The agreement would address trade in services, with the aim of allowing market access to provide services under host state rules, including as regards right of establishment for providers, to an extent consistent with the fact that the UK will become a third country and the Union and the UK will no longer share a common regulatory, supervisory, enforcement and judiciary framework."[17]

13 The EU27's Chief Negotiator has argued that there is not a single example of a trade agreement that is open to financial services.[18] However, the EU agreements (eg with Canada, Singapore, South Korea, Switzerland and Turkey) are all with countries which have never been members of the EU, in contrast to the UK which, as a result of being a member of the EU, will start with complete regulatory alignment with the EU, including in financial services.[19] The Governor of the Bank of England has rejected the argument that, just because an agreement on financial services has not been done in the past, it cannot be done in the future;[20] and the Chancellor of the Exchequer has stated: "I am clear not only that it is possible to include financial services within a trade deal but that it is very much in our mutual interest to do so."[21] It is also relevant

14. Jeremy Corbyn, Leader of the Opposition: 26 February 2018.

15. British Prime Minister, Mansion House speech, 2 March 2018.

16. British Prime Minister, Mansion House speech, 2 March 2018.

17. European Council Guidelines: 23 March 2018.

18. Michel Barnier, Brussels, 9 January 2018.

19. Sam Woods, CEO of the PRA: "A detailed free trade agreement covering financial services could be agreed within a three-year period from now. We are fortunate in starting this discussion in the unique position in terms of having completely aligned rules and strongly aligned supervision.": 16 January 2018.

20. Mark Carney, Governor of the Bank of England: 20 December 2017.

21. Philip Hammond, Chancellor of the Exchequer: Speech at HSBC, 7 March 2018.

to note that, in the Transatlantic Trade and Investment Partnership negotiations with the US a few years ago, and in its initial proposals for CETA with Canada, the EU proposed a trade agreement which included provision for financial services.[22]

Implications for the international capital markets

14 Given the differences between the UK and EU27 negotiating positions, there is a risk that very little progress will be made in the negotiations leading up to the framework agreement before Brexit, leaving the difficult issues to be resolved during the transition period after Brexit. What would be the implications for the international capital markets?

15 A standstill transition would prolong the existing situation, but international capital market firms would be no clearer about the ultimate outcome of the negotiations: whether a future trade deal including financial services could be achieved (as the UK proposes), or whether there is a Canada-style trade deal, under which financial services would not meaningfully be covered at all (as the EU27 propose).

(i) Mutual recognition

16 The British Government considers that the best way to preserve open markets between the UK and the EU27 after Brexit would be through mutual recognition of each other's regulatory standards, given that the UK is proposing to leave the Single Market on Brexit and that, on Brexit, the UK and EU27 regulatory regimes will be the same:

- Agreement on mutual recognition would involve setting common objectives with broad equivalence of regulation in terms of outcomes, supervisory cooperation and effective information sharing.[23] An approach of this kind would also recognise the difference between the principles-based common law system in the UK and the rules-based system in the EU27. If regulatory alignment between the UK and the EU27 were to continue after Brexit and regulatory divergence were to be avoided, the result would be to maximise UK access to the EU Single Market and vice versa, and to minimise the risk of market fragmentation that would otherwise arise, with costs for both sides.[24]
- The potential criticism of this approach is that the EU27 have so far stated that they will not accept it;[25] and that, from the UK's perspective, continuing regulatory alignment after Brexit would mean that the UK would effectively be signing up to EU rules in future without any say in making them. While there would be freedom for UK regulation to diverge in future by not maintaining equivalent outcomes, there may be consequences in doing so.[26] There is also a related concern that the EU27 without UK influence in the future will be different from the EU including the UK in the past, when the UK had a significant influence over the development of the EU Single Market.
- However, cross-border rules on financial services all need to be consistent with the global approach to regulation taken by the Financial Stability Board, which both the UK and the EU27 support. The UK authorities are committed to "maintain standards of resilience at least as high as those we have today".[27] Wholesale financial markets are global and "cannot in practice diverge much in terms of regulatory outcomes; and regulatory arbitrage is not an allowable ground for competition."[28]

(ii) Alternatives to mutual recognition

17 The EU27 have so far rejected an approach based on mutual recognition of regulatory standards between the UK and the EU27. An alternative would be for the UK – as a third country – to use EU provisions for regulatory equivalence. This is currently a patchwork: it applies to some parts of the EU regulatory framework, but not others; where it does apply, it is not always complete; it requires a judgement by the European Commission as well as a

22. Philip Hammond, Chancellor of the Exchequer: Speech at HSBC, 7 March 2018.

23. Andrew Bailey, CEO, FCA: "What underpins freedom to trade is not a trade agreement of the long-established sort – it's not about the WTO, very important though the WTO is in other spheres of activity. It's not about tariffs or import quotas or licensing agreements. No. It's about mutual recognition of regulatory standards which appropriately protect the public interest: *The Future of the City,* 5 February 2018.

24. See also Philip Hammond, Chancellor of the Exchequer: "The principle of mutual recognition and reciprocal regulatory equivalence, provided it is objectively assessed, with proper governance structures, dispute resolution mechanisms, and sensible notice periods to market participants clearly could provide an effective basis for such a partnership.": Speech at HSBC, 7 March 2018.

25. President Tusk, President of the European Council: "There is no possibility to have some form of exclusive single market for some parts of our economies.": 7 March 2018.

26. Philip Hammond, Chancellor of the Exchequer: "Where rules do evolve differently we will need an objective process to determine whether they provide sufficiently equivalent regulatory outcomes. ... In certain circumstances, we may choose not to maintain equivalent outcomes, but we know there may be consequences.": Speech at HSBC, 7 March 2018.

27. Sam Woods, CEO, PRA: FT, 5 February 2018.

28. Andrew Bailey, CEO, FCA: *The Future of the City,* 5 February 2018.

technical assessment, and it takes time to assess; and the determination of equivalence can be withdrawn at short notice, though this has not happened so far. The assessment of regulatory equivalence is based on measuring outcomes, but outcomes are not straightforward to measure. It is not yet clear whether, during the UK/EU27 negotiations, there will be scope to improve the arrangements for regulatory equivalence for third countries.

18 Regulatory equivalence is useful for international capital market firms, in so far as it goes. But if it is not possible to rely solely on regulatory equivalence, the other option is for firms to ensure that they are authorised to provide financial services in both the EU27 and in the UK.[29] Most large firms either have authorised operations in the EU27 already or are planning to seek authorisation to do so, as long lead times are involved. The Single Supervisory Mechanism of the ECB has stated that any bank wishing to relocate from the UK to the euro area should submit its licence application by the end of the second quarter of 2018.[30]

19 The ECB has set out the basis on which banks can relocate to the euro area:

- "After the UK has left the EU, EU branches of UK credit institutions may lose their passporting rights and will consequently no longer be allowed to operate in the EU. In order to continue any regulated activities, these institutions will need to ensure that they have an appropriate authorisation."
- "Banks in the euro area should be capable of managing all material risks potentially affecting them independently and at the local level and should have control over the balance sheet and all exposures."
- "With specific reference to the "back-to-back booking model", the ECB and national supervisors would expect that part of the risk generated by all material product lines should be managed and controlled locally."
- "The operational independence of the supervised bank should not be compromised as a result of the outsourcing of funds or services. Outsourcing arrangements will be reviewed and assessed by ECB and national supervisors on a case-by-basis."[31]

20 In addition, in the case of delegation decisions made by firms to outsource or transfer risk outside the EU27, whether to the UK or to other third countries, the European Commission is proposing to give the European Supervisory Authorities new powers to review delegation to third countries. The delegation framework under UCITS and the AIFMD enables investment funds to delegate functions such as custody and portfolio management while being subject to strict oversight and accountability by those funds' national regulators in compliance with EU rules. The EU framework requires firms to meet various conditions before they can delegate activities to ensure that they are not just "letter box" entities.[32]

21 The UK authorities have also set out their approach to supervising international capital market firms with operations in the UK:

- The UK FCA has stated: "During [the implementation (ie transition) period] EU law would remain applicable in the UK, in accordance with the withdrawal agreement. Firms and funds would continue to benefit from passporting between the UK and EEA during the implementation period. Obligations derived from EU law would continue to apply and firms must continue with implementation plans for EU legislation that is still to come into effect before the end of December 2020.[33]
- The UK PRA has stated: "Firms may plan on the assumption that PRA authorisation will only be needed by the end of the implementation period. Firms should consider how best to make use of the additional time provided by the implementation period in their planning.[34]
- The Bank of England has also stated: "The Government has committed to bring forward legislation, if necessary, to create temporary permission regimes to allow relevant firms to continue their activities in the UK for a limited period after withdrawal. In the unlikely event that the Withdrawal Agreement is not ratified, this provides confidence that a back-stop will be available."[35]

29. See Dr. Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank: "Looking at banks, proper preparation includes establishing at least basic entities in the other economic area – that is, the EU27 or the UK – in order to continue doing business there.": *The Future Relationship Between Germany and the UK in Finance After Brexit,* 8 February 2018.

30. Sabine Lautenschläger, Vice-President of the Single Supervisory Mechanism of the ECB: 7 February 2018.

31. ECB: *Relocating to the Euro Area:* FAQs, January 2018.

32. Steven Maijoor, Chair of ESMA: "We are not looking to question, undermine or put in doubt the delegation model. What our opinions are seeking to address is the risk of letterbox entities": Brussels, 20 March 2018.

33. FCA *Statement on EU Withdrawal Following the March European Council*, 28 March 2018.

34. PRA: *Firms' Preparations for the UK's Withdrawal from the EU: Update Following March European Council,* 28 March 2018.

35. Bank of England: *Update on the Regulatory Approach to Preparations for EU Withdrawal,* 28 March 2018.

(iii) Supervisory coordination

22 Coordination between UK and EU27 supervisors will be important to ensure that market disruption from Brexit is avoided, if at all possible. The Bank of England's approach to preparations for EU withdrawal is based on "the presumption that there will continue to be a high degree of supervisory cooperation between the UK and the EU."[36]

23 As a condition for authorisation to operate in the EU27, it is not yet clear to what extent EU27 supervisors will insist on the relocation of capital market activities and the market infrastructure – through the transfer of bank capital, infrastructure and staff (eg for risk management) – from the UK to the EU27 on the grounds that location within the EU27 is necessary to ensure financial stability, or whether an acceptable alternative would be an agreed form of coordination between UK and EU27 supervisors, where activities are located outside the EU27 (eg in London). Clearly, the UK and EU27 supervisors would need to agree that the supervisory arrangements would be sufficiently robust to ensure that financial stability would not be put at risk.[37] Indeed, avoiding financial instability would be one of the main reasons why coordination between supervisors would be necessary in the first place.

Conclusion

24 Agreement between the UK and the EU27 on a transition period after Brexit gives international capital market firms more time to prepare for the outcome of the UK/EU27 negotiations on a future trade agreement, provided that the transition period goes ahead as planned. But the agreement on a transition period does not resolve any of the difficult issues that the negotiations on a future trade agreement need to address. So ICMA members – both in the UK and the EU27 – still face considerable uncertainty in the meantime. ICMA will continue to keep members informed to the extent that it is possible to do so.

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36. The Bank of England: *Update on the Regulatory Approach to Preparations for EU Withdrawal:* 28 March 2018. See also: Philip Hammond, Chancellor of the Exchequer: Speech at HSBC, 7 March 2018.

37. Dr. Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank: "I am confident that this cooperative style [ie the proposals by the PRA and the SSM] can be an important contribution towards a smooth transition." *The Future Relationship Between Germany and the UK in Finance After Brexit*, 8 February 2018.