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Post-Brexit: should the transition period be extended?

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Summary

This Quarterly Assessment considers the prospects for the negotiation of a financial services partnership between the EU and the UK during the transition period post-Brexit, and discusses in particular: the timing and scope of a possible future trade agreement between the EU and the UK; market access for financial services in both directions between the EU and the UK; EU regulatory equivalence; and supervisory cooperation. It is not yet clear whether the COVID-19 pandemic will have an impact on the post-Brexit timetable for the transition period.

Introduction

1 The UK's Withdrawal Agreement with the EU, which took effect on Brexit day on 31 January 2020 and is binding, covers the UK's divorce payment, citizens' rights, and the avoidance of a hard border between Northern Ireland and the Republic. It does not cover financial services. The Political Declaration accompanying the Withdrawal Agreement refers to financial services only at a high level of generality and is not binding.[1]

2 But the Withdrawal Agreement does provide for a transition (or "implementation") period, which began on Brexit day on 31 January 2020. During the transition period, the UK is no longer involved in EU decision-making, but in other respects the *status quo* continues. Under the EU (Withdrawal Agreement) Act, law in the UK is subject to EU law, including for new EU legislation, until the end of the transition period. At that point, EU law is due to be "on-shored" into law in the UK.[2] During the transition period, it is intended that the EU and the UK should negotiate a free trade agreement.

Timing and scope of a possible future free trade agreement

3 The transition period is due to end on 31 December 2020. By historic standards, a period of 11 months (from 31 January to 31 December 2020) is a very short period in which to negotiate a comprehensive trade agreement:

- There is provision in the Withdrawal Agreement for the EU and the UK to agree by the end of June 2020 that the transition period can be extended from the end of 2020 until the end of 2022. But the British Government has stated that the transition period will not be extended and has written this provision into law in the UK.
- The Government hopes that by June the broad outline of an agreement will be clear and capable of being finalised by September; but if not, it will decide whether to focus solely on continuing domestic preparations to exit the transition period in an orderly fashion.[3]
- It is not yet clear whether the global coronavirus (COVID-19) pandemic will have an impact on the post-

1. The revised text of the Political Declaration sets out the framework for the future relationship between the EU and the UK on 17 October 2019: paragraphs 35-37.

2. The 2020 Withdrawal Act amends the 2018 Withdrawal Act so that the conversion of EU law into UK domestic law now takes place at the end of the transition period instead of on Brexit day. It is not yet clear how EU legislation "in flight" at the end of the transition period will be treated in the UK subsequently.

3. HM Government: *The Future Relationship with the EU: The UK's Approach to Negotiations*, February 2020.

Brexit timetable for the transition period and whether there are any lessons to learn from the authorities' response to the one for the other.

4 The scope of any future trade agreement may be limited by the time available to negotiate it:[4]

- The British Government has said that the UK is proposing to negotiate a Canada-style comprehensive trade agreement with the EU. But the EU has said that a comprehensive agreement cannot be negotiated in that time.[5] A comprehensive agreement would also involve difficult political trade-offs;[6] and it is important to note that EU trade agreements with third countries generally also include a prudential "carve-out". In addition to the scope and complexity of the issues to be addressed, a comprehensive agreement would normally need to be ratified by national and regional parliaments in EU Member States as well as by EU institutions. Precedent suggests that this could take a considerable period of time. The broader the scope of the agreement, the more likely is the need for ratification by national and regional parliaments as well as by EU institutions.
- By contrast, a "bare bones" trade agreement covering only goods – eg in the form of a tariff-free quota-free trade deal (though not necessarily removing regulatory barriers to trade in goods) – would be much less complex and could be agreed on the EU side by EU institutions only. Even so, a "bare bones" trade agreement before the end of 2020 would be consistent with a comprehensive trade agreement later if the approach adopted in the negotiations was to reach agreement in stages: ie agreement that issues not covered by the end of 2020 would be subject to further negotiation later.
- In any trade agreement, one of the outstanding questions is whether the EU and the UK will be able to agree on a chapter on financial services. There is a case for setting out the regulatory framework and supervisory arrangements within which both the EU and the UK will seek to cooperate in future.

5 In parallel with its negotiations with the EU, the UK is also seeking to negotiate a trade agreement with the US, and possibly with other third countries.[7] The impact of UK negotiations with the US on the EU and vice-versa will therefore also need to be considered, including on financial services. And within the UK, there are potential differences to consider between the regime in Britain and the regime in Northern Ireland, if Northern Ireland continues to be aligned on trade in goods with the EU, but not with the rest of the UK.

Market access for financial services

(i) UK access to the EU

6 How will market access for financial services be addressed? It is clear that the UK will leave the EU Single Market, as a result of which the Single Market will become two separate markets when passporting rights cease at the end of the transition period.[8] It is not yet clear whether the UK's proposal to negotiate a Canada-style trade agreement will be acceptable to the EU, on account of the EU's geographic proximity and the high degree of economic interdependence with the UK; and, if it is, whether the agreement will cover financial services in any detail. If no agreement is reached, the default option would be to fall back on World Trade Organisation terms, which do not fully cover financial services. Without an agreement, many of the cliff-edge risks originally identified when preparing for a no-deal Brexit (ie on 29 March, 12 April and 31 October 2019) would arise again.[9] Market participants in both the EU and the UK need to be prepared for all contingencies.

7 Having had to prepare for cliff-edge risks on three previous occasions, the financial services industry – located both in the EU and in the UK – would be better prepared for another cliff-edge when passporting rights cease at the end of the transition period. Large international sell-side and buy-side firms are authorised to operate in both the EU and the UK, and are as well prepared as they can be, though it is less clear how well prepared some smaller

4. Michel Barnier, Chief EU negotiator: "If we want to give this relationship [with the UK] all its dimensions, we need to give it more time and continue beyond the end of transition.": European Parliament, 18 December 2019.

5. By comparison, the free trade agreement between the EU27 and Canada (CETA) took seven years to negotiate and ratify.

6. President of the European Commission: "With every decision comes a trade-off. Without the free movement of people, you cannot have the free movement of capital, goods and services. Without a level playing field on environment, labour, taxation and state aid, you cannot have the highest quality access to the world's largest single market. ... And without an extension of the transition period beyond 2020, you cannot expect to agree on every aspect of the new partnership.": European Parliament, 18 December 2019.

7. It is also worth noting that the UK attempted to encourage the development of a single market between the EU and NAFTA (ie including the US) in the 1990s.

8. Michel Barnier, Chief EU negotiator: "Does [the UK] want to distance itself, and if so how far, from our regulatory model? It is the answer to this question that will determine our level of ambition.": European Parliament, 18 December 2019.

9. President of the European Commission: "In case we cannot conclude an agreement by the end of 2020, we will face again a cliff-edge situation. This would clearly harm our interest, but it will impact the UK more than us." European Parliament, 18 December 2019.

The EU and UK opening positions on financial services

The opening positions of the two sides on a future trade agreement, including on financial services, appear to be far apart, though they may not in practice be as far apart as they appear, with political will on both sides:

EU's position

The EU is ready to offer a highly ambitious trade deal as the central pillar of its economic partnership with the UK. But because of the EU's geographic proximity and the high degree of economic interdependence with the UK, the EU's offer is conditional on making sure that competition is – and remains – open and fair. This requires guarantees to ensure a level playing field over the long term, including high standards on social, environmental, climate, tax and state aid matters, today and in the future. EU standards should be a reference point.

Where EU and UK rules converge – either because the UK chooses to match EU standards or where activities are subject to international regulations that the EU shares – it will be easier to reach agreement. The more the EU and the UK will have common standards, the higher quality access the EU will be able to offer to its market.

Even so, there will be two separate markets instead of a Single Market. Access to the EU market will be subject to market authorisation and supervision; there will be no harmonisation or mutual recognition of rules; and passporting rights for UK financial services will cease.

The determination of equivalence for financial services or adequacy of the UK data protection regime will be unilateral decisions of the EU. The parties should commit to preserving financial stability, market integrity, investor and consumer protection and fair competition, while taking equivalence decisions in their own interests and being able to adopt any measure for prudential reasons.[10]

UK's position

The agreement should be on the lines of the Free Trade Agreements already negotiated by the EU in recent years with Canada and with other friendly countries. There should be liberalised market access for trade in goods, with no tariffs, and non-tariff barriers should be addressed.

Any agreement must respect the sovereignty of both parties and the autonomy of UK legal orders.[11] It cannot therefore include any regulatory alignment, any jurisdiction of the European Court of Justice over the UK's laws, or any supranational control in any area. The Government will not agree to measures on competition policy, subsidies, environment and climate, labour and tax which go beyond those typically included in a comprehensive free trade agreement.

The UK will be leaving the Single Market and the Customs Union at the end of 2020 and stakeholders should prepare for that reality.

The agreement should promote financial stability, market integrity, and investor and consumer protection for financial services, and include legally binding obligations on market access and fair competition, in line with the recent CETA precedent.

The agreement should also build on recent precedent by establishing regulatory cooperation arrangements that maintain trust and understanding between autonomous systems of regulation as they evolve. This could include appropriate consultation and structured processes for the withdrawal of equivalence findings, to facilitate the enduring confidence which underpins trade in financial services.

The fact that the UK leaves the EU with the same rules provides a strong basis for concluding comprehensive equivalence assessments before the end of June 2020.[12]

10. Statement by Michel Barnier at the presentation of the Commission's proposal for a Council recommendation on directives for the negotiation of a new partnership with the UK: 3 February 2020; European Commission: *Future EU-UK Partnership: European Commission Takes First Step to Launch Negotiations with the UK:* 3 February 2020; and European Council Decision Authorising the Opening of Negotiations with the UJK for a New Partnership Agreement, 25 February 2020.

11. David Frost, Chief UK negotiator: "We must have the ability to set laws that suit us – to claim the rights that every other non-EU country in the world has. So to think that we might accept EU supervision on so-called level playing field issues simply fails to see the point of what we are doing. That is not a simple negotiating position which might move under pressure – it is the point of the whole project.": *Reflections on the Revolutions in Europe:* 17 February 2020.

12. HM Government: *The Future Relationship with the UK: The UK's Approach to Negotiations: February 2020.*

firms would be. But however extensive the preparations, they are unlikely to be sufficient to avoid cliff-edge risks altogether. So the agreements previously negotiated by the EU and the UK to address cliff-edge risks to financial stability need to renewed, where possible, or extended so that they cover, in particular: the ability of EU counterparties to trade with UK central counterparties; the novation of non-cleared derivatives contracts from the UK to the EU; the transmission of data from the EU to the UK;[13] and also the continuing delegation of fund management. Agreement to address cliff-edge risks is in the interests of both sides, but the outcome may depend on the political climate in which the negotiations take place.

8 The UK FCA has set out, for UK firms, considerations affecting whether any business that they undertake in the EEA from the UK can continue on the same legal basis after the end of the transition period or whether new regulatory permissions will be needed.[14] They include:

- permission under local law or based on rules of a local financial market infrastructure;
- local exemptions in an individual EEA country;
- whether "reverse solicitation" is permitted without local authorisation;
- whether an EU Member State has put in place a regime to provide continuity of business for a temporary period; and
- whether an activity is covered by an EU decision on the UK's equivalence.

(ii) EU access to the UK

9 Unlike the EU, the UK has a Temporary Permissions Regime (TPR) which will allow EEA firms currently using a passport to operate for a limited period when the passporting regime ends at the end of the transition period while they seek authorisation to carry out business in the longer term. Under the TPR, a firm that is authorised to carry on regulated activities in the UK can obtain permission to carry on those activities for a maximum of three years from the end of the transition period. The objective of the TPR is to help the UK PRA and FCA ensure a smooth and orderly authorisation process and avoid risks to financial stability.[15]

10 Longer term, the UK authorities have said: "The UK, and the global financial centre we host, will remain open to access from the EU and its members as we are open to access from the US and Asia."[16] How will this work in practice? The UK authorities have in the past had a significant influence over EU rules. But now that they no longer have any say over EU rules,[17] it is already clear that the UK will need the capacity to review and adapt its own rulebook.[18] In doing so, some of the questions that need to be considered include:

- how the UK authorities will treat EU legislation "in flight" at the end of the transition period: unless the UK continues to follow EU rules, minor differences between EU and UK rules will begin to occur very soon after the transition period ends;
- how they will organise, on the UK statute book, the variety of EU Regulations and Directives at Level 1, and Regulatory and Implementing Technical Standards at Level 2 "on-shored" in the UK;
- whether the UK authorities will review EU Regulations and Directives (eg MiFID II/R, Solvency II, PRIIPs, CSDR, AIFMD), as the EU does periodically, and propose changes that are considered more appropriate for the UK; and whether they will regulate new initiatives (eg on FinTech) in a different way from the EU;
- whether they will treat firms which operate in the domestic UK market – especially in the retail sector – differently from international firms providing wholesale financial services across borders;[19] and
- whether they will maintain the same standards as the EU, but simplify the legislation needed to achieve them: eg by hard-wiring less detail into UK legislation than the EU and leaving more latitude to UK regulators. One option would be for Parliament to give UK prudential and conduct regulators operational independence within a clear mandate for which they

13. See ICMA Quarterly Report, Fourth Quarter 2019, *Can Capital Market Fragmentation Be Avoided?* Box A on addressing cliff-edge risks on a no-deal Brexit. See also evidence submitted by the FCA and PRA to the House of Lords Select Committee on the EU, Financial Affairs Sub-Committee, 12 February 2020.

14. FCA, 3 February 2020.

15. Bank of England: Temporary Permissions Regime.

16. Sir Jon Cunliffe, Deputy Governor Financial Stability, Bank of England: *Governance of Financial Globalisation,* 11 February 2020.

17. Except by influencing them indirectly, by setting an example.

18. Andrew Bailey: Evidence to the House of Lords Select Committee on the EU, Financial Affairs Sub-Committee, 12 February 2020.

19. See also Lord Blackwell: *Britain Should Diverge on Domestic Financial Services Rules,* FT, 25 February 2020.

are politically accountable and subject to Parliamentary scrutiny.[20] Such an approach would conform more closely to the use of common law in the UK and provide the flexibility that regulators need to adapt to the requirements of overseeing a global financial centre. In the EU, civil law tends to require more detailed codification of rules. EU regulation also helps to ensure that all EU Member States implement EU rules in a consistent way.

EU regulatory equivalence

11 Market access for financial services in both the EU and the UK will be influenced by the determination of regulatory equivalence. The EU negotiates with third countries on market access for financial services through regulatory equivalence, which is determined unilaterally by the European Commission, where there is provision to do so in specific EU regulations. While decisions on regulatory equivalence are technically separate from negotiations on the future trade agreement between the EU and the UK, in practice the political context is likely to be important. The Political Declaration attached to the Withdrawal Agreement states that the EU and the UK should attempt to complete an assessment of regulatory equivalence by the end of June 2020, though decisions will only be taken by the EU later.[21] There are three key questions:[22]

(i) Scope for regulatory equivalence at the outset

12 The first is whether there will be regulatory equivalence between the EU and the UK at the outset (ie at the end of the transition period), as at the end of the transition period EU and UK rules will be the same. As EU and UK rules will initially be the same, the scope for regulatory equivalence should be considerable, unless the two sides cannot agree on a level playing field intended to prevent unfair competition or on the scope for regulatory divergence later.[23]

13 But regulatory equivalence is a patchwork. EU financial services law currently includes around 40 provisions which allow the European Commission to adopt equivalence decisions, of which around 240 have been taken so far affecting 30 third countries. These provisions generally relate to wholesale markets rather than retail markets, and they tend to be included only in more recent EU legislation (like MiFID II/R). So the scope for equivalence does not cover the regulation of financial services (or capital markets) as a whole, and it does not cover supervisory cooperation. Equivalence needs to be considered case by case in relation to the terms of the EU Regulations and Directives to which it applies.

14 Given that EU and UK rules will initially be the same, there is a case for considering whether the scope for regulatory equivalence can be enhanced, though that would also involve considering the implications for other third countries. But even if regulatory equivalence cannot be enhanced in legal form, there may be opportunities to achieve enhancement in practice: eg through regular exchanges of information between the EU and the UK about regulatory priorities.

(ii) Outcomes-based equivalence in the future

15 While EU and UK rules will start the same when the transition period ends, the second question is how to develop a stable and predictable EU/UK regulatory framework for the future. This needs to cover in particular the scope for sensible divergence between EU and UK rules. It is already clear that the British Government will want to be able to change UK rules so that they do not automatically follow EU rules, but instead that the UK has the ability to diverge from them.[24] Rules in other third countries (eg the US) have historically developed in a different way from the EU and, as a result, they are not the same as EU rules when regulatory equivalence is determined between them. In the case of the UK, the position is the other way around. UK and EU rules will start the same, but they are then expected to diverge. The UK authorities have said that "the UK cannot outsource regulation and supervision of the world's leading complex financial system to another jurisdiction."[25]

20. The HM Treasury review of the post-Brexit regulatory framework will include "the need for ensure financial stability is delivered through an effective regulatory framework, with the responsiveness necessary to a dynamic an open financial services sector and an appropriate level of democratic accountability." A Financial Services White Paper is expected in spring 2020. See also: Victoria Saporta: *The Ideal Post-EU Regulatory Framework*, 10 March 2020.

21. Valdis Dombrovskis, European Commission: "We should start assessing equivalence as soon as possible with a view to concluding these assessments by the end of June. But we will take the actual decisions later, taking into account overall developments, including any divergences from EU rules.": 10 March 2020.

22. See also Andrew Bailey's evidence to the House of Lords Select Committee on the EU, 12 February 2020.

23. President Macron: "Ease of access to the European market will depend on the degree to which the EU's rules are accepted, because we cannot allow any harmful competition to develop between us: Letter to *The Times,* 1 February 2020.

24. The British Prime Minister spoke in favour of "an ambitious free trade agreement, with no alignment on EU rules, but instead control of our laws and close and friendly relations.": House of Commons, 20 December 2019.

25. Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England: *Governance of Financial Globalisation,* Berlin, 11 February 2020.

16 Although the EU and the UK will not necessarily follow the same rules after the end of the transition period, they both believe in achieving equivalent outcomes (eg ensuring financial stability, investor and consumer protection, fair competition, market integrity and the prevention of regulatory arbitrage).[26] There should therefore be scope for achieving regulatory equivalence based on equivalent outcomes, unless the EU insists that equivalent outcomes can only be achieved if both parties have the same rules. As the rules are not the same in the case of EU agreements with other third countries (eg Canada and Japan, which have comprehensive agreements with the EU),[27] the remaining question is whether or not the UK should be treated differently because of its geographical proximity to the EU and the high degree of economic interdependence between them.

17 An outcomes-based approach to regulatory equivalence is particularly relevant in cases in which both the EU and the UK are implementing, in their own respective jurisdictions, global commitments agreed by global bodies such as the Financial Stability Board of the G20, the Basel Committee of Banking Supervision and IOSCO.[28] Such an outcomes-based approach would also help to reflect the differences between the legal systems in the EU and the UK: ie where the EU's legal system is based on codification of rules under civil law and the UK's system is based on principles and practice under common law.

(iii) Withdrawal of equivalence

18 The third question is what process should be used for the withdrawal of regulatory equivalence and how much notice needs to be given. In the EU, extra powers have recently been granted to the European Supervisory Authorities to monitor equivalence with third countries, and equivalence can be withdrawn unilaterally by the EU at 30 days' notice or granted only for a period with a time limit. Equivalence has been withdrawn by the EU in two recent cases: equivalence for the trading of Swiss shares in the EU; and equivalence under the CRA Regulation in the cases of Australia, Brazil, Canada and Singapore.

19 In the case of equivalence between the EU and the UK, agreement is needed on joint monitoring and on arbitration to resolve disputes.[29] That should make it possible in practice for both sides to consider the regulatory consequences of divergence sufficiently in advance. It is clear that 30 days' notice is much too short a period for market firms to prepare for regulatory changes and would carry risks to financial stability. For example, if equivalence for UK-based clearing houses were to be withdrawn so that EU clients were no longer authorised to use them, an orderly process of unwinding that collateral would take about three months.[30] In some other cases, the period of adjustment would need to be significantly longer.

Supervisory cooperation

20 In order to help ensure financial stability, continuing supervisory cooperation between the EU and the UK will be essential, with or without a deal at the end of the transition period. Against the risk of a no-deal Brexit in 2019, the EU and the UK negotiated Memoranda of Understanding to ensure that supervisory cooperation continued between them. Similar considerations need to apply in the event of no deal at the end of the transition period. Over the past 18 months, the Bank of England has signed 30 MOUs with EU and EU Member State authorities covering nearly all aspects of financial sector activity. The FCA has followed a similar approach.[31]

21 Continuing supervisory cooperation will also be needed if there is a trade agreement between the EU and the UK before the end of the transition period. In the case of the UK, large EU financial institutions active in London will need to be able to reassure the UK authorities about risks they import into the UK, as the Bank of England has made clear that it is committed to maintain a level of financial sector resilience which exceeds the requirements of

26. Steven Maijoor, Chair of ESMA: "EU equivalence decisions taken in financial markets have been overwhelmingly outcome-based resulting in reliance on home country regulation and supervision.": June 2019.

27. Mark Carney: "If we project forward 20 or 25 years, we are not going to have textual equivalence relationships with China on financial services. We are going to have something outcome-based.": Evidence to the House of Lords Committee on Economic Affairs, 11 February 2020.

28. G20: "Jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way.": 2014. See also Mark Carney: "[The future relationship] will require developing a form of equivalence that would look like the forms of equivalence that have been applied with respect to derivatives between the Bank of England and the CFTC. It would also look consistent with the principles that were developed through the FSB." Evidence to the House of Lords Select Committee on Economic Affairs, 11 February 2020.

29. The dispute settlement mechanism in the EU-Canada Comprehensive Economic and Trade Agreement (CETA) and the binding commitments agreed in the EU-Japan Economic Partnership Agreement (EPA) provide precedents.

30. Evidence by Mark Carney to the House of Lords Select Committee on Economic Affairs, 11 February 2020.

31. Sir Jon Cunliffe, *Governance of Financial Globalisation,* Berlin, 11 February 2020.

international standards. A degree of joint supervision will also be needed in some cases (as in the case of colleges of supervisors for the financial market infrastructure).

22 The EU has a similar concern to ensure as far as possible that its regulatory system is not undermined by risks affecting the EU arising from the activities of financial firms in third countries outside its control. Where the EU considers that systemic risks are greatest, EU regulatory and supervisory oversight can be expected to be the most intense. One way in which the EU has sought to address this risk is by following a location policy, under which financial institutions with EU customers need to be located within the EU so that they can be authorised and supervised by EU supervisors. Another way would be to intensify supervisory cooperation between the EU and the UK so as to be able to manage risks to financial stability across borders.

A financial services partnership?

23 The EU and the UK have an opportunity to avoid most potential cliff-edge risks at the end of the transition period, when passporting rights cease, by agreeing that: (i) there is regulatory equivalence at the outset, as at the outset EU/UK rules will be the same; (ii) regulatory equivalence should not be withdrawn in the event that divergence takes place later, so long as outcomes remain the same; and (iii) that, if regulatory equivalence is withdrawn, there should be a process for managing this jointly in a way that minimises risks to financial stability. The result would be that, while EU and UK rules would be able to diverge in principle, in accordance with British Government policy, they would only diverge in practice if either the EU or the UK were to determine that they should. Both sides would have the right to diverge, but divergence would not be an obligation. These arrangements for an EU/UK partnership on financial services could be written into a proposed future free trade agreement as a separate chapter; or agreed as a joint declaration on cooperation with MOUs.

24 It is in the interests of both the EU and the UK to agree as much common ground as they can on the regulation and supervision of Europe's capital markets in future so as to maximise the opportunities for sustainable growth across Europe. From the UK's perspective, an agreement with the EU (eg on regulatory equivalence and supervisory cooperation) would help to bridge the gap between the two separate EU and UK markets once passporting rights cease. From the EU's perspective, continued access to London's markets would support the financing of the EU economy while Capital Markets Union in the EU continues to develop. Instead of developing in isolation, EU markets would then continue to be sufficiently integrated with London as the largest global financial centre in Europe. Integrated capital markets would also help the whole of Europe confront global challenges, like the coronavirus (COVID-19) pandemic in the short term and climate change over the longer term, and unnecessary capital market fragmentation would be avoided. There would be a better opportunity to negotiate a lasting settlement if the transition period is extended.

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