Brexit means Brexit, or out means out – and that includes the UK’s exit from the single financial market. With financial services accounting for about eight per cent of the country’s GDP, it is understandable why the UK attaches immense importance to retaining access to the EU's single market. But putting a mutually acceptable regime in place will take years of negotiations, and the final agreement will clearly allow much less access than UK-licensed firms enjoy today. The “equivalence” assessment is the basic tool used under current EU financial services legislation to recognise that a third country’s legal, regulatory and/or supervisory regime is equivalent to the corresponding EU framework; however, as will be discussed in greater detail below, it applies only to some measures and to some of the freedoms created by the relevant EU regulations, not across the board. In addition, the equivalence decisions vary and can be revoked by the European Commission at any time. This framework offers a fairly bleak basis on which the City might continue to thrive as a global financial centre in Europe.

The UK, and the City in particular, is an archetypal example of the functioning of the single market, as envisaged at the end of the 1980s. By harmonising basic rules and providing for mutual recognition, firms could sell goods and provide services freely throughout the EU with a single licence. As a consequence, each EU country or region could specialise in those services and products it was good at. For the UK, this was services, and for the City, it was financial services in particular. Many financial services providers concentrated their wholesale financial market activities in the City, from which they covered the entire EU. However, from the moment the UK’s withdrawal from the EU is complete, the single passport will cease to exist for UK-licensed firms. The only way that the UK could continue to have a single licence would be through its accession to the European Economic Area (EEA), but this is not compatible with the referendum outcome to leave the EU.

The single market freedoms for financial services providers are contained in a multiplicity of different EU directives and regulations. They cover basic rules for banking, investment services and insurance, but also investment products and financial infrastructures. Since the start of the single market in 1992, these freedoms have been further elaborated in updates and extensions to the rules. The 2008 financial crisis led to a substantial broadening of the regulatory maze and an extensive deepening, with consensus reached on a “single rulebook” and the far-reaching use of secondary legislation. Prior to the crisis, important elements of the financial system were not regulated at the EU level (nor even at the national level in most cases), including ratings agencies, derivative markets and hedge funds. Many key pieces of legislation, such as those covering banking and investment services, have become

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1 D. Gros: The Economics of Brexit: It’s not about the Internal Market, CEPS Commentary, September 2016.
The facilities provided by these directives have been further developed and extended to other financial services in recent years, especially following the G20’s commitment to ensure that all financial services, institutions and markets are responsibly regulated in the wake of the financial crisis.4

The key components of the EU's passport for financial services providers

The single market freedoms created for the various forms of financial services have been embedded in a variety of directives. In most cases, the free provision of services (FPS) or “passporting”, has become extensive. For basic financial services such as banking, investment services or insurance, this has been the result of an extensive and long process of de- and re-regulation at European level. In other cases, for non-core services or products such as clearing, settlement, financial data and hedge funds, it started much later and/or was largely driven by the experiences and lessons of the financial crisis.

These freedoms also apply in the EEA countries, which implement all these rules, as well as EU regulations, into national law. The EEA recently concluded an agreement with the EU by which they will also become observers in the European Supervisory Authorities and implement secondary legislation.

The FPS framework is accompanied by additional prudential measures. The financial crisis led to an agreement on common rules for resolving banks in the Bank Recovery and Resolution Directive (BRRD). The UK authorities played an important role in the debate for a resolution framework for banks, drawing on their experience with Northern Rock in September 2007 and other banks following the collapse of Lehman Brothers, and adopted their own rules in the 2009 Banking Act. This Act requires banks to have recovery plans readily available and set a framework for the resolution of banks, including inter alia the concept of a “bridge bank”. These concepts were later incorporated in the BRRD. Another part of the resolution framework, the rules for deposit insurance, was also harmonised as a result of the financial crisis, in the Deposit Guarantee Schemes Directive of 2014.

Remuneration rules, a particularly sensitive issue for the City, have become standard in most post-crisis updates of EU directives and other new measures (see Table 1). They are now part of many of the FPS rules, covering banking, investment and alternative funds, and rating agencies, but

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3 Ibid.

4 See K. Lannoo: Brexit and the City, CEPS Commentary, 22 January 2016.
there are substantial differences across the various measures. The tightest and most widely debated are contained in the Capital Requirements Directive (CRD IV), which limits a banker’s bonus to a maximum 1:1 ratio of his/her annual salary. The rules were challenged by the UK government before the Court of Justice of the European Union (CJEU) on the grounds that these rules would not make the system safer, but the case was withdrawn. The UK’s resistance to implementing EU rules was also later reflected in its refusal to apply the European Banking Authority’s implementing rules, because they did not take proportionality into account.

**EU financial services measures of greatest concern to the City**

Markets in Financial Instruments Directive (MiFID) is an essential measure for the City, as it provides for a single passport for trading platforms and brokers in the EU. The Directive has just gone through a long process of upgrades and adaptations, which will only come into force in early 2018 because of the depth of the review. It now sets rules for trading of non-equity financial instruments and commodity derivatives, regulates algorithmic trading and data vendors, and implements the UK rules of the Retail Distribution Review, which requires the unbundling of investment advice from investment services, at the EU level. As an illustration of the importance of this directive, the UK currently hosts 2,250 firms using the MiFID passport outbound, as compared to 988 from other EU and EEA countries using the passport in the UK.5

The Alternative Investment Fund Managers Directive (AIFMD) is another core measure for the City, as it sets EU-wide rules and a single passport for managers of hedge funds and other alternative funds. The rules were heavily criticised by UK-based firms and organisations when proposed, but the lobbying campaign backfired and remuneration rules were added to the Directive in October 2010, the first EU financial services measure to contain such provisions. EU lawmakers argued that a fund’s remuneration rules should promote sound and effective risk management and not encourage risk taking, and they need to be authorised by supervisors. The Directive requires the full disclosure of remuneration in the annual report, broken down by staff members. There are 212 firms in the UK

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holding the AIFMD passport, as compared to 45 from other EU and EEA countries.6

Credit rating agencies (CRAs) were not regulated before the crisis, but since 2010 they have been subject to a licence and supervised by ESMA. The regulation requires CRAs to be independent and to identify and manage conflicts of interest, also in their compensation policies. Supervisors can monitor the methodologies and business model of rating agencies. The three largest ratings agencies, which control 94% of the EU market, have located their head offices for Europe in London.7

The European Markets Infrastructures Regulation (EMIR) sets rules for the obligatory clearing of OTC derivatives and for the functioning and governance of central counterparties (CCPs), which clear such instruments. The UK is home to a very large part of derivatives turnover, both OTC and on exchange, in the EU.8 EMIR establishes that CCPs can offer clearing services throughout the EU. The passporting of CCPs in all EU member states was the subject of a CJEU case between the UK and the ECB, in which the latter argued that euro-denominated clearing could only occur within the eurozone. The Court ruled against the ECB, finding that clearing services were a single market freedom.

Financial institutions can have several passports under one roof, depending on the services they provide and the number of EU countries in which they are active. This fact explains the huge number of passports that UK-based firms possess, according to the Financial Conduct Authority.9

Third-country access to the single market

Leaving the EU means that third-country rules will apply to firms based in the UK for access to the single market, unless another agreement is found. The basis is the equivalence assessment, which determines that a third country’s regulatory and supervisory framework should achieve the same results as the corresponding provisions in EU law, provided that it is incorporated in relevant rules. Brexit led many groups to argue that this should not be a problem, as the UK applied the same rules as the EU until secession. The situation is not that straightforward, however.

The debate on third-country access provisions is as old as the single market. Foreign banks in the City led the charge in the early 1990s, when reciprocity provisions were contained in the Second Banking Directive (today called the Capital Adequacy Directive). It was argued that market access in the EU should be “reciprocal” to that given in other jurisdictions, which raised fears that the EU would become a “fortress”. The provision was never applied, however. Later on, in the measures adopted under the Financial Services Action Plan (FSAP), the term “reciprocity” was replaced with “not more favourable treatment”, enabling the EU to start negotiations with third countries seeking to obtain the same treatment as that given in EU member states. The financial crisis changed this more lenient regime, as the conviction emerged that much stricter supervision was required, and the post-crisis term became “equivalence”.

According to the European Commission, equivalence means that “in certain cases the EU may recognise that a foreign legal, regulatory and/or supervisory regime is equivalent to the corresponding EU framework”.10 It allows the EU authorities to rely on the compliance of foreign entities with the equivalent foreign framework, stating that “equivalence decisions may apply to the entire (regulatory) framework of a third country or to some of its authorities only”.11 Equivalence decisions are taken unilaterally by the Commission, but can be revoked at any time. They are prepared on the advice of the European Supervisory Authorities. The recent equivalence decision on CCPs under EMIR, for example, states that a review of the decision can be undertaken at any time and that “such re-assessment could lead to the repeal of this Decision”.12

A comparison of the third-country regime provisions of the different EU FPS measures presents a highly complex puzzle. In certain cases, such as the AIFMD, the third-country regime is quite developed, whereas in other cases, it is brief and restricted to certain provisions or is very specific.13 In still other cases, it is not provided for at all. Table 2 provides an overview of the key items of the third-country regime for banking, investment services, investment funds, trading venues, and clearing and rating agents.

6 Ibid.

11 Ibid.
What emerges from the above enumeration of the main features of third-country regimes is that there is no full access to the single market for third countries. Member states, however, can individually authorise bank branches, investment firms and funds to provide services, but only within their own territory. Access to the EU’s single market is governed by equivalence assessments of the third country’s regulatory regime, which are carried out by the European Commission. For banks, the equivalence assessment is focused on the third country’s prudential regime. For third-country investment firms, the access is limited to eligible counterparties and professional clients and to trading venues.

For UK-based financial institutions, this means that future access to the EU’s single market will be very limited compared to what is available today. The UK could start negotiating a trade agreement with the EU as soon as Art. 50 is triggered, but this will certainly not provide for the free provision of financial services. In line with international trade conventions, it could provide for most favoured nation treatment. In the area of financial services trade, this would require a local establishment for firms, but with a “prudential carve-out”, meaning that access could be denied on prudential grounds. For trading venues and clearing services, an equivalence assessment would be required. In the meantime, the UK will need a transitional agreement, which will provisionally grandfather some existing single-market conditions, but possibly in a broader manner than what is foreseen under the various rules today.

Either route entails important drawbacks. A trade agreement takes years to conclude, is difficult to sell to public opinion and may have to be ratified by all EU member states. A transitional equivalence agreement should effectively prepare for the best, but may only cover what is foreseen in the different measures governing the single market in financial services. To highlight how political such
In the area of financial services, the UK has much to lose and little to gain from leaving the EU. Those that will be most severely hit are large integrated financial institutions using multiple passports under one roof and specialised investment firms and asset managers with a single passport. They will need to disentangle their operations, split up their capital base, and create separately capitalised and licensed operations within the EU. There is an urgent need therefore to give careful thought to the content and shape that a new deal with the EU might take.

Inspiration could be taken from the relationship that the EU has formed with other trading partners. As with Switzerland in insurance, the UK could strive to negotiate a bilateral agreement for market access with the EU on financial services, pending a more comprehensive trade deal, similar to the arrangements the EU has with many other jurisdictions. The British government, however, will have to overcome the animosity that prevails in the EU towards a special deal with the UK, certainly in the domain of financial services. It will therefore have to start a long and difficult process of persuading the EU that it is important to the European economy that London be allowed to remain a global financial centre.

Conclusion

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