How Will The UK Financial Services Sector Adapt To Changes As A Result Of Brexit?

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Introduction

When Prime Minister (PM) Theresa May triggered Article 50 of the Treaty of Lisbon on May 29, 2017, she set into motion the official withdrawal of the UK from the EU. This unprecedented departure from the EU provoked intense debate among the residents of the UK and the EU about the uncertain future of their relationship. Article 50 provides that any member state may withdraw from the union in accordance with its own constitutional rights (The Lisbon Treaty). Due to this provision, there is considerable uncertainty about what will replace the existing laws that soon will not apply to the UK. The financial services sector is especially concerned with Brexit negotiations as much of that sector’s operations depends on access to the EU single market.\(^1\) The potential denial of unrestricted access to this market presents significant challenges. The currently thriving landscape of the financial services sector will not remain unless the UK is able to negotiate a deal with the EU that allows it access to the single market while maintaining some regulatory sovereignty.

With negotiations under way, PM May announced her plan for the Great Repeal Bill, which essentially converts existing EU laws into domestic UK laws. The ambiguity surrounding how the UK will establish these new laws while maintaining stability has left many businesses and consumers frantic for answers. London is the global hub for the financial services sector, which makes withdrawal from the EU even more complex. This article explores the various challenges the UK faces while trying to negotiate a deal for the financial services sector that allows it to maintain its prominence in the world economy.

\(^1\)The single market is defined by the European Commission as “one territory without any internal borders or other regulatory obstacles to the free movement of goods and services” (European Commission).
Financial Services Overview

The financial services sector is a primary contributor to the UK's economic success. John Armour, a Professor at Oxford University, explains this sector: “[f]inancial services comprise[s] all the activities undertaken in the financial system...It includes banks, asset managers, financial markets, and insurance” (Armour). The Global Financial Centres Index ranked London as the world’s leading global finance center in both its 2016 and 2017 reports (Yeandle, p. 2). This index is based on several key factors, including human capital, business environment, infrastructure, reputation, and financial sector development (Yeandle, p. 8). In both reports, London ranked at the top of each of these categories; however, London fell 13 points during 2017 (Yeandle, p. 8). Other than New York City, most cities’ points rose between the 2016 and 2017 reports. The 2017 report named Brexit as a possible reason for London’s fall in the rankings.

In 2014, UK-based financial and related professional services contributed €190 billion to the UK economy (“Key Facts...”). The financial services sector affects the lives of millions of UK citizens: 2.2 million people work in financial or related professional services (“Key Facts...”). One reason the UK achieves success and influence in the financial services sector is the passporting rights it receives as a member of the EU (discussed later).

More than half the world’s financial services firms have chosen to set up their headquarters in London (Magnus et al.). If the UK fails to receive a favorable deal with the EU, it is likely that many of those firms will be forced to move their headquarters elsewhere in the EU. This constantly expanding and consistently profitable sector has played a large role in boosting the status of the UK internationally as well as providing jobs, high incomes, and prestige domestically. As the government continues to grapple with the aftereffects of the Brexit vote, the financial services sector has been placed in a position of uncertainty. Losing access to the single market, coupled with the changing relationship with the EU, could have hugely detrimental effects on the financial services sector in the UK. The access the passporting rights provide to the EU is critical to the state of the financial services sector in the UK.

Passporting Rights and Equivalence

Two key concepts that dominate the financial services–related Brexit discussions are passporting rights and equivalence. Passporting rights allow countries that are members of the EU or the European Economic Area (EEA)2 to trade freely among themselves; these rights also allow citizens to operate their businesses in all member countries with limited authorization requirements. Passporting rights are fundamental to the existence and success of the EU single market for financial services (UK Finance, “Brexit Quick Brief #3”). The intricacies of passporting must be fully explored in order to assess how the financial services sector will function after the UK’s withdrawal. It is crucial to recognize that there is not one single “passport” but several passports that the UK must maintain if it wants to preserve its current status with the EU. If the UK were to lose its passporting rights, UK businesses would need to apply for licenses to operate within each EU member country. This would not only lead to a loss of ease in conducting business but also add additional costs to obtain the correct licenses and permits.

UK Finance, a coalition of over 300 firms that focus on finance, banking, markets, and payments-related services in or from the UK, has published several briefing papers on the consequences of Brexit on the financial services sector. The briefing paper focusing on passporting gives a detailed assessment of the complexity and legal uncertainties concerning passporting rights after the withdrawal. This report outlines the nine different passports that banks and other financial services institutions rely on to operate within the EU and the EEA; it also explains consequences that would result from the loss of access that the UK might experience. There are several possible outcomes. If the UK loses its passporting rights, it will not lose its privilege to conduct business in the EU entirely;

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2The EEA includes the EU countries as well as Iceland, Liechtenstein, and Norway.
however, the regulations would be stringent and the services UK businesses would be allowed to provide could be highly limited (UK Finance, “Brexit Quick Brief #3”).

UK Finance explains the process of achieving equivalence as “[w]hen assessing the operational rights or treatment of foreign banks in the EU the EU assesses whether the standards of regulation and supervision in a bank’s home market are ‘equivalent’ to those of the EU” (UK Finance, “Brexit Quick Brief #4”). The principle of equivalence is pivotal in the context of Brexit negotiations. Failure to achieve equivalence within the EU and the EEA would make preserving London as the world’s financial hub extremely difficult. UK Finance also notes that equivalence and passporting rights are not synonymous; rather, “EU market access rights available under equivalence assessments are narrower, more onerous and more unstable, and many banking services or other financial services cannot be provided at all via equivalence” (UK Finance, “Brexit Quick Brief #4”). Facing the potential loss of passporting rights and the uncertain future status of equivalence for the UK in the EU, the UK’s financial services businesses are in a difficult period of confusion that has prompted businesses to make Brexit contingency plans (Buyck).

The Great Repeal Bill

The House of Commons report on the Great Repeal Bill stipulates the bill’s three main components: the repeal of the European Communities Act (ECA), the transposition of EU law into UK domestic law, and the proposed use of delegated powers. One of the first steps in the official withdrawal process from the EU is repealing the ECA, the act that brought the UK into the EU and established the supremacy of EU law over UK law. PM May and David Davis, Secretary of State for Exiting the European Union, both believe that the most effective withdrawal route is to repeal the ECA while simultaneously passing the Great Repeal Bill (Caird and Lang). This bill hopes to avoid legal uncertainty and chaos by converting all applicable EU law into UK law (Department for Exiting the European Union and Davis).

EU and UK laws have been intertwined for the past several decades, which makes untangling them extremely complex (Moloney, “Extracting…”). There are more than 12,000 EU regulations in force within the UK, which makes the translation of EU law to domestic UK law an arduous task (Smith-Spark). The mass of EU regulations in place makes it incredibly difficult for Parliament to ensure that the Great Repeal Bill does not leave a legal vacuum. Daniel Greenberg, a former Parliamentary office member, said that the transfer of EU law to UK law is “a civil service legal exercise on a scale that has not been encountered at any other time in our recent legal history” (Williams-Grut). Because EU laws applicable in the UK cover all different kinds of regulation, a clear withdrawal plan is important to avoid what is now known as the “cliff-edge effect” (UK Finance, “Brexit Quick Brief #2”). The cliff-edge effect might occur if the UK and the EU fail to reach an agreement about the status of their partnership during the two-year negotiation period, in which case the UK would have to follow the baseline trade rules set by the World Trade Organization (UK Finance, “Brexit Quick Brief #2”).

The UK Finance report on the withdrawal bill outlined three primary challenges for Parliament when attempting to write the Great Repeal Bill (UK Finance, “Brexit Quick Brief #7”). The major goal is to sort through all the EU laws and identify which are applicable to the UK, with an aim to retain the UK laws created through EU regulations and directives. Several different classifications of laws are created for the entirety of the EU. While some of these laws are automatically binding, others are not and must be adopted by each member state. Two of the most important classifications of laws in navigating the Great Repeal Bill are “directives” and “regulations.” Since the EU’s primary role is to create uniform regulation and safety within its member states, preserving those protections remains paramount. The European Parliament defines “regulations” as binding legislative acts that require quick implementation by every member state, whereas “directives” are legislative acts that set goals that the member states must reach but do not give specific timelines or pathways
of implementation. Instead, countries are left to independently develop their own laws (“Regulations, Directives…”). If the Great Repeal Bill did not exist, then all current EU regulations and laws would cease to have authority within the UK, creating potential havoc from a legal vacuum, or as Brexit news has started to refer to it, a black hole (UK Finance, “Brexit Quick Brief #7”).

Another factor that makes writing the Great Repeal Bill so difficult is that each law must be analyzed to see if it needs reworking to apply in the UK. Laws ill-suited to the UK’s legal structure require new laws to take their place, adding to the legislative burden. Finally, the most challenging task of creating this bill is to identify any gaps in the law and for Parliament to discern how to manage these gaps and create new laws. Since such legislation has never been necessary before, it will be exceedingly arduous not only to create the withdrawal bill but also to flesh out the details within two years. One way Parliament chose to combat this problem is through granting Henry VIII powers to Ministers. These powers allow the use of secondary legislation to amend the text of primary legislation (Caird and Lang). Davis has implied that changes to law will not require the full force of Parliament. This shift of power away from Parliament to the executive branch has many businesses and consumers worried about their fate.

The Importance of Financial Services Regulation

Financial regulations are arguably the most important type of regulation due to the catastrophic effects that financial market failures can have on the economy, as demonstrated by the 2008 US subprime mortgage crisis, which turned into the global Great Recession (The Warwick Commission). Because London is the world’s financial center, it is imperative that Brexit negotiations maintain regulatory standards in the UK. The report of the second Warwick Commission discusses the two main causes of market failure—asymmetric information and social externalities. Asymmetric information occurs when one party in a transaction has relevant information that is either not disclosed to the other party or not known. One of the main responsibilities of the regulatory system is to protect the less knowledgeable consumers from the well informed. For the consumer to be protected, regulation must provide guidelines for how these transactions take place (The Warwick Commission).

In financial services, the social externality stakes are also high: “…[t]he costs of a failure of the financial system are far in excess of the costs to the shareholders of the bank that failed” (The Warwick Commission). While financial services regulation is crucial, those same regulations ideally should not stifle creativity and innovation. Finding the optimal balance of regulation is remarkably difficult within the financial sector. As the UK separates from the EU, the regulatory challenge lies in maintaining high levels of protection while also fostering growth and prosperity and continuing to work with the EU.

Niamh Moloney, a law professor at the London School of Economics, provides insight into the two main reasons financial services regulation is so crucial in the context of Brexit. Moloney (“Bending,” p. 1339) writes that EU regulation seeks to do two things: to support the construction of an integrated, single financial system with minimal regulatory frictions, and to regulate that financial system so that the pathologies, notably cross-border risk transmission, are minimized and managed. The single-rulebook of regulations for the EU will no longer apply to the UK after its exit, calling into question how the regulatory environment will change and what will happen to the directives and regulations regarding financial services.

Moloney’s analysis demonstrates the imperative that the UK maintains a strong regulatory system comparable with the EU’s. Failure to keep an effective system in place could imperil the entire world economy.

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3The abilities to change the laws without the permission of Parliament are often referred to as Henry VIII powers, after the 1539 Statute of Proclamations that gave King Henry VIII the power to legislate by proclamation.
Since the 2008 financial crisis, the UK financial services sector has worked toward enacting more effective regulation (The Warwick Commission). EU regulations of financial services have at the same time become stricter. However, the UK and the EU have long disagreed about the intensity of regulation. UK sentiment has always been critical of regulation; many UK residents believe that the EU regulations place too great a burden on businesses. Many UK citizens who voted for Brexit believe that economic regulations will be loosened if the UK reclaims its regulatory sovereignty from Brussels. Thus one of the main points on Brexit and the Great Repeal Bill is how closely the new UK regulations on financial services will reflect these tightened EU regulations.

On February 16, 2018, the Financial Times reported on the UK establishing its goal of “mutual recognition” of financial regulations. The goal of mutual recognition is to allow the UK to access the single market while preserving regulations. Stephen Jones, Chief Executive of UK Finance, is quoted in the article: “Through mutual recognition, closely aligned standards and supervisory cooperation, we can preserve some of the benefits of market access without sacrificing regulatory autonomy” (Parker and Brunsden). While this demonstrates movement toward compromise, it is still too early to say whether the EU will move away from the hard line on financial services and make a deal that will not wound the financial hub in London. To understand the complexity surrounding financial services regulation it is crucial to explore the different regulatory bodies within the UK.

**UK Financial Regulatory Bodies**

Four main bodies comprise the UK financial regulatory system: the Financial Conduct Authority, which works independently from the government; the Bank of England’s Prudential Regulation Authority; the Treasury; and the Financial Policy Committee. The financial crisis that originated in the United States in 2008 prompted a large restructuring of the financial sector (“UK Regulators”). In 2013, Parliament created the Financial Conduct Authority to achieve five main objectives: “enhancing trust in markets, improving how markets operate, delivering benefits through a common approach to regulation, working to prevent harm from occurring, and finally, helping put things right when they go wrong” (“How We Regulate”). Achieving these objectives allows the Financial Conduct Authority to manage financial services and, in turn, protect the public.

The Bank of England is also central to financial stability in the UK; the Prudential Regulation Authority’s main role is to minimize the burden on the rest of the economy when a financial institution fails. In parallel, the Treasury is responsible for monitoring public spending and working on financial services policy (“About Us”). Finally, the Financial Policy Committee established at the Bank of England is tasked with “identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system” (Bank of England). The financial services sector is a multifaceted institution, which makes it difficult to envision the best-case scenario after the withdrawal.

**Possible Brexit Scenarios: Which Will Be the Best for UK Financial Services?**

The UK is the first country to ever withdraw from the EU, leaving both sides in a state of speculation about the nature of their future relationship. PM May outlined her vision in a 12-point plan during her first remarks on Brexit. She envisioned a bold and dominant “Global Britain” that was not leaving Europe but instead just leaving the EU (Amur). PM May emphasized the need for certainty, autonomy, a free trade agreement that allows for the greatest access to the single market without membership, and stronger control of immigration (Amur).

The Brexit negotiation period began on March 29, 2017, prompting the UK and the EU to prepare their respective negotiating teams for the first phase of Brexit talks. Six months of heated debate and discussion finally achieved a divorce settlement, enabling progressing to the second round of negotiations (“Brexit Passes...”). The UK and the EU both entered
Brexit talks with very specific intentions; however, the EU had the clear victory during the first phase. According to the Financial Times, the UK was unable to achieve many of the primary objectives of those who voted to leave in the referendum. The leave voters’ dreams of being free of a financial obligation to the EU is far from reality; rather, the UK will end up paying approximately €40 billion to €45 billion to the EU as well as continuing its association with the European Court of Justice (“Brexit Britain…”).

The red lines set by both the EU and the UK permeated Brexit discussions and debate even prior to the referendum vote. The Financial Times argues that maintaining these red lines and failing to compromise will make achieving PM May’s “deep and special partnership” difficult (“Brexit Britain…”). Michel Barnier, European Chief Negotiator for the United Kingdom Exiting the European Union, has made it clear that the city of London and the financial services sector will not be included in a trade deal. It is evident after the second round of Brexit negotiations that PM May and the chief negotiator hold wildly different views on the fate of their relationship. Barnier further emphasized, “[It is the consequence of] the red lines that the British have chosen themselves. In leaving the single market, they lose the financial services passport” (Saeed).

PM May, however, believes that the UK can achieve a bespoke, or custom-made, deal that has greater benefits than either of the other models in practice.

The two most likely models for a potential Brexit deal are the Norway Model and the Canada Model. The Norway Model allows membership in the EEA, full access to the single market, and the same free movement rights that apply in the EU. However, the trade-offs of this deal include expected financial contributions to the EU and that EU laws will have force within Norway (BBC News, “Five Models…”). The EU–Canada deal, the Comprehensive Economic and Trade Agreement, is a free trade agreement that eliminates many barriers and fosters greater exports of both goods and services (“EU–Canada…”). Davis, during an interview on the Andrew Marr Show, expressed hopes for a “Canada Plus Plus Plus EU Trade Deal,” which combines all the best parts of trade deals with other countries. He continued to say that “[w]hat we want is a bespoke outcome. We’ll probably start with the best of Canada and the Best of Japan and the best of South Korea and then add that the bit missing which is the services” (BBC News, “The Andrew…”).

As the Brexit negotiations move forward, PM May will need to make contentious comprises about the UK’s level of autonomy while operating within the EU. Emmanuel Macron, the President of France, initially declared that there was no possibility that financial services could have full access to the single market in any EU-UK trade deal; however, he has recently indicated his willingness to possible compromise.

**Conclusion**

The Brexit deal that PM May and those who voted to leave the EU hoped for is largely impossible, especially with regard to a special deal for the UK financial services sector. Significant compromises need to be made by both sides; however, the UK is evidently in the weaker negotiating position. For London to remain the top global financial services hub, a Brexit deal must be struck that allows the greatest access to the single-market system while keeping the regulatory equivalent to that within the EU.

On January 31, 2018, the Financial Times noted a turning point in the Brexit negotiations that officially ended hope for a “special deal” (Brunsden). This announcement from the EU Brexit negotiators represents a clear departure from May’s ambitions for the EU-UK Brexit trade deal. The EU maintained that the UK knew from the beginning that there was not going to be a special deal and the UK should focus its efforts on equivalence rather than “a wide-ranging new pact.”

Perhaps the most intriguing piece of information in this report was that the European Commission had earlier stated that a smaller financial hub in London might positively benefit Europe. The article stated that Brussels has prepared itself for Brexit by toughening the criteria for achieving equivalence (Brunsden). While negotiators, as of February 2018, are still uncertain about what the trade deal will look
like, it is abundantly clear that the UK financial services sector will be negatively impacted by the departure from the EU.

On June 23, 2016, the UK’s citizens voted to leave the EU and in doing so irrevocably changed the fate of the financial services sector. The UK and indeed the rest of the world will continue to discover the implications of this vote for decades to come.

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