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IMPROVING GLOBAL FINANCIAL SERVICES REGULATION

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IMPROVING GLOBAL FINANCIAL SERVICES REGULATION

Fostering Economic Growth and Innovation in Financial Services

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About iTCU

The International Trade and Competition Unit (iTCU) at the IEA is dedicated to promoting open trade, competitive markets and property rights, which are the fundamental building blocks of wealth creation and growth.

iTCU works on initiatives around the world which will improve these building blocks in all nations.

We engage at four different levels. First, what countries can do unilaterally to improve their own trade and regulatory systems to promote competition, and remove trade barriers. Second, how bilateral trade agreements can achieve these results. Third, we examine what regional and platform agreements can do to promote trade and competitive regulatory frameworks. And finally, how the global trading system can deliver these goals.

While some of our work is theoretical, such as our work to measure anti-competitive market distortions, iTCU is also acting as a resource on all aspects of the UK leaving the EU and developing an independent trade policy.

Guernsey is a leading international financial centre whose regulatory regime conforms to international standards. As an active and engaged global citizen we believe in the positive role that innovation and improving global regulatory standards can play in fostering economic growth. We therefore welcome the IEA’s contribution to this important debate.

Introduction

As the most globally active financial services provider, the UK has the potential to be a key player in helping to develop a more efficient international regulatory framework after it leaves the EU. All entities that have efficient and attractive financial services offerings will benefit from having better global financial services regulation.

The UK financial services industry is a major component of its economy. In 2016, UK financial services contributed 6.7% of the total UK GVA[1], provided 3.1% of all jobs in the UK and generated a trade surplus of £68bn[2] in the finance and insurance sectors.

[1] OECD Data, National Income, Value Added by Activity
[2] ONS Trade in Service by type of service 2014 2016

Context

The UK voted to leave the European Union in June 2016; and after the triggering of Article 50 in March 2017, the UK will be leaving the European Union at 11pm, on the 29th March 2019. Honouring this democratic decision, and with the backing of parliament, it is important that, in leaving the European Union, the UK Government makes the most of the opportunity to re-examine existing regulations and directives, learning from them and modifying them to better suit the UK's needs as an independent nation.

Governments are able to influence their trade in four different ways[3]:

- Unilaterally by altering their domestic regulations,
- Bilaterally by forming an agreement between themselves and another nation or trading block,
- Plurilaterally by joining a trading block with a similar economic agenda
- Multilaterally using World Trade Organisation (WTO) rules.

This paper sets out to look at what the UK can do in the context of Brexit that would not only improve the UK's financial service industry, but also improve global financial services and the availability of capital, hedging mechanisms and insurance internationally. In doing so, it sets out to provoke thought as to what a more efficient financial services regulatory framework would be, and how the UK could help to implement this in its domestic regulation as well as with its international trading partners.

[3] An explanation of the 4 Pillar Trade Policy can be found in: The Blue Print for Brexit, Legatum Institute, 2017

Table of Contents

Executive Summary 5

1 The scope for adaptation of UK financial regulations 12

2 The achievement of global regulatory cooperation 14

3 The EU's equivalence and passporting regime 18

4 Risks to the financial services market post Brexit 22

5 The evolution of a global regulatory regime 32

6 Conclusions 42

7 Appendices 44

Executive Summary

1. The scope for adaptation of UK financial regulations

Existing UK regulation should evolve using international standards where possible as a threshold regulatory framework to create a transparent regime based on shared outcomes.

Financial regulations must ensure financial stability and investor protection but should be sufficiently competitive so as to;

- not restrict growth in financial services,
- not encourage regulatory arbitrage,
- not prevent sections of the economy from accessing capital or other financial products.
- Help to develop safe but competitive markets
- Facilitate the growth of new and Small and Medium sized Enterprises with proportionate regulation

The UK must accept that it will no longer have a direct influence over the EU27 but that it can and should evolve its own regulations and work with other financial centres and international standard setters to create a more competitive regulatory environment globally.

2. The achievement of global regulatory cooperation

In many key areas financial regulation is already based on international standards set by the Basel Committee of Banking Supervision (BCBS), the International Association of Insurance Supervision (IAIS) and the International Organisation of Securities Commissions (IOSCO). All three work closely with the Financial Stability Board (FSB) and the G-20.

The framework for global regulatory cooperation was reenergised at the G-20 Pittsburgh Summit in 2008 where leaders committed their national authorities to implement global standards consistently in a way that avoids systemic risks, fragmentation of markets, protectionism and regulatory arbitrage.

Outside the EU, the UK will have the advantage of greater agility in decision making, entering into regulatory recognition arrangements with 3rd countries and implementation of appropriate regulations.

The UK should promote more pro-competitive regulation in the global standard setting organisations and challenge global rules with anti-competitive effects.

According to the IMF, the developing economies and emerging markets presently account for approximately 40% of world GDP, up from 20% twenty years ago.[4] It is predicted that by 2050, the E7[5] emerging economies will account for 50% of Global GDP at PPPs.[6]

3. The EU's equivalence and passporting regime

The main weaknesses of the EU's Equivalence regime are that;

- EU Equivalence does not cover the entire spectrum of financial services,
- EU Equivalence is granted unilaterally and can be unilaterally withdrawn,
- EU Equivalence is not granted on purely user protection and market stabilisation concerns.
- There are no transparent or consistent criteria for EU Equivalence recognition.

Although a country must have comparable regulations to be granted EU Equivalence, it is not the only consideration of the European Commission; politics, reciprocal benefits and local protectionism all play their part as well.

Thirty two of the world's largest financial centres already have financial service trade agreements based on some level of EU Equivalence. It is important for the UK to sustain sufficient equivalence to enable these agreements to novate more easily to the UK post-Brexit ensuring the smooth continuation of trade. Existing equivalence should continue as part of the European Union Withdrawal Bill.

[4] IMF World Economic Database, Oct 2017
[5] E7 = China, India, Brazil, Russia, Indonesia, Mexico and Turkey
[6] The World in 2050: how will the world economic order change? Feb 2017, PWC

4. Risks to the financial services market post Brexit

Forcing euro denominated clearing into the Eurozone, would undermine financial stability, increase systemic risk and endanger consumers by reducing the netting effect for central Counterparties (CCP's) and Clearing Houses and dividing the traded volume. This would simply create two markets, echoing the creation of the Eurodollar market in London in the 1960s. The Euro is now a global reserve currency; it has grown beyond the constraints of the ECB.

Dividing the London market up across various cities in the EU27 will necessarily reduce the traded volume and magnify the risk of larger price fluctuations. High trading volumes will always give the most efficient pricing and enable professional investors to buy and sell large positions without influencing the market price. For this reason, a handful of global cities have become the major financial market places in their time zone, without any government legislation forcing them to do so.

Most OTC Derivative agreements are based on common law and this is expected to continue.

In default of any other arrangements, certain financial activities would be able to continue in certain member states depending on that country's national regime regarding overseas providers, solicitation, reverse solicitation and characteristic performance. MiFID II permits third-country service providers to offer investment services and activities to professional clients or on the 'exclusive initiative' of the client without requiring authorisation or registration in the EU.

Limiting access to capital, hedging instruments, investment products, foreign exchange and insurance by creating financial services trade barriers will restrict the growth of EU companies and could have serious repercussions for both the EU and consequently the UK economies and their governments' growth agendas.

Although the UK is the largest asset manager in the EEA managing 36.3% of all Assets Under Management (AUM), over half of these funds are domiciled outside of the UK. UK Funds domiciled in the EEA are predominately domiciled in Luxembourg and Ireland. The UK should develop a UK authorised investment scheme comparable to the EU UCITS fund.

The insurance industry will be less effected by Brexit as it has always operated on a basis of subsidiaries and branches in EU member states with separate legal entities. Solvency II has been adopted by the FSA / PRA and it can be argued that, of all the countries that now fall within its scope, the UK has been the most rigorous adopter.

Even if the European Commission passed a directive that EU financial services could only be conducted in the EU27 financial centres, trying to force people to use their local markets with electronic banking, machine trading, fintech and free movement of capital would be impossible without external currency controls, which would limit capital raising to the extent of local savings.

5. The evolution of the global regulatory regime

5.1 Establish regulatory coherence agreement between the UK and EU27

The UK and EU should announce their intention to establish a regulatory coherence agreement as soon as possible and ensure it is operational from 30th March 2019 or the end of any agreed interim period.

The EU and the UK should continue to operate with a consensually established set of shared regulations, based on international standards and common outcomes and with mutual transparency and cooperation between home state regulators, provided that such cooperation does not prevent either party from diverging, nor allow such divergence to act as a hair trigger to loss of recognition. Such cooperation should include shared cost benefit analyses in regulatory promulgation having regard to a range of factors including impact on trade and competition.

The ECB and the Bank of England should agree to an enhanced collaborative arrangement addressing the ECB's systemic risk concerns regarding Euro denominated transactions along the lines of the present arrangement between the USA and the UK as regards the clearing of US Dollar denominated instruments by UK central counterparties.

Disputes should be settled in a dispute settlement mechanism by an independent tribunal as is included in most modern FTAs.

UK/EU financial services regulation must ensure financial market stability and investor protection but also ensure that regulations do not prevent competition or discourage new service providers.

5.2 A Strong Domestic Regime

The UK should establish its own regime in line with global standards and best practices established by the BCBS, IOSCO, IAIS and the FSB G20 and other international standard setting bodies.

Reshape its financial regulations by removing any unnecessary processes and focusing instead on proportionality of the regulatory outcomes in a transparent and cooperative manner.

This would allow the UK to limit systemic risk and protect consumers from unacceptable conduct without stifling the provision of capital, investment opportunities or insurance provision to companies and individuals.

This would allow the UK to cooperate with other countries and businesses that achieved similar regulatory outcomes reached in a similarly transparent manner.

5.3 Building on WTO Disciplines

The UK should pursue with renewed vigour and urgency, the built-in agenda on services in the WTO, and actively push for deeper liberalisation.

The WTO understanding on financial services should be built on with the goal of increasing the liberalisation of market access, but also ensuring that domestic regulation and competition are sufficient and proportionate to achieve their prudential goals, without sheltering anti-competitive and discriminatory regulation.

The UK should encourage WTO members to build on existing WTO disciplines that relate to mutual recognition in the WTO GATS and in the built-in agenda on services and which finds its fullest expression in the TBT/SPS agreements. The notion that recognition should not be defeated simply because of technical divergence provided the ultimate goal of regulation is the same, should be one foundational principle of mutual recognition and equivalence provisions in trade agreements dealing with conditions of competition and domestic regulatory issues. The other foundational principle should be based on the existing WTO disciplines that ensure non-discrimination in domestic laws and regulation as initially expressed in the GATT agreement (Article III.4).

The WTO Most Favoured Nation (MFN) principle of non-discrimination should be at the core of any agreement on international financial service

provision, any agreement should be as open as possible on market access and national treatment and shall make progress on liberalisation of domestic regulation and conditions of competition.

5.4 Form an alliance with the other major financial markets

Combining several global financial centres into a cooperative regulatory alliance would;

- allow this alliance to agree an acceptable mutual recognition regime.
- give the combined bloc a strong negotiating position when discussing regulatory matters with other global financial centres.

The F4 Alliance project, proposed by the Swiss Bankers Association, aligning the UK with Switzerland, Hong Kong and Singapore could enable further and deeper integration opportunities. This project could grow to include other financial centres such as Japan and New York and the Crown Dependencies, which we discuss below.

Establishing a UK regime of multilateral mutual recognition (MMR), would allow the UK to strengthening their involvement in global regulation formation and dispute resolution.

5.5 Form an alliance with the UK Linked international financial centres

The UK should make comprehensive bilateral agreements based on mutual recognition with the Crown Dependencies (CDs) and the Overseas Territories (OTs) that have established adequate home regulatory standards in key financial service sectors such as banking, asset management, insurance and reinsurance.

We assume that any CD or OT that presently has EU Equivalence recognition should be granted similar recognition by the UK as part of the EU Withdrawal Bill allowing financial services to continue smoothly post Brexit. As recognized in the 2009 Foot review[7] the CDs and OTs are assets to the City of London that can allow the UK to build on its global network.

[7] Review of British offshore financial centres, Michael Foot, Oct 2009

The UK should develop its own authorised retail investment scheme that could replace the EU domiciled and managed UCITS funds, where the new category funds might be managed and domiciled in the UK, CDs or the OTs.

Encouraging EU domiciled, investment funds managed from London, to move their domicile out of the EU by reinstating Section 270 of FSMA.

5.6 Introduce regulation to encourage innovation

Proportionate regimes of regulation and taxation for SMEs in financial service start up and specialist fintech companies are beneficial in ensuring good conditions for new entrants and dynamic high growth firms.

Regulation based on global standards should apply to companies that are internationally active, but be more proportionately applied to purely domestic companies

National standards should be set to encourage competition in the local market by raising the “de minimis” exemptions threshold from the current EU imposed level of €100,000.

5.7 Allow EU27 headquartered banks with UK branches to continue as branches or quickly convert to subsidiaries post Brexit

The UK regulators should sustain the option of EU27 banks being able to set up branches or subsidiaries in the UK provided that their home regulators continue to cooperate with the UK authorities, and expedite conversion from branches to subsidiaries if desired.

The process of branch conversion should be allowed to start now, before any EU/UK agreement is concluded, so that all necessary licences are in place for a smooth transition and continuous trading post Brexit.

Allowing EU27 banks to continue to operate in the UK would;

- provide certainty for EU banks trading in the UK,
- be a show of good faith to the EU that the UK is not planning on restricting EU27 access to financial services
- ensure UK market stability by extending UK prudential regulations over all subsidiaries of EU27 banks operating in the UK.

1 The scope for adaptation of UK financial regulations

1.1 Why are financial regulations important?

The ability to raise capital is the key to economic growth and prosperity. Well-regulated financial markets improve economic efficiency, lead to a better allocation of productive capital and increase long-term economic growth.[8] The expansion of global capital markets and the increase in access to capital was found to increase global prosperity by 1% per year from 1960 to 1990.[9] If a market is not well regulated or trustworthy then local and international investors will be cautious about lending or borrowing capital from that market.

The purpose of most recent prudential, financial regulation has been to prevent systemic market risk after the Global Financial Crisis in 2007/8 and to address money laundering and the funding of terrorism. In 2012 the US Dodd-Frank Act, the G20 Clearing Mandate and the EMIR Directive in the EU required that standardised OTC derivative transactions must be cleared at a clearing house and all counterparties must post collateral. This has greatly reduced the funding and credit risks long associated with OTC interest rate swaps. The introduction of "know your client" regulations and the requirement to re-document many accounts has reduced money laundering, tax evasion and mis-selling.

However, such regulation was never meant to slow down access to capital for new businesses while the compliance process takes place or even prevent consumers from accessing financial services completely. Some countries have additional, so-called "Gold Plated", regulations which are even more likely to discourage financial service providers from offering many services in their countries. In the UK, there are views expressed that the FCA appears to be regulating to something closer to 'zero failure' than is optimal. This stifles the innovation that is required to keep the UK at the forefront of financial services.

1.2 The UK must look to global regulation

The UK financial services industry is a major component of the UK economy, in 2016 UK financial services;

- Contributed 6.7% of the total UK GVA,
- Provided 3.1% of the jobs in the UK,

- Financial Service and Insurance exports produced a trade surplus of £68bn
- Financial Service and Insurance exports of £79bn, 32% of all UK services exports.

The UK financial services industry is a global business centred in London. The Prudential Regulation Authority (PRA) is responsible for the host supervision of around 170 international banks from over 50 jurisdictions including every global Systemically Important Bank (SIB)[10]. This is more than any EU27 country.

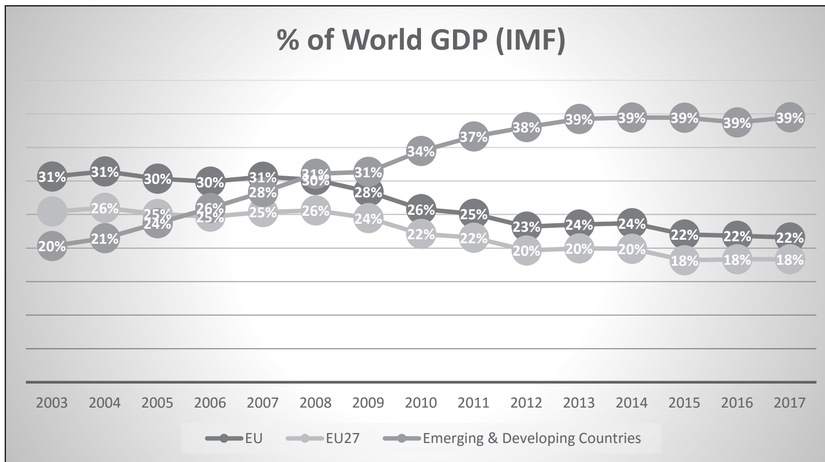
The overall global regulatory framework is of critical importance for London. The UK cannot merely consider domestic or even EU concerns when defining its financial services regulations as;

- 40% of the world's largest 250 companies have a global or regional headquarters in London.
- UK exported £16.7bn financial and insurance services to the US in 2016, more that the UK exported to France, Germany and the Netherlands added together.
- LCH Swapclear completed $9,291bn worth of Interest rate swaps in non-Euro currencies but only $2,692bn of Euro denominated Interest rate swaps.

In addition, when non-EU countries apply for EU Equivalence, they are most likely hoping to gain access to UK financial services. Allowing the EU Commission to withhold Equivalence has therefore not been to the benefit of the UK financial services industry.

The UK financial services companies should concentrate their marketing efforts on global, rather than EU based clients. The developing economies and emerging markets presently account for approximately 40% of world GDP (see chart overleaf), up from 20% twenty years ago[11]. The G7 economies account for only 42% of world GDP, having dropped from 65% twenty years ago and the EU has dropped from 30% of world GDP twenty years ago to only 22% including the UK and only 18% if you only consider the EU27. It is predicted by PWC that this trend will continue; and by 2050, the G7 economies will have dropped to 20% of the world

[8] Levine, R 2005 Finance and growth: Theory, evidence and mechanisms
[9] King and Levine Finance and Growth, Quarterly Journal of Economics, 108, 1993.
[10] Sam Woods Deputy Governor, PRA, Speech, Mansion House City Banquet, London, 4 Oct 2017
[11] IMF World Economic Outlook Database figures



GDP, while the E7[12] emerging economies will account for 50% of Global GDP at PPPs.[13]

1.3 Post Brexit, the UK could adopt a much more open and competitive approach to mutual recognition in financial services. We should note here that while the UK regulator is often seen to be the most resistant to granting equivalence, the dynamic between UK firms and UK regulators would change post-Brexit, as UK firms will now be dealing with a sovereign regulator as opposed to one that is itself under broader EU supervision.

2 The achievement of global regulatory cooperation

2.1 What are the differences between the existing global regulatory regimes?

Many key areas of financial regulation are already based on international standards set by the Basel Committee of Banking Supervision (BCBS), the International Association of Insurance Supervision (IAIS) and the International Organisation of Securities Commissions (IOSCO). All three work closely with the G-20 Financial Stability Board (FSB) after the G-20 Pittsburgh Summit in 2008 where leaders committed their national authorities to implement global standards consistently in a way that avoids systemic risks, fragmentation of markets, protectionism and regulatory arbitrage. There are many different types of Global regulatory regimes but countries have still managed to form cooperative regulatory alliances allowing cross border financial service transactions. (See appendix A for a comprehensive list.)

[12] E7 = China, India, Brazil, Russia, Indonesia, Mexico and Turkey
[13] The World in 2050: how will the world economic order change? Feb 2017, PWC

The FSN Forum in its paper written with Norton Rose[14], Barnabas Reynolds in his paper written for Politeia[15] and the Legatum Institute/ CMS paper[16], have all concluded that a country's regulations should be judged by their principles and outcomes, which should be aligned to the aims of international standard setting bodies where they exist. Principles and outcomes based regulatory coordination allows greater divergence than seeking line-by-line equivalence to a prescriptive rulebook and facilitates more consumer welfare enhancing outcomes. Countries whose regulations meet these principles and outcomes can engage in cross border financial services without the need to be in a single market or customs union with any of their partner jurisdictions.

Recently, the EU and US signed a bilateral agreement on insurance and reinsurance[17], based on regulatory cooperation between well-regulated jurisdictions. The agreement allows US supervised insurers to compete in Europe and EU regulated insurers to operate in the US. The covered agreement eliminates collateral and local presence requirements for qualified reinsurers and streamlines group supervision requirements allowing insurers and reinsurers to operate on a level and more predictable regulatory environment. This agreement represents a critically important, mutually beneficial recognition among the United States and the European Union that insurance and risk are often global in nature.

Financial services regulation must also aim to produce the most competitive market possible, consistent with reasonable prudential goals and ensure that regulations evolve in a less anti-competitive direction. This could be facilitated by a strong financial services component in a trade agreement, as advocated in our four pillared trade policy,[18] which reduces all barriers to services trade, including processes for regulator-to-regulator co-operation and regulatory coherence. The advantage of a trade agreement approach is that it harnesses the power of those firms that seek to break down barriers to services trade, including anti-competitive regulation, in addition to regulator-to-regulator dialogues that often consider only prudential and not competition goals.

Global regulatory regimes are presently focused on market stabilization rather than market access and competition. Our proposed regulatory regime should move the substance of financial regulation in a more pro-competitive, principles based direction, and should not create

[14] FSNForum Norton Rose Fulbright, Examining Regulatory Equivalence, 12 Jan 2017
[15] Barnabas Reynolds, A Template for Enhanced Equivalence, July 2017
[16] Legatum Institute CMS, A New UK/EU Relationship on Financial Services, April 2017
[17] European Commission, EU - US Agreement on insurance and reinsurance, 22 Sep 2017
[18] Shanker Singham, A Blueprint for UK Trade Policy, April 2017

unnecessary entry barriers. Equally, the cost of regulation on new entrants should not create unnecessary entry barriers. Including cost benefit analyses in these mechanisms which included an evaluation of how the proposed regulations impact both trade and competition would be an important of ensuring this overall objective.

Including a more robust financial services chapter in future UK Free Trade Agreements (FTAs), which deals not only with market access and national treatment but also with domestic regulation and conditions of competition, will be necessary for the UK's financial services industry after Brexit.

2.2 How to achieve harmonised and pro-competitive global financial regulation?

There is a need for a globally harmonised approach to financial regulation and several international regulatory bodies have made recommendations as to how this could be achieved. Financial services, like other services, must operate in markets that are open to competition as much as is possible while remaining consistent with any regulatory goal. If cooperating jurisdictions have financial regulations focused on the same international standards as appropriate benchmarks for assessing the regulatory outcomes, rather than a strict adherence to line-by-line regulations, then they should be able to defer to the relevant foreign regulator in matters of host state supervision. If international standards were robust and comprehensive enough, regulators would be able to be confident that adherence to them by other countries would address their supervisory concerns.

International Organization of Securities Commissions (IOSCO) is the leading international policy forum for securities regulators and is recognized as the global standard setter for securities regulation. The organization's membership regulates more than 95% of the world's securities markets in more than 115 jurisdictions.

IOSCO has no legal jurisdiction, but aims through its soft power to promote adherence to internationally recognized and consistent standards of regulation, oversight and enforcement, in order to:

- protect investors,
- maintain fair, efficient and transparent markets, and
- seek to address systemic market risks.

IOSCO encourages regulators to exchange information at both global and regional levels on their respective experiences, in order to assist the development of markets, strengthen market infrastructure and implement appropriate regulation.

As we consider the IOSCO and Financial Stability Board (FSB) systems, it is important to note that these are international standard-setting fora and it is outside their remit to consider competition in markets. It has also proved extremely difficult to have regulators adopt competition-based approaches to regulatory promulgation.

In its 2015 report[19], IOSCO concluded that cross border regulation needed international standards in mutual recognition. IOSCO considered both unilateral and multilateral bases for recognition. Under unilateral recognition, such as the EU's equivalence system, cross border activities of a firm from a recognised foreign jurisdiction are permitted to take place under specific conditions. Under multilateral recognition, regulators in two or more jurisdictions recognise each other in respect to the same cross border activity. The advantage of multilateral recognition agreements would be to incentivise reciprocity between the countries involved.

In 2014 the FSB published a report on "Deference"[20], stating that 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, paying due respect to home country regulation regimes. The FSB's concept of deference requires the recognition of another country's regulatory regime as achieving similar outcomes, and for the home state to rely on that country's regulators provided that information sharing and supervisory cooperation arrangements are in place.

We believe that a Global Regulatory Framework should follow both IOSCO outcomes and mutual recognition, and the FSB recommendation of deference when regulations are based on similar outcomes while also ensuring that markets remain competitive.

2.3 How would disputes be settled between Countries?

Modern FTAs include dispute settlement mechanisms. Under the Canada/EU Comprehensive Economic and Trade Agreement (CETA), disputes

[19] IOSCO Task Force on Cross Border Regulation: Final Report, FR23/2015, Sep 2015
[20] FSB, Jurisdictions ability to defer to each other's OTC derivatives market regulatory regimes, Sep2014

between Canada and the EU will be settled by an independent tribunal. The EU and Vietnam have also included an investment dispute resolution system in their 2015 Free Trade Agreement expected to come into force in 2018. This system has international standing and a fully independent Investment Tribunal System where members are appointed in advance by the EU and Vietnam, subject to strict requirements of independence and integrity. Cases will be heard by divisions of three members, one from the EU, one from Vietnam and a presiding member from a third country. There will also be a permanent Appeal Tribunal.

It would also be possible to include regulatory co-ordination and regulatory coherence chapters in an FTA as a matter of law and form, in which case a similar process of crafting a dispute settlement mechanism that escalated disputes to a hierarchy of committees, before ultimately referring to independent, binding arbitration could be applied.

3 The EU's equivalence and passporting regime

UK based banks and financial service companies, which do not have a subsidiary in the EU27, will lose their passporting rights when the UK leaves the EU. Despite the name, the EU's passporting regime is not a single, comprehensive, registration system; the 5,476 UK firms that currently hold EU passports have on average 61.4 passports each, covering different EU Member State regulatory areas. After Brexit, the UK will need to operate under the EU's 3rd country equivalence regime, where available, unless a mutual recognition regime can be established.

EU Equivalence is the European Commission's permission allowing providers authorised in one country to transact financial services in the EU without being separately authorised in the EU member state. Although a country must have adequate regulations to be granted EU Equivalence, it is not the only consideration of the EU Commission; politics, reciprocal benefits and local protectionism all play their part as well. While at the point of Brexit on 30th March 2019 the UK will have identical financial regulations with the EU27, it cannot be assumed that the UK will necessarily be granted Equivalence.

3.1 The main weaknesses of the EU's Equivalence regime

- EU Equivalence does not cover the entire spectrum of financial services. Of the 32 EU areas where Equivalence is available, 18 presently have no Equivalence status granted to Non EU countries. There are also some EU regulations that do not include Equivalence

provisions, in these areas market access will depend on the national regimes of each member state.

- EU Equivalence is not granted on purely consumer protection and market stabilisation concerns.
- EU Equivalence is a unilateral and discretionary act of the Commission after the Non-EU country applying for EU Equivalence has met all of the requested criteria of the relevant EU regulatory colleges.[12]
- Equivalence may be granted to a country only partially or only for a

  specific time period or for only certain products, competent authorities or entities.[12]
- EU Equivalence can also be changed or withdrawn at any moment.[12]
- A European Commission Equivalence act must be confirmed by the EU member states in a regulatory committee vote and European Parliamentary observers are invited to all meetings of the regulatory committee,[21] thus opening the process to politics, protectionism and general horse-trading.

3.2 Would the EU Commission grant the UK Equivalence?

Factors that can be taken into consideration when granting EU Equivalence include; 12 promoting the internal (EU) market for financial services, the size of the relevant 3rd country market, its importance for the functioning of the internal EU market, the interconnectedness between the 3rd country and the EU and “the risk of circumvention of EU rules may play a role”.[21] This assessment seems directed at the UK post Brexit, certainly, the UK is by far the most interconnected financial market to the EU and the continuing flow of capital from the UK banking system is important to EU businesses. However, the paper seems to suggest that should the UK deviate too far from its present completely harmonised financial regulations, then it may not be granted EU Equivalence.

There is some precedence for countries meeting all of the EU’s stated regulatory requirements but still not be granted EU equivalence. The most obvious case of this was the application for AIFMD passports by Non-EU

[21] European Commission, Commission Staff Working Document, EU equivalence decisions in financial Services policy: an assessment. 27.2.2107, SWD(2017) 102 Final

countries in July 2015 and again in September 2016. Despite meeting the equivalence requirements on both the 2015 and 2016 applications neither Guernsey, Jersey nor Switzerland were granted AIFMD passports.

It is for these reasons that we are proposing that the UK, while seeking to improve the process of EU equivalence, and seeking a free trade agreement with the EU which enables regulatory recognition and a reduction of anti-competitive regulation must, at the same time proceed to create an enhanced global regime of market cooperation and mutual recognition with likeminded global financial centres.

However, it is important to reiterate that most wholesale banking activity is not discretionary expenditure but a vital tool enabling corporations and banks to raise capital and hedge or insure their market exposure. It is estimated that the UK has 90% market share of EU27 wholesale banking[22], including foreign exchange, issuing and trading securities and derivatives, it is hard to see how the EU will be able to make up the loss of access to UK markets if they do not allow current levels of access in wholesale markets or something close to it, to continue.

In their paper, Sapir, Schoenmaker and Veron[23] have proposed that part of the UK's banking industry could move to the EU27 after Brexit but also note that for this to happen the EU27 needs governance reform, greater power for ESMA, forming the Banking Union, policy integration, improved infrastructure, increased skills base, English language proficiency, and more flexible tax and employment laws. As all of this will take some time to achieve, and as wholesale banking is essential for both EU27 corporations as well as banks, it is imperative for the EU to agree to a means of maintaining integration in wholesale banking even if only on an interim basis until a formal agreement between the UK and the EU is concluded.

3.3 Novating existing EU Equivalence agreements

Thirty two of the world's largest financial centres already have financial service trade agreements based on some level of EU Equivalence. It is important for the UK to sustain sufficient equivalence to enable these agreements to novate more easily to the UK post-Brexit ensuring the smooth continuation of trade. Existing equivalence should continue as part of the European Union Withdrawal Bill.

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[22] Sapir, Schoenmaker, Veron, Making the best of Brexit for the EU27 Financial System. Feb 2017

[23] Sapir, Schoenmaker, Veron, Making the best of Brexit for the EU27 Financial System. Feb 2017

The UK should also further develop in other fora, avenues to deliver pro-competitive regulation and ensure that the EU Equivalence process, as well as other countries regulatory recognition mechanisms, are disciplined by ordinary international trade principles of market access, national treatment and ensuring equality of competitive opportunity in domestic regulation. Under the General Agreement on Trade in Services (GATS), where a WTO member has accepted a commitment in a service (and many members, including the EU, have accepted commitments in financial services) there are a number of disciplines on how regulations are administered and requirements on licensing and qualification requirements and technical standards.[24] The GATS provides for WTO members to be able to recognise the regulations of other countries (including specifically prudential measures)[25] without violating the Most Favoured Nation (MFN) principle. Where recognition is given to one country, it must be made available to other countries that meet the same criteria. In the case of financial services, these provisions are subject to the so-called prudential carve out, which permits members to take measures for prudential reasons (such as financial stability and protection of investors), notwithstanding the other commitments in the GATS[26].

In terms of future development in the area of regulatory recognition, the principles that apply to trade in goods and agriculture are built on the broad goal that regulatory recognition mechanisms should be available to parties as long as the regulatory goals of the parties overall are the same, even if technical regulation differs. The WTO Agreement on Sanitary and Phytosanitary Measures (the "SPS Agreement") (which covers measures relating to animal and plant health and risks arising from diseases carried by animals, plants or products thereof) compels recognition of other members' SPS regulations even if they are different, as long as it can be objectively demonstrated that they meet the appropriate level of SPS protection.[27] The WTO agreement on Technical Barriers to Trade (the "TBT Agreement") (which covers technical regulations in relation to all goods) requires that Members "give positive consideration to accepting as equivalent technical regulations of other Members, even if these regulations differ from their own, provided they are satisfied that these regulations adequately fulfil the objectives of their own regulations"[28]. Each of the GATS, the TBT Agreement and the SPS Agreement require and encourage reference

[24] GATS Article VI
[25] GATS Article VII and paragraph 3 of the Annex on Financial Services
[26] GATS paragraph 3 of the Annex on Financial Services
[27] SPS Agreement article IV
[28] TBT Agreement article II

to and development of international standards to inform decisions as to equivalence and appropriateness of the relevant regulations[29], so there is a firm footing in existing WTO rules to progress further in these areas.

4 Risks to the financial services market post Brexit

There has been some discussion that the European Central Bank (ECB) may try to regulate that all Euro denominated transactions by EU banks are cleared through clearing houses based in the Eurozone. Dividing the Euro denominated OTC market would only reduce both markets' liquidity and fracture the counterparty netting system, both of which would increase the overall euro market risk. An additional problem of enforcing the movement of euro clearing to the Eurozone would be that most existing OTC derivative contracts are transacted under UK common law and the EU may be minded to mandate a Eurozone choice of law. An equally big risk would be to the overall prosperity of the EU economies and export sectors that rely heavily on the UK financial service sector to supply their capital, foreign exchange, hedging and investment products.

4.1 Clearing- Why Dividing Clearing Operations Increases Risk

A broker and, at a higher level, the clearing house, will collect initial and variable margins on all positions, from both buyers and sellers, even though due to the binary nature of the markets, when one trade loses, the other obviously gains. However, both counterparties must post equal amounts of initial margin to ensure that they can fulfil their obligations should they be on the losing side of the transaction. For instance, in Sep 2017, 1 FTSE100 futures contract, had an initial margin of £3,621 which represents a movement of + or - 362 index points. Investors must also pay daily variation margins if the market moves against them, and if they hold a profitable position their account will be credited with their gains but this money will not be available to them until their position is closed.

Since the G20 Pittsburgh summit in 2009, in order to reduce the systemic risk in the OTC market, all standardised OTC derivatives should be cleared through a central counterparty or be subject to higher capital requirements.

Rarely will a brokerage house have a completely netted position between buyers and sellers, but as no trade can be done without a counterparty, at the higher clearing house level, more trades will cancel out. If there were, only one clearing house then all cleared trades would cancel out,

as there are always equal amounts of purchases as sales. The threat by the ECB to force EU based banks to clear Euro denominated transactions in the Eurozone, would divide the clearing system, reduce this netting, and increase the capital required for collateral. At the end of Dec 2016 the notional amount of outstanding OTC derivative contracts stood at $483 Trillion, while the gross market value of outstanding OTC derivative contracts, (a more meaningful measure of the amounts at risk) was only $15 Trillion however the gross credit exposures which adjusts for legally enforceable bilateral netting agreements was only $3.3 trillion.[30]

Fragmenting the Euroclearing system is even more dangerous as at least seven EU cities are hoping to gain some part of the London market. Dividing the clearing system into several pieces will increase the risk for everyone by reducing the netting effect and lowering the traded volume on any one market. Increasing the risk that a catastrophic event could push the markets beyond the limits of the held collateral or initial margin and the ability of the losing counterparties to pay their margin calls.

Disaggregation of the clearing system will also increase the amount of margin and therefore the amount of capital required by both the clearing members and the CCPs. Many European commercial banks have seen their earnings eroded by the enduring flat yield curve close to zero levels that has reduced their capacity to take risks or provide credit. Dr Markus Krall expects most German commercial banks to start suffering substantial operational losses from 2019/20 onwards[31]. Increasing the collateral requirements on their hedging books will only add to this balance sheet pressure. Writing in The Times in May 2017, then London Stock Exchange CEO Xavier Rolet, estimated that the multicurrency efficiencies of the LCH alone saved its customers $21 billion in capital last year. He added that if the EU insisted on trying to implement an artificial and inefficient location based policy for clearing, it would only hurt the European capital markets and the real EU economy.

4.2 Liquidity -Why Lower Market Liquidity Increases Risk

Both buyers and sellers will always gravitate to the largest market, as it will always give the most efficient pricing. High trading volumes enable investors to buy and sell without influencing the market price, this is

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[30] BIS, Statistical release, OTC derivatives statistics at end December 2016, Monetary and Economic Department May 2017

[31] Dr Markus Krall, The Brexit Negotiations – A German Perspective, Speech to the House of Lords, 24 Oct 2017

especially important when professional investors are trying to move large positions. Dividing the London market up across various cities in the EU will necessarily reduce the amount of buyers and sellers trading in any one of the new EU markets. This will magnify the risk of greater price fluctuations, leading to uninformed, panicked or computerised trading; causing larger margin calls which could force small investors to close out what would have been, in a higher volume market, a stable position. It is for this reason that without any government legislation, a handful of global cities have, over many years, become the major financial market places in their time zone, as eventually all buyers and all sellers will move their business to the market with the greatest liquidity.

A large drop in liquidity in the financial markets is a real risk to investment valuations and can be brought about by ill-informed legislation or overzealous regulations that attempt to tax financial transactions, or protect private investors from market losses or that assume all sales people are unscrupulous. MiFID II prevents stockbrokers from recommending an investment, commenting on market activity or even providing clients with free research on listed companies; all of these issues are predicted to lower the traded volume in individual companies and increase price fluctuations. Many investment banks are predicting a drop in the traded volume of small and medium sized companies because of these regulations restricting “free” research and see a move towards index based passive fund investments. As only larger and established companies are included in the main stock indices, this will lower the ability of small and medium sized companies to find initial investors and raise additional capital through the financial markets.

The extensive compliance systems imposed on every EU bank and broker, attempting to protect investors from unacceptable conduct, have had the unintended consequence of driving many smaller speculators into the accounts of the off-shore financial betting industry. It is unlikely that this was the intended outcome of the MiFID regulations.

Driving out the small speculators and individual investors will always make a market less liquid. A less liquid (lower volume) market has fewer lots available at the bid (buying price) and the offer (selling price). This means that if an investor needs to close out his position quickly he will be forced to sell at the bid price regardless of whether it reflects the true value of his investment. The investor may also find that even that bid price is not available for more than a small part of his investment. Illiquid markets are also dangerous because they give investors a false impression of

their investments' value as the purchase of a small number of units can push the price up momentarily. It would be impossible to comply with the MiFID II "Best Execution" requirements if EU27 investors are not able to access UK or other major 3rd country markets after Brexit.

4.3 Contract Law risks

While it has been noted most recently by the Bank of England in its latest statement from the Financial Policy Committee (FPC) that it is essential to ensure the protection of the OTC derivatives market and to offset risks arising from the continuity of contracts between UK and EU27 counterparties. It is possible that OTC trading activity, at least, could continue under English contract law in the EU27 post-Brexit. Most OTC agreements are based on master agreements drawn up by international derivative groups such as the International Swaps and Derivatives Association's (ISDA). These master agreements are based on common law as it is used in the UK and the US, the world's two largest derivative markets. In their paper on Brexit and the European financial system[32], Batsaikhan, Kalcik and Schoenmaker suggest that market participants expect to continue to be able to use English contract law as a basis for trading documentation and that contracts under English law can be the subject of judicial decisions from EU27 courts. They go on to say that, "The advantage of this solution would be that well-established legal practices (contracts and case law) can continue without disruption."

4.4 Impact of no UK-EU arrangement post Brexit

Commercial sense would suggest that complete absence of equivalence arrangements for the UK and EU post Brexit should be unthinkable. The UK provides at least a quarter of all financial services to the EU27 so it will be difficult for the EU to consider restricting access to UK financial services post Brexit. However, we must of course consider what would happen if such arrangements were not available.

In default of any other arrangements, certain activities would be able to continue in certain member states depending on that country's national regime for overseas providers, but this carries risk and cost in establishing the patchwork of national regulations and determining the boundaries between solicitation and reverse solicitation and the place of characteristic

[32] Brexit and the European financial system: mapping markets, players and jobs, Batsaikhan, Kalcik and Schoenmaker 2017

performance of a financial transaction. In particular, this is not a matter of UK regulations permitting the provision of services from the UK; it is a matter of member state regulations permitting the supply of services to customers in their territories.

While EU Member States may choose to use regulation to attempt to attract financial institutions to establish in the EU27 we believe such a course of action would be unlikely. Encouraging large international banks presently based in the UK to form a subsidiary in a EU27 state, would also allow them to provide retail services that could easily wipe out the existing smaller local banks and investment providers. There would also be no way for the member state instigating the restrictive regulations to ensure that the UK based bank choose to form a subsidiary in their State as under the EU's free movement of capital and free movement of services, the bank could move to any one the 27 Member States and operate from there.

The high corporation tax and social security contributions as well as strict employment law in the larger EU27 countries will discourage some international banks from moving large parts of their UK operations there. However, many EU27 countries have recently lowered their taxes or announced tax cuts in the near future which unfortunately coincides with the UK introducing an additional bank corporation tax surcharge of 8%. This surcharge makes the UK relatively less attractive to the banking industry, one of the UK's major industries. (See appendix C)

The UK is by far the major provider of wholesale financial services to EU banks and corporates, providing roughly three quarters of all EU OTC derivatives and EU foreign exchange, both are essential tools of commerce used for hedging exposure to interest rate movements and international payments for exporters. However, most of these transactions are provided from dealing rooms based in the UK, the trades are then cleared in the UK and even the counterparties could be UK based EU27 bank branches. It is unlikely that the UK authorities will prevent UK banks and CCPs from providing these services to EU27 customers post Brexit as financial services are one of the UK biggest exports. Several of the largest EU27 headquartered investment banks have already announced that they will continue to run their UK operations after Brexit in order to remain part of London's international financial markets.

Nor would the EU necessarily want to stop these transactions immediately as they presently do not have an EU27 based comparable industry

and such financial services are important to the prosperity of EU27 businesses. However, it is possible that, in the hope of building up a competing wholesale banking business in the future, some member states could try to limit cross border wholesale banking from the UK. We believe that this could be a dangerous path as under WTO MFN rules, it would be hard to close access to UK financial markets while retaining access to other major international financial markets. Historically extending the limitation on cross border financial services to total exchange controls has had disastrous results on economies. However, the EU presently imposes currency controls on Greece so it is not out of the question that the EU could attempt to introduce such controls but even in the case of Greece, the EU allows inbound movements of capital and only applies restrictions to outbound transactions.

MiFID II, which came into force in Jan 2018, permits a service provider in a third country to provide investment services and activities to certain types of client and on the exclusive initiative of the client without requiring authorisation or registration in the EU. This would enable some MiFID business to continue even in the absence of Equivalence.

We should also not assume that all banking services from the UK into the EU27 are equally important, for instance, the UK does very little retail banking into the EU27 with less than 1% of UK retail bank loans going into the EU27.

Individual EU Member States have national discretion to allow 3rd country financial institutions to provide services limited to their territory to EU professional investors in the absence of an equivalence decision.[33] The reality is that between 2007 and 2015 the 9 wealthiest EU member states[34] with capital hungry and/or export orientated industries, bought on average, 86% of all UK financial service exports to the EU.[35]

From the UK's perspective, EEA entities will become "overseas" following Brexit, and so will be entitled to rely on the "overseas person's exemption", even absent a comprehensive EU-UK deal, provided they satisfy the criteria for such exemption. The UK could also "Grandfather" in financial services firms currently operating through the EU passport system into the

[33] European Parliament, Directorate-General for Internal Policies, Implication of Brexit on Financial Services 2017
[34] France, Germany, Netherlands, Italy, Ireland, Spain, Luxembourg, Belgium and Denmark
[35] ONS, Trade in services, exports and imports by type of services, 2007 -2015, Aug 2016

UK. This would only cover existing firms to the extent that they currently hold EU Financial Passports.

It is important that the UK government and private sector, fully explain to the European Commission that the EU and the UK have extremely integrated financial systems. The idea that the EU will be able to walk away from the UK financial markets on 30 March 2019 and move to another EU provider at a large scale is not realistic as there are currently no 3rd countries with CRD IV EU equivalence. EU corporates will not find another immediate and local source of capital to replace the UK financial system and any other provider of capital outside of the EEA would also be subject to the same limitations as banks in the UK post Brexit. The results of this would be an increase to the cost of capital for EU corporates.

4.5 Capital Adequacy

At present there are 552 EU based firms using the CRD IV wholesale banking passport to gain access to the UK. However, CRD IV, the European regulation that translates the Basel commitments on capital adequacy, does not provide for an equivalence mechanism. Third country authorisation requirements for deposit taking and lending are therefore un-harmonised and still with member state competence and each member state operates a different regime on a spectrum of openness. In August 2016, the UK accounted for 49% of private equity funds raised, 30% of equity market capitalisation and 26% of bank lending in the EU. It will be difficult for the EU27 market infrastructure and banks to make up this lost market capacity and capital if there is no EU deal with the UK or if the EU tries to restrict access to the UK financial markets[36]. It has been estimated that if the EU manages to force even a third of the UK wholesale banking to move to the EU27 that this would increase the cost of capital in the EU27 by 0.5% to 1% of the EU27 GDP.[37] Simply raising enough capital to compensate for the loss of access to UK capital markets and restructuring existing debt holdings out of the UK would be equally problematic and also add to the cost of capital.

As all of the large global banks based in London also have at least one branch or subsidiary in another EU27 location, it is likely that EU firms will

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[36] Implications of Brexit on EU Financial Services, Directorate-General for internal policies, European Parliament 2017.

[37] European Parliament, Economic and Monetary Affairs, Implications of Brexit on EU Financial Services, 2017

still be able to trade with UK based banks unless future EU regulation tries to limit access to 3rd country markets. The EU's regulatory flexibility in this regard is limited in some ways by the financial service commitments under the GATS and the associated Understanding on Commitments in Financial Services, although these provisions would not prevent EU member states from requiring local licensing and capitalisation. In many cases, EU corporations have established or will be able to establish offices in the UK in order to continue to have unrestricted access, as customers, to UK financial services and markets. The UK and other WTO members shall seek to deepen WTO commitments in financial services as soon as the UK is able to do so.

EU member states have national discretion to allow UK financial institutions to provide banking services limited to their territories, and this is something the UK should negotiate with national regulators. It is more likely to be available in respect of wholesale customers, which accounts for most of UK banking activity into the EU27 in any event.

4.6 Fund Management

The European Fund and Asset Management Association (efama) calculates that Assets under Management (AuM) in the EEA were €22.8tr at the end of 2016. Institutional clients including insurance companies and pension funds represent 73% of the total AuM with retail investors accounting for 27%. The UK is the largest asset manager in the EEA with €7.8tr AuM representing a 36.3% market share[38]. The UK market share is roughly equal to the next four biggest EU markets, (France, Germany, Netherlands and Italy) added together. The Investment Association estimates that only 16% of assets managed in the UK are tied to EEA clients.

Post Brexit, UK Alternative Investment Managers (AIFs) will be able to market their funds through an EU AIFM to professional or "qualified" investors or get authority through the member states National Private Placement Regime (NPPR) where these exist. The UK is the dominant provider of Alternative Investment Funds in the EU, in Aug 2016 it was estimated that the UK managed 85% of Hedge Fund Assets in the EU and 49% of Private Equity funds in the EU.[39]

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[38] Efama, Asset Management in Europe, May 2017

[39] Impact of Brexit on EU Financial Services, Directorate-General for internal Policies, European Parliament, 2017

Efama calculates that there were €8,658bl net assets held in Understandings in Collective Investments in Transferable Securities (UCITS) funds at the end of 2016;[40] the UK is by far the largest UCITS manager in the EU, but over 50% of UCITS funds managed in the UK are domiciled outside the UK. The EU's "delegation" regime allows funds to be domiciled and regulated in one EU country, typically Dublin or Luxembourg, while being actively managed and marketed from another, typically the UK. Any attempt by the EU to reverse the "delegation rules" in investment management would also have ramifications for other 3rd country managers as well as the UK. However, if the EU does reverse the delegation rules, then the UK should actively encourage investment funds presently managed from London, but domiciled in the EU27, to move their domicile either back to the UK or to other financial centres such as the British Overseas Territories and Crown Dependencies.

Another issue for fund managers is the UCITS brand itself as UCITS funds must be both registered and domiciled within the EU as well as complying with all EU UCITS fund regulations. After Brexit, UK registered UCITS could no longer be called UCITS even if they continue to comply with the UCITS regulations and the UK authorities would need to develop a UK authorised investment scheme that is comparable to the UCITS or the US Mutual Fund scheme. The UK regulators should also allow the new UK retail funds to be domiciled in non EU jurisdictions, as Germany has done with Swiss retail funds, provided those jurisdictions meet UK investment regulatory standards.

4.7 Insurance

The insurance industry will be less effected by Brexit as it has always operated on a basis of subsidiaries and branches in EU member states with separate legal entities. Insurance and reinsurance companies fall within the European Solvency II regime of equivalence. This equivalence gives mutual recognition of solvency capital, Group regulation for multi-nationals, and credit worthiness of reinsurance. Currently Bermuda and Switzerland have full equivalence. The recent agreement between the EU and the USA will give mutual equivalence. Others territories have applied to European Insurance and Occupational Pensions Authority (EIOPA) to join the list. Whilst 3rd countries may be deemed to be EU Equivalent, the structure of their solvency regimes can vary considerably.

Solvency II has been adopted by the FSA / PRA and it can be argued that, of all the countries that now fall within its scope, the UK has been

[40] Efama Annual Report 2016, European Investment fund developments in 2016

the most rigorous adopter. Lloyds, in particular, with its mandatory adoption of a full internal model has led the way in the most sophisticated methodology envisaged by Solvency II. EIOPA should therefore have no issues with recommending Solvency II equivalence for the UK to the European Commission at the point of Brexit.

4.8 Impact on the EU if no adequate regulatory recognition arrangement is negotiated

Some EU academics have suggested that a “No Deal” with the UK could potentially force the breaking up of UK financial Services and allow EU firms to gain some of the UK’s massive market share. We submit, however that this is unlikely to transpire, for several reasons. First, within the EU-27 after Brexit, free movement of capital will continue to apply under Article 63-66 of the Treaty on the Functioning of the European Union (TFEU). In practice, this means it will be very difficult for any one EU city to emerge with sufficient depth and liquidity to challenge London or the other global financial centres likely to attract business as opposed to any nascent centres in the EU-27. Trying to force people to use their local markets while there is electronic banking, screen-based trading, fintech and the free movement of capital would be impossible without external currency controls which limit capital raising to the extent of local savings. It is just as likely that EU corporates will open financing offices in the UK. However, in either scenario a fractured or divided market will result in lower volumes (liquidity) and consequently higher risk in all EU/UK markets, causing an increase in collateral requirements and the cost of capital in continental Europe. There would also be the additional risk of UK and EU consumer confusion due to the differentiated standards of protection and restricted access to investment products.

The real question that we should be asking is whether the UK regulators should grant the European Union “UK Equivalence”, a UK seal of approval of well-regulated markets, post Brexit? The following questions would have to be answered. Are the EU markets well regulated following international standards and more importantly are these regulations being enforce in an open and transparent way? Do EU members add their own local requirements that hinder other EU Member States as well as Non-EU countries from competing for business?

If EU regulations do discriminate against UK providers, and are implemented in anti-competitive ways, the withdrawal of recognition is a powerful lever. In air transport services for example, the US Department

of Trade (DoT) has used the withdrawal of landing rights as a threat used against countries that operate protectionist or anti-competitive rules in respect of the treatment of foreign air transport providers. For example, when Argentina charged a tax on US airlines that was applied in a discriminatory fashion, the US DoT withdrew landing rights from the Argentine carrier, Aerolineas Argentinas resulting in the quick resolution of the Argentine tax issue.[41] Similar levers certainly could exist for the UK in the event that it is faced with protectionist or anti-competitive regulation in the EU post-Brexit.

5 The evolution of a global regulatory regime

5.1 Establish regulatory coherence and a cooperative agreement between the UK and EU27

The EU and the UK should continue to operate as they do now with a consensually established set of regulations, based on international standards, mutual transparency and cooperation between home state regulators, provided that such cooperation does not prevent either party from diverging, nor allow such divergence to act as a "hair-trigger" to loss of recognition. Such cooperation should include shared cost benefit analyses in regulatory promulgation having regard to a range of factors including impact on trade and competition. EU financial services regulation aims to ensure financial market stability, equal access to all types of financial products and markets and consumer protection. We believe that financial services regulation must also ensure that regulations do not prevent competition or discourage new service providers.

It is important that the intention to establish a coherent regulatory recognition regime between the UK and the EU is announced as soon as possible and that it is operational from 30th March 2019. This will remove the pressure on financial service providers to deploy contingency plans that may require establishing fully licenced and capitalised subsidiaries in the EU or the UK. It is extremely important for the EU that such an agreement is reached as UK financial services currently provide at least a quarter of all financial services in the EU27. Another threat to both the UK and the EU is that the US financial centres could become more attractive if tax reductions and regulatory improvements proposed by the present administration come to fruition.

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[41] Aerolineas Argentinas S.A. v U.S. Department of Transport 415F.3rd (D.C. Cir. 2005)

A major barrier to cross border financial services is full host state regulation in addition to the application of regulation in the home state. Conduct of business is likely to remain the domain of the host state. Coherent regulatory co-operation would permit regulatory divergence within agreed parameters provided that the criteria for assessing sufficiency and proportionality are not breached. At present, the EU grants market access to 3rd country providers through its system of Equivalence. However, as noted above, EU Equivalence is unilateral, it does not cover the entire spectrum of financial services and it is not granted on purely consumer protection and market stabilisation concerns. Countries may meet all of the EU's stated regulatory requirements but still not be granted EU Equivalence.

As mentioned previously, the EU27 market infrastructure and EU27 banks do not have the capacity or infrastructure to provide the services and capital lost if there is no EU deal with the UK. In addition, a divided OTC swaps market will result in lower volumes, consequently higher risk, and higher collateral requirements in both the UK and the EU27 markets. It is therefore in the best interests of both the EU and the UK for the ECB and the Bank of England to agree to an enhanced collaborative arrangement addressing the ECB's systemic risk concerns regarding Euro denominated transactions in order to ensure the continued stability of the Euro denominated UK based market. This should be along the lines of the present arrangement between the USA and the UK as regards the clearing of US Dollar denominated instruments by UK central counter parties. Similarly, the EU and the US have recently signed a bilateral agreement on insurance and reinsurance that is an acknowledgement by the European regulatory community that it can rely on third country, home-state regulation.

For the UK/EU process of recognition and co-operation to work better from a starting position of substantial harmonisation, there must be some disciplines on the UK and EU as to how any subsequent divergence will be managed. In addition, if one or other party engages in protectionism or anti-competitive regulation, then the trade agreement between the two sides should allow discipline such as withdrawing authorisation for the offending territory's providers to operate or some other sanction. Establishing an independent dispute settlement mechanism along the lines of modern Free Trade Agreement (FTA) will be critical.

UK/EU financial services regulation should ensure financial market stability and investor protection but also ensure that regulations do not

prevent competition or discourage new service providers.

Any market access restrictions that effectively amount to restrictions on movement of capital may be vulnerable to a challenge under article 63 TFEU, but the EU's and member states' default third country regulatory frameworks (which would apply to the UK in the absence of a deal) do not appear to violate this article at present and are presumably permitted in any event under article 65 (b) as "requisite measures to prevent infringements of national law and regulation… in the field of… the prudential supervision of financial institutions."

5.2 A Strong Domestic Regime

The UK should establish a market friendly regulatory framework, in line with global standards and best practices established by the BCBS, IOSCO, IAIS, FSB-G20 and other international standard setting bodies. The new regime would allow Britain to reshape its financial regulation by removing any unnecessary processes and focusing instead on the outcomes produced by that regulation. The purpose of the regime should be to limit systemic risk and protect consumers from unacceptable conduct without stifling the provision of capital, investment opportunities or insurance provision to companies and individuals. A market friendly regulatory framework would allow the UK to establish alliances and cooperate with other countries and businesses that achieved similar regulatory outcomes reached in a similarly transparent manner.

5.3 Building on WTO Disciplines

The UK should pursue with renewed vigour and urgency the built-in agenda on services in the WTO and actively push for deeper liberalisation. In the WTO, the direction of travel was for gradually increasing services coverage starting with the GATS agreement itself. In 1997, after the conclusion of a Basic Telecommunications Agreement and Reference Paper, financial services was to be the next sectoral area to be considered for increased liberalisation and removal of trade barriers. The Financial Services Understanding, negotiated by WTO members, was intended to pave the way for a deeply liberalising agreement like the Basic Telecoms Agreement. Regrettably with the collapse of the trade liberalisation consensus in 1999, and the subsequent stalling of the Doha Development Agenda, very little progress has been made in the subsequent twenty years on any meaningful liberalisation. In addition, the built-in services agenda was supposed to include the following elements:

- liberalise more fully market access and national treatment across all sectors,
- ensure that domestic regulation and conditions of competition were properly considered.
- build on existing WTO disciplines that relate to domestic regulation and mutual recognition in existing WTO agreements so that financial services can be more liberalised and domestic regulation not act as a barrier to trade or competition;
- ensure competition safeguards that clarify that any prudential carve-out is limited to regulation, which is sufficient and proportionate to the prudential goal, and not used to shelter anti-competitive and discriminatory regulation.

This financial services agreement could possibly include a reference paper on such competition safeguards, as was the case for the Basic Telecommunications Agreement, especially if a clear pattern of abuse of the prudential carve-out could be identified.

5.4 An alliance with the other major financial markets

Having established a strong domestic regime in line with global standards and best practices established by the BCBS, IOSCO, IAIS and the FSB-G20, the UK should welcome financial alliances with all countries and businesses that achieve the UK's regulatory outcomes in a transparent and cooperative manner. Developing a coherent regulatory regime with other major financial markets would keep the UK involved in the regulation formation and dispute resolution.

The UK should look at the F4 Alliance project, proposed by the Swiss Bankers Association. They have suggested an alliance between the UK, Switzerland, Hong Kong and Singapore that would agree upon issues such as common definitions and interpretations of international standards. This could grow to include other interested parties such as New York, Chicago, Tokyo or the Crown Dependencies. Combining the global financial centres into a cooperative regulatory alliance would allow this global alliance to agree an acceptable mutual recognition regime as well as giving the combined bloc a strong negotiating position when discussing regulatory matters with other global financial centres and ultimately require the EU to negotiate recognition with the UK.

The UK should lead in the international organisations described above

and move them in a more pro-competitive direction. Such leadership should not be limited to UK financial regulators, but also include other agencies such as the UK's trade negotiators (in DIT and DExEU) and its competition agency, the Competition and Market Authority (CMA) who is the prime agency charged with ensuring pro-competitive markets. UK financial services firms should have a strong voice in the UK input into these bodies to ensure that market opening and competition concerns are heard in addition to prudential ones.

5.5 An alliance with UK linked international financial centres

The UK should also look to make comprehensive bilateral agreements based on mutual recognition with the Crown Dependencies (CDs) and the Overseas Territories (OTs), provided their regimes conform to international standards and achieve equivalent regulatory outcomes to the UK. The Banking regimes of the CDs comply with Basel III, a standard not yet fully met by many EU member states. The UK should establish a regime with the CDs and OTs of recognition of and co-operation with their regulations and regulators. As with other 3rd country financial centres, any CD or OT that presently has EU Equivalence recognition should be granted similar recognition by the UK under the mechanisms that will be carried into UK law by the European Union Withdrawal Bill presently before Parliament. This will allow financial services to continue smoothly post Brexit. Bermuda is currently a major provider of North American insurance and reinsurance and has also been accorded EU Solvency II Equivalence for 3rd country reinsurers, EEA subsidiaries in 3rd countries and 3rd country group supervision as well as EU Audit Equivalence. Both Guernsey and Jersey have EU Audit Equivalence and Capital Exposure requirements, while the Cayman Islands has EU Audit Equivalence.

As all of the CD and OT as well as the UK have large asset management businesses, having formed such an agreement, it would make sense for the UK to develop its own version of the EU's Undertakings for Collective Investments in Transferrable Securities (UCITS) authorisation category for managed funds. Presently a UCITS fund must be registered and domiciled in the EU. After Brexit, it has been suggested by Doug Shaw of Roxbury Asset Management that the UK establish a UK Investments in Transferable Securities (UKITS)[42] fund authorization scheme. At the point of Brexit, the UK and EU will still have identical asset management

[42] https://www.linkedin.com/pulse/asset-management-my-brexit-vision-douglas-shaw/

regulations so that existing UK managed UCITS funds should be able to continue to operate as UKITS.This initiative has been picked up by HM Treasury in its second UK Investment Management Strategy paper[43] published in December, which states that the government is committed to establishing a UK regime for UCITS, but without details of the scheme.

In creating a UK authorised investment scheme that can take over from UK managed UCITS funds our goal should be to create a better investment product. The UCITS fund vehicle has become very popular with investors both inside and outside of the EU due to its regulatory strength and high level of investor protection. However, there is potential to be more flexible and proportionate when creating a new UK investment scheme by addressing the problems with UCITS;

- UCITS Net Asset Value (NAV) need only be calculated twice a month unlike an open-ended US mutual fund that must calculate their NAV every day. If UK asset managers want to appeal to US investors used to the mutual fund regime, daily NAV calculations should be included in the new UK regime and this would not be a disincentive for non-US investors.
- The EU's equity short selling rules should be removed as they prevent an investment manager from protecting a fund's gains or capitalising on analysis that a company should be sold rather than bought. The idea that buying is the only legitimate investment strategy causes the equity market to be bias to the positive. For a market to remain healthy and firms to remain dynamic, there needs to be a way for investors to show their expectations of a drop in a company's profits or disapproval of a company's management strategy.
- There is also potential to be more flexible than the UCITS V model from a management perspective. Doug Shaw from Roxbury Asset Management and New City Initiative have both advocated that regulations should be more proportionate for small and new fund management firms. Encouraging new entrants into any market keeps it vibrant. Smaller owner-managed asset management firms must align their interests with their clients in order to survive without requiring prescriptive regulations. Competition encourages good practice and consumer outcomes as well as forcing established asset managers to maintain their performance.
- A more proportionate authorised investment scheme should also reconsider the UCITS V remuneration rules. In order to promote

[43] HM Treasury, The UK Investment Management Strategy II, Dec 2017

effective risk management UCITS V requires that at least 50% of variable remuneration be in units of the UCITS fund; this is intended to discourage managers from taking disproportionate risks in the fund's investments in the hope of getting a large performance fee. While this is a sensible approach for large and established funds, for smaller funds or new market entrants, remuneration in fund units will not pay the managers' bills. Remuneration in fund units is perceived by many UCITS investors to ensure the integrity of the management team, other methods such as investment limits in proportion to the fund's AuM would produce a similar outcome and could be sufficient to allay investor concerns.

After Brexit, the UK would be able to open its retail investment fund market to authorised investment products from both EU and other non-EU providers by reinstating Section 270 of FSMA. The UK should also actively encourage investment funds presently managed from London but domiciled in the EU to move their domicile either back to the UK or to the CDs and OTs that operate acceptable prudential regulations. As the Luxembourg economy is heavily dependent on providing domicile and custodian services for many UK managed funds, currently accounting for 27% of GVA[44], even the hint of such a move, could also help to bring the EU to the negotiation table with respect to the future relationship.

The suggestion has also been made by commentators in the Channel Islands that Brexit could provide an opportunity to catalyse fresh moves towards a global template for global funds regime recognition[45].

5.6 Introduce regulations to encourage innovation

The UK should also introduce a proportionate regime of regulation and taxation for financial service start-up companies. The UK should extend the EU's example of "de Minimis" exemptions in the AIFMD into other areas of Financial Services and Fintech but potentially raise the threshold from €100,000 to £500,000. Singapore has chosen a similar threshold for new and small companies where new private companies incorporated in Singapore are fully exempt from corporate tax on the first SG$100,000 and 50% exempt on the next SG$200,000 of chargeable income for the first three consecutive years of assessment.[46] For small companies a partial tax exemption of 75% is granted on the first SG$10,000 and 50%

[44] https://data.oecd.org/natincome/value-added-by-activity.htm
[45] Dr Andy Sloan, Director of Strategy at Guernsey Finance at the Global Financial Regulation roundtable, 5 Mar 2018
[46] Deloitte, Taxation and Investment in Singapore 2016

on the next SG$290,000 of normal chargeable income applies.

Regulation based on global standards should be proportionately applied to companies that are only dealing in their local markets for local clients. Regulations for small or start-up companies should be set to encourage competition in the local market and capital requirements should take into consideration the risk profile of the company.

Although we expect the UK to be granted EU Solvency II Equivalence, after Brexit there is no reason why the UK cannot evolve its own solvency regime from the starting position of Solvency II. There are concerns about some aspects of Solvency II and its impact on competition in the market. Examples are the burdensome reporting requirements and data requirements of the 3-pillar framework, the overcautious solvency capital requirements, the allowable asset classes and durations, and the encouragement to put too much credibility on probability assessments that in turn rely on small data samples or poor quality data. The UK Government could also consider revisiting the taxation of loss equalisation reserves and catastrophe reserves, or the illegality of using sex as a risk factor in driving or life insurance calculations.

The UK will need to agree a recognition mechanism with the EU to allow it to diverge from the current strictures of Solvency II, without losing the recognition necessary to enable UK providers to continue to do business.

Any divergence should enhance the competitiveness and efficiency of the UK market without eroding the fundamental regulatory goal that underpins Solvency II, which is transparency of an insurer's financial position and its ability to absorb loss. Again, the provisions of any regulatory recognition arrangement should be built on the general trade principle that if the regulatory goal is the same, technical difference in regulatory details should not defeat recognition. However, it is clear that these mechanisms must be negotiated.

5.7 Allow EU27 Headquartered banks with UK branches to continue as branches or quickly convert to subsidiaries post Brexit if necessary

The PRA is also responsible for the host supervision of around 170 international banks from over 50 jurisdictions, including every foreign

Global Systemically Important Bank. This is more than any other EU country. The international banks' UK banking sector assets amount to more than twice UK annual GDP.[47] A foreign bank can operate in the UK as a subsidiary or as a branch. A subsidiary is a separate legal entity from its parent bank, is supervised and can be resolved in the UK, has financial resources and has governance in the UK. In contrast, a branch is part of the same legal and financial entity as its head office and is monitored by its home state prudential regulator.

Under the EU passporting system, EU27 headquartered banks can operate in the UK as branches however the PRA prefers UK based branches of foreign banks to establish a subsidiary. A subsidiary with its own capital, risk management and governance is a more sustainable business model for the EU27 bank to continue offering banking services to UK based retail or SME customers[48].

The UK regulators should put arrangements in place that allow EU27 banks who already have branches in the UK, to continue to operate in the UK provided that their home countries continue to have regulatory cooperation with the UK authorities. This allows regulators to work together to manage cross border challenges to financial stability, implement common standards, and share information when necessary.

The Bank of England has recently announced that it will not force UK based branches of EU27 or EEA headquartered banks and insurers to form subsidiaries in the UK, unless they were conducting retail services, assuming there is ongoing adequate supervisory cooperation between the UK and the EU.[49]

If EU27 Bank branches want to convert to subsidiaries, then the process of conversion should be allowed to start now so that all necessary licences are in place for a smooth transition and continuous trading post Brexit. This would also provide certainty for EU banks trading in the UK and be a show of good faith to the EU that the UK is not planning to restrict EU27 access to financial services.

5.8 The UK as a leader in innovative financial services regulations in global fora

[47] PRA Annual Report and Accounts July 2017
[48] Supervising International Banks: the PRA's approach to branch supervision; Sep 2014
[49] Bank of England: Approach to the authorisation and supervision of international banks insurers central counterparties, 20 December 2017

There is no reason why the UK should not lead the world in basing cooperative regulations on international standards, outcomes and transparency. Such leadership is sorely needed and Brexit could be a critical opportunity to kick-start the global economy after the global financial crisis from which it has not fully recovered.

The UK has a massive advantage of being the dominant European, Middle Eastern and African (EMEA) financial market place. Its language is the language of finance internationally and its legal system forms the basis of most international financial and commercial contracts. Outside of the EU, the UK will have the advantage of greater agility in decision-making and implementation. The UK's objective should be to combine this newfound flexibility with its strength as the dominant financial service provider in the European time zone to form a truly global regulatory regime. The UK should make sure that its home regulation and taxation environment is conducive for financial innovation and market competition.

6 Conclusions

The UK financial services sector has submitted a number of different policy proposals to the government regarding the management of the EU-UK relationship post Brexit. Other think-tanks and scholars have also submitted similar proposals. We believe that distilling out of these proposals some common themes reveals the following broad architecture:

1. The UK should ensure that its regulatory environment continues to provide the best environment for new and existing financial services to thrive. The UK must capitalize on its natural advantages of size, skill, creativity, language, law, time zone and new found flexibility and responsiveness to retain it dominate market position by forming alliances with other international financial centres.

2. The UK and EU should, if possible agree a comprehensive free trade agreement that includes a financial services chapter that gives the maximum liberalisation possible in the areas of market access and national treatment across all modes of supply.

3. Such an agreement should also go beyond what other trade agreements have covered so far, in particular regulatory recognition, coherence and co-operation chapters, which ensure management of divergence while at the same time imposing disciplines on both sides to avoid anti-competitive regulation.

4. Agreements with other countries (such as the US) which also include these disciplines.

5. Advancing the WTO agenda especially the built-in services agenda on financial services, which would include a deeper treatment in the areas, laid out above. In particular, the UK should be a leader in ensuring clarification of the prudential carve-out and ensuring it is not used to support anti-competitive or discriminatory legislation, but that normative principles of sufficiency and proportionality are applied. Such agreement could take the form of a reference paper on competition safeguards, as was the case for the basic telecommunications agreement in 1997. The goal would be to attract other jurisdictions to this in the WTO context.

6. Agreements with other major financial centres along the lines set forth above to ensure that these financial centres have common positions in international organisations.

7. Improvement of domestic regulatory arrangements where possible (such as in the area of fund management), and aggressive marketing

of those models to the deeper sources of capital available in the world. We could ensure that the UK's OTs and CDs are fully utilised to support this effort.

We believe that if these tracks are initiated, the future for UK financial services should be very bright, and the future of the City of London should be secure.

7 Appendices

Appendix A- Existing international regulatory co-operation

There are **National Regimes** where foreign entities, products and operatives must comply with the same requirements imposed by the national regulators on a domestic operator. **Exemptive Regimes** focused on selected aspects of cross border activity of foreign firms where supervisors are in a position to apply broad exemptions. **Passporting** allows for the provision of services within an area regulated by a single supervisory authority, covered by an international treaty establishing a common set of rules which permit market access. Besides the EU there is also an Asia Region Funds passport initiative. **International Agreements** can also allow bilateral or multilateral mutual commitments in financial services to reduce compliance overlaps and enhance regulatory and supervisory reliance. This type of regime has been used by the global insurance and reinsurance industry.

The **USA** has a sector specific approach to equivalence in recognition so that different areas of financial services can benefit from different supervisory tools once they have been permitted to provide services into the US. For example, for derivative clearing organisations the Commodity Futures Trading Commission, (CFTC) is committed to maintaining and improving its system of “Deference” to home country regulators within the Pittsburgh G-20 framework rather than requiring regulatory uniformity[50]. In some areas the CFTC requires a direct ability to enforce against foreign firms through its “consent to jurisdiction” requirement, while for foreign securities exchanges, the CFTC is prepared to defer to the exchanges home regulator.

In **Singapore** the regulator, Monetary Authority of Singapore (MAS), can recognise a foreign firm, as being adequate if arrangements exist for cooperation between MAS and that firm’s home regulatory authority provided that its regulations meet comparable requirements and supervision to those of the Singapore Securities and Futures Act.

In **Australia** the Australian Securities and Investment Commission (ASIC) has a principles based regime of unilateral and mutual recognition to ensure that it protects the interests of Australian Investors, the integrity of

[50] Remarks of CFTC Chairman, J. Christopher Giancarlo, at Burgenstock Conference on Global Forum for Derivative Markets, 12th Sep 2017.

the Australian markets and to manage systemic risks. The ASIC principles use international standards as benchmarks as well as outcome-based assessments of an overseas regulatory regime. The ASIC general principles are focused on conduct, require risk disclosures and allow Australian investors direct rights of enforcement.

Canada has an equivalent regulatory regime and uses a system of MOUs.

Japan has an outcomes based approach using international standards.

South Africa has an equivalent regulatory framework.

Switzerland requires that a foreign entity is adequately regulated and supervised, and that its home regulator allows cross border activities and grants mutual assistance. Switzerland also has bilateral agreements with other countries and groups including Germany and with the EU collectively. All of the examples included here have very similar regulatory regimes broadly based on global standards and some level of mutual cooperation.

It is also possible for countries to run dual regulatory regimes with separate parallel regimes, such as **Bermuda**'s reinsurance industry. Bermuda is a major provider of North American insurance and reinsurance yet it also has been accorded EU Solvency II Equivalence. Both Bermuda and Switzerland have been accorded EU Solvency II Equivalence even though both jurisdictions have different granular regulations and both countries' insurance regulations differ from the EU's insurance regulations.

Appendix B – The EU's equivalence and passporting regime

What are the Weaknesses in the EU Equivalence Regime?

We have to be careful not to confuse equivalence, two things being equal, with the European Commission allowing providers who are authorised in one country to transact financial services in the EU without being separately authorised in the EU member state ("EU Equivalence"). Although a country must have adequate regulations to be granted EU Equivalence, it is not the only consideration for the European Commission; politics, reciprocal benefits and local protectionism all play their part as well.

There are two main weaknesses of the EU's Equivalence regime, one is

that Equivalence does not cover the entire spectrum of financial services; the other is that Equivalence is not granted on purely consumer protection and market stabilisation concerns.

The Equivalence Process

The European Commission performs the assessment of EU Equivalence and the decision to grant equivalence is a unilateral and discretionary act of the Commission after the Non-EU country requesting EU Equivalence has met all of the EU's requested criteria. Sometimes Equivalence may be granted to a country only partially or only for a specific time period or for only certain products, competent authorities or entities. As a unilateral and discretionary act, EU Equivalence can also be changed or withdrawn at any moment however to date this has not happened. An EU Equivalence decision must be confirmed by the EU member states in a regulatory committee vote and European Parliamentary observers are invited to all meetings of the regulatory committee,[51] thus opening the process to politics and protectionism.

While at the point of Brexit on 30th March 2019, the UK will have identical financial regulations with the EU27, it therefore cannot be assumed that the UK will necessarily be granted EU Equivalence in the sectors where EU Equivalence is available and where UK service providers need it in order to continue doing business.

Would the EU Commission grant the UK EU Equivalence?

Of the 32 EU areas where EU Equivalence is available, 18 presently have no Equivalence status granted to Non EU countries. There are also some EU regulations that do not include EU Equivalence provisions. Due to the discretionary nature of the granting of EU Equivalence, many other factors besides market stability and consumer protection can influence the Commission's decision. According to a Commission Staff Working Document published in Feb 2017 factors that can be taken into consideration include "promoting the internal (EU) market for financial services", "the size of the relevant market, the importance for the functioning of the internal market and the interconnectedness between the market of the 3rd country and the EU" and "the risk of circumvention of EU rules may play a role". This assessment seems directed at the UK post Brexit, certainly, the UK is by far the most interconnected financial

[51] European Commission, Commission Staff Working Document, EU equivalence decisions in financial Services policy: an assessment. 27.2.2107, SWD(2017) 102 Final

market to the EU and maintaining the flow of capital from the UK banking system is important to EU businesses. However, the working document seems to suggest that should the UK deviate too far from its present completely harmonised financial regulations, then it may not be granted EU Equivalence, or any EU Equivalence granted may be taken away. To reiterate this point, the Commission working document also adds that it needs to factor in wider external policy priorities such as “the requirement for corresponding recognition possibilities in a third country” and “the need for adequate protection of financial market participants in the EU”. The working document also states that the Commission considers the market share of the third country when granting equivalence, stating that a “high impact” third country whose market operators use the Equivalence access intensively could jeopardise the EU’s financial stability and increase the market risk. Post Brexit, the UK will most definitely be seen as a “high Impact” third country by The European Commission.

Currently wholesale banking in the EU is regulated under the Capital Requirements Directive and Regulation (together CRD IV) legislation this allows deposit taking, lending and payment services while investment banking, providing advisory services, investment services and portfolio management, operates under MiFID. The EU CRD IV regulation does not allow EU Equivalence or meaningful third party access while the MiFID legislation allows EU Equivalence but currently this has not been awarded to any Non EU country. It is estimated that the UK has 90% market share of EU27 wholesale banking, including foreign exchange, issuing and trading securities and derivatives, it is hard to see how the EU will be able to make up the loss of access to UK markets. **Wholesale banking is not discretionary expenditure but is vital for both EU27 corporations as well as EU27 banks, it is imperative for the EU to agree to a means of maintaining integration in wholesale banking even if only on an interim basis until a formal agreement between the UK and the EU is concluded.**

Politics versus Risk Assessment

Countries may meet all of the EU’s stated regulatory requirements but still not be given EU Equivalence. The most obvious case of this was the application for AIFMD passports by Non-EU countries in July 2015 and again in Sept 2016. Six countries applied in 2015; US, Guernsey, Jersey, Hong Kong, Switzerland and Singapore. The same six reapplied in 2016 along with Australia, Bermuda, Canada, Cayman Islands, Isle of Man and Japan. Despite meeting the ESMA regulatory requirements

on both applications where ESMA concluded: “Having regard to the above assessment ESMA is of the view that there is no significant obstacles regarding investor protection, competition, market disruption and the monitoring of systemic risk impeding the application of the AIFMD passport to Guernsey.”[52] Exactly the same conclusion was given by ESMA to Jersey in 2015 and again to both Guernsey and Jersey in 2016.[53] However, the EU Commission has yet to grant either country an AIFMD passport despite the ESMA recommendation.

[52] ESMA’s advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFM’s and AIFs. 30 July 2015, ESMA/2015/1236
[53] ESMA’s advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFM’s and AIFs. 12 Sep 2016, ESMA/2016/1140

Appendix C – EU Tax and Social Security Contributions, as at Jan 2018

Country	Corporate Tax Rate 2018 %	Corporate Contribution Social Security %	Top marginal Tax Rate %	Employee Contribution Social Security %	VAT %
Malta	35.00	10.00	35.00	10.00	18
Belgium	34.00	27.50	53.70	13.07	21
France*	33.00	50.00	45 +3-4%	20.00	20
Germany	29.72 - 33	19.38	47.50	20.43	19
Greece	29.00	25.06	48.00	15.50	24
Italy	27.9 - 29.3	31.78	18.80	9.49	22
UK Banks	27.00	13.80	45.00	12.00	20
Luxembourg**	26.01	15.01	43.60	12.95	17
Spain	25.00	29.90	45.00	6.35	21
Austria	25.00	21.48	55.00	18.12	20
Netherlands	25.00	19.00	52.00	28.15	21
Sweden	22.00	31.42	57.10	7.00	25
Denmark***	22.00	0.00	55.80	8.00	25
Slovakia	21.00	35.20	25.00	13.40	20
Portugal	21.00	23.75	56.50	11.00	23
USA Federal	21.00	7.65	37.00	7.65	varies by state
Estonia****	20.00	33.80	20.00	1.60	20
Finland	20.00	22.08	51.60	8.97	24
Latvia****	20.00	24.09	23.00	10.50	21
Czech Rep	19.00	34.00	22.00	11.00	21
Poland	19.00	21.00	32.00	13.71	23
UK	19.00	13.80	45.00	12.00	20
Slovenia	19.00	16.10	50.00	22.10	22
Croatia	18.00	17.20	47.20	20.00	25
Romania	16.00	2.25	16.00	16.50	19
Lithuania	15.00	31.18	15.00	9.00	21
Cyprus	12.50	7.80	35.00	7.80	19
Ireland	12.50	10.85	48.00	4.00	23
Bulgaria	10.00	19.00	10.00	12.90	20
Hungary	9.00	21.00	15.00	18.50	27

Rates are indicative only and do not include all corporate taxes or deductions

Light Blue denotes Non-Eurozone Countries other than UK and US

* France plans to reduce its corporate tax rate to 28% by 2020.

**Luxembourg has an 80% tax exemption on income and capital gains derived from IP but to comply with BEPS regulations it will no longer apply to trademarks only copyright and patent related income.

***Denmark's Corporate Social Security Contributions are fixed amounts charge annually. DKK 4643 (2016).

****Estonian and Latvian corporate tax is only payable when profits are distributed

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