Brexit Briefing 1

13th September 2016, 08:00 - 10:00
Dining Room A, House of Commons

What are the UK's negotiation options?

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1. The G20 consensus after the crisis was that it was critical to the future safety of the global economy to supervise both markets and globally systemically important banks (G-SIBs) and institutions on a coherent basis. Given that Brexit will involve the dismantling of existing regulatory and supervisory co-operation arrangements covering some of the largest G-SIB, it is important to start thinking about how supervision post-brexit can be configured in order to maximise systemic stability.

2. In order to think about the way in which regulatory structures should work post-Brexit, it is necessary to come up with a hypothesis as to what the post-Brexit European financial landscape will look like.

3. It appears increasingly unlikely that the UK and the EU will reach a meaningful compromise on financial services, since the UK is unlikely - given its current political complexion - to make the necessary concessions on immigration. Consequnelty it is likely tha there will be no interim arrangement in place by the time of the Art 50 notification.

4. This in turn means that banks will start executing their contingency plans as soon as the Art 50 notice is announced. It should be noted that an interim arrangement announced significantly later than the service of the Art 50 notice will have no effect on this implementation – in broad terms, it takes two years to relocate a business, and two years is the time Art 50 provides. If firms are told (say) one year into the process that an interim arrangement will be made available, they will be far too far down the road of restructuring to be able to stop and turn back.

5. The implementation of these plans will result in some shrinkage of the City - the core forecast seems to be that around 20% of the business currently done there will have to be either relocated to the EU or closed. There are also functions (particularly for the non-EU banks with large London operations) which are conducted in London but could equally be conducted in the home jurisdiction - particularly the US). As the attractiveness of London as a financial centre decreases, the tendency to repatriate roles will increase.

6. Given that much of this business is barely profitable, and the costs of relocation are very high, it is likely that more will be closed than will be relocated. However, no global bank can credibly turn its back on the largest trading area in the world. Consequently it is likely that most banks will relocate sufficient staff to be able to continue to serve larger corporates across the EU.

7. Thus a good rule of thumb might be that for every 10 jobs in the city, one will be axed completely, one relocated to the EU and one relocated to the US. The remaining seven will stay where they are.

8. There is an argument that the relocation figure could be lower if the EU and the UK agree equivalence - however, given that equivalence is precarious and can be withdrawn at any time, firms will not refrain from

relocating businesses even if equivalence can be established.

9. This retreat will, of course, be a significant detriment to the UK economy, but is unlikely to be sufficient to cause any major change to the role of the City as Europe's financial centre.

10. It is possible that the EU will seek to create a separate freestanding EU financial centre, located within the Eurozone and competing with and eventually superseding the UK. However this is very unlikely to occur within a timescale shorter than decades. Substantial relocation of financial institutions from London to an EU financial centre would involve infrastructure, premises, regulatory and tax structures and local capability, staff, social and communication links which do not exist today in any possible European alternative centre. It is entirely possible that the EU could, with sufficient political investment and determination, procure this outcome within a 20-30 year horizon. However it is not a practical proposal for the next decade.

11. It is therefore important to think through the impact of this development on the regulation of financial markets. The primary aim should be to reconfigure the arrangements in such a way as to ensure that it does not lead to a reduction in the ability of authorities to address risks to systemic stability, or the ability of supervisors to supervise and bring enforcement action in respect of regulated firms.

12. The EU will cease to have any regulatory voice in the financial centre on which it is dependant. The experience of the 2008 crisis, and in particular the close linkages between the outcomes of financial regulation and the real economy, should make this a cause for significant concern for the EU.

13. The EU will also be a significantly diminished player in global financial regulations, and in some sectors will become irrelevant. Without a significant market in its jurisdiction there will be little for ESMA to do, and MiFID will be a dead letter except to the extent that the UK chooses to adhere to it. . The EU will effectively cease to have a voice in global capital market regulation, which will become a UK/US duopoly. Europe will continue to host a number of globally significant banks, so the ECB and the EBA will continue to have a strong voice in global banking regulation - thus we expect Basel discussions to become triangular between the UK,, the US and the EU. Europe will also remain a significant Insurance jurisdiction. However co-ordination in international insurance regulation is still nascent, and EIOPA will also have the problem of being left to grapple with Solvency 2 without the UK input which largely designed it.

14. This also means that the UK and the EU regulatory systems are likely to diverge for almost the opposite reasons from those which are generally considered today. In practice, the UK financial regulators will continue to worry about new market threats, and to relate rules to address them. It is unlikely that an EU regulatory machinery stripped of its UK component will be either as committed or as capable as the UK, and as a result it is likely that new regulatory policy in the UK will take it away from the EU. Given the relatively close links

between the UK and the US on regulatory policy, we would expect over time that the UK would gravitate to a position somewhere between the EU and the US.

15. This may not be an entirely bad thing. There are a number of problems with the existing EU/US regulatory dialogues, many of which arise from the very different approaches to regulation adopted in the EU and the US. In many regards the UK is significantly better placed to deal with the US than is the EU, and significantly better placed to deal with the EU than is the US. It is therefore possible that the UK bay be able to organise a more effective approach to global regulation than the current duopoly.

16. This does, however, take us back to the question of how regulatory arrangements could be structured between the EU and the UK.

17. It seems clear from the above that the EU should be given some say in the regulation of a market which is likely to be critical to its economic performance - the idea that the UK should simply shut out the EU from having any meaningful voice in the regulation of the City is not sensible.

18. If a structure were put in place between the UK and the EU, however, it seems unlikely - at least in the early stages - that such a structure would form the basis for any market access rights (although this could occur over time). The primary aim would be to Improve the “holy trinity” of regulation - rule making, supervision and enforcement - in practice, to harmonise rule-making, co-ordinate supervision and mutually assist with enforcement.

19. Over time this arrangement could ripen into a set of ”substituted compliance” provisions, under which the fact that a firm is regulated in one jurisdiction justifies a disapplication of the rules of another jurisdiction when the firm does business in that other jurisdiction. However, developing this would be an extended task reliant on political goodwill which is likely to be in short supply after Brexit.

20. The eventual aim in this direction would be a permanent structure on a firm legal base, establishing a framework for long-term collaboration in financial services on a mutually beneficial basis between those jurisdictions which host major markets.

21. The broad principles of such a structure would be:

1) It should support day-to-day co-operation between supervisors in respect of the supervision of financial firms and groups active in multiple jurisdictions;

2) It should support policy liaison between rule makers and legislators in respect of regulatory responses

to market developments;

3) It should provide a forum for discussion as to divergence between laws, rules and supervisory practices, along with a mechanism for deciding whether divergences are substantive enough to threaten mutual treatment;

4) It should provide a forum for agreeing common approaches to third country authorities and rule makers (for example, China, which already hosts a number of G-SIBs); and

5) It should be permanent, and in particular should provide for relatively long disengagement periods in the event of fundamental divergence

22. The establishment of any such structure would require considerable analysis as to its position within the GATS. Both the UK and the EU are bound by the"most favoured nation" (MFN) provisions, whose effect is that a state cannot agree to grant persons in another state rights of access to its markets which are better than those available to other nations. This does not prohibit the grant of preferential rights of access based on mutual recognition of regulatory requirements, since this is explicitly provided for in the GATS as an exception to the MFN rule. However, such an arrangement must, in order to be permissible under the GATS, be open to other countries. Since the Swiss would almost certainly apply for equal treatment as regards any concession given to the UK, this would be problematic for the EU. In practice, this is probably a theoretical rather than an actual problem - the well-known difficulties of determining whether two regulatory regimes are in fact equivalent are such that it is unlikely that the EU (or the UK) could ever be compelled to accept that another regulatory regime was in fact equivalent.

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September 2016