How will EU-UK normalisation impact financial services trade?

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The agreement of the Windsor Framework on the Northern Ireland protocol is an important step towards 'normalisation' of relations between the EU and the UK. One immediate consequence has been speculation that the EU and the UK may disinter and sign the Memorandum of Understanding (MOU) on cooperation in financial services that stalled in mid-2021. While normalisation is clearly a positive for EU-UK financial services trade, it is also important to be clear what improved political relations may change, and what they probably will not.

The agreement of the Windsor Framework revising the terms of the EU-UK Northern Ireland Protocol has been welcomed as potentially opening the way to a wider 'normalisation' of EU-UK relations. One early sign of this has been growing speculation that the two sides might resurrect the MOU on financial services that was negotiated after the agreement of the TCA at the end of 2020. This raises the important question of what normalisation might mean for the EU-UK financial services trade. To know that we need to understand the extent to which the problem with agreeing on advanced forms of financial services market integration for a post-Brexit context was tension elsewhere in the relationship, and where it was a deeper problem.

THAWING THE MOU

The MOU at times risked being both oversold and misunderstood. It was never intended by either side to be a serious additional leg to the TCA that would add to the rights for FS exporters in that agreement. Although the UK was more ambitious than the EU, the aim was to flesh out a set of protocols for how the EU and the UK might cooperate on financial services trade and market integration.

The UK was keen to ensure that this left clear scope open for the use of 'deference' – willingness by one side to rely on authorisation and supervision by the other in a range of ways. The EU itself had already explored these ideas with the US in the context of the TTIP negotiations five years earlier. Leaked drafts of the MOU in 2021 strongly suggested that the document would be a broad set of commitments to cooperation and mutual transparency. But ultimately the EU was unwilling to offer even this limited gesture in the context of deteriorating relations in mid-2021.

So the fact that the MOU is back in play is a good sign in the same way that its stalling in 2021 was a bad one. But it is not ultimately a difficult concession for the EU to make at the level of practice. Nevertheless, it does raise the question of the ways in which easing tensions in EU-UK relations might impact EU-UK financial services trade. The MOU is low hanging fruit. Looking further ahead it is useful to draw a basic distinction between the question of creating passporting-like rights for UK firms in the EU, and almost all other areas of potential cooperation on financial services.

ARE EQUIVALENCE-BASED RIGHTS BACK ON THE TABLE?

The EU decided early in the exit negotiation process to withhold any form of passporting-like rights from the UK. The most important of these are the equivalence-based rights potentially available via the MIFID II framework. These had never been used when the UK left the EU and they were obviously not designed for the use case of a London outside the single market. MIFID equivalence in 2020 would have been a major EU concession to the UK and very asymmetric in its benefits in the UK's favour. More importantly, it would have worked against a broader EU strategy of forcing UK-based investment services firms wishing to serve EU counterparties to relocate adequately into the EU's market and jurisdiction.

This was partly a prudential strategy but chiefly an attempt to erode EU dependence on London and develop alternative wholesale markets inside the eurozone.

Two additional factors are also at work here. The first is that EU firms wishing to serve UK-based clients can use the UK's OPE system to access them in a way that has no equivalent at the EU level or at the level of any EU member state. This creates an additional structural disincentive for the EU to pursue reciprocal cross-border rights. Although the UK is reviewing the OPE, it is unlikely in practice to conclude that it wants to restrict these freedoms, which would disrupt established import relationships in the UK in a way that would be unlikely to deliver proportionate leverage with Brussels.

The second is that the UK authorities themselves have cooled somewhat on equivalence for MIFID as the UK sector has moved to channel much of its exports to the EU through commercial presence there. Additionally, any equivalence framework would involve tying UK practice to that of the EU in a way that UK supervisors were never especially keen on once they lost any measure of influence over that practice. UK rules have already begun to diverge from EU practice, and this will continue.

The key point here is that financial services trade between the EU and the UK should not really be seen as one part of a wider set of trade-offs. The idea of a 'fish for financial services' exchange never had any merit. In practice, nevither side has ever seen it this way and neither are ever likely to. The reason for this is a mix of high politics and prudential reality. The EU already provides relatively good rights for UK firms wanting to establish in the single market. The next level of preferential treatment for UK firms supplying the EU under the TCA (and vice versa) are formal rights to supply services cross-border without a full regulated presence.

This is a big step - the biggest step in financial services trade policy. Technically, this would take us into the territory of equivalence, which independent regulators will not trade off against anything and would in practice require the UK to harmonise its rules with the those of the EU to a very high degree. Politically, they go to the heart of the EU's strategy for its financial services market and its independence from extra-jurisdictional supply, which is similarly resistant to wider trade-offs. The Windsor Framework changes none of this.

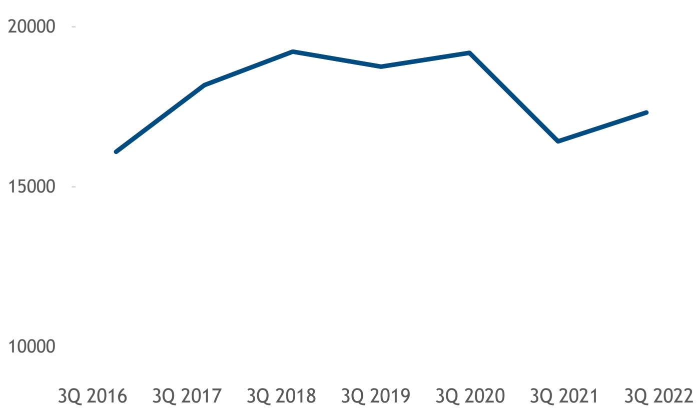
WHAT MIGHT GOOD RELATIONS HELP DELIVER?

This does not mean that the normalisation of EU-UK relations will not be a good thing for financial services. There are three main areas where a more constructive relationship could end up being important.

The first concerns areas where the EU has adopted a political compromise on relations with the UK that could become a

FIG 1: UK CROSS-BORDER FS EXPORTS TO THE EU

Q1-3; £mn



Source: UK ONS. Excludes pensions and insurance services. For further analysis of this trade performance see this useful CityUK assessment

longer-term solution with the right mix of atmospherics and regulatory cooperation . The most important of these is the position on allowing euro-denominated derivatives clearing in London until mid-2025 in the hope that a sufficient capacity will develop in the EU to provide a similar degree of liquidity and netting. Good political relations make it more likely that the hard line on cutting off EU firms from the UK market in 2025 softens permanently into something more pragmatic.

The second is in helping build the trust that needs to underpin long term maintenance of a range of operational models in the EU-UK financial services relationship. Central to these is the scope to delegate certain FS functions from regulated entities in the EU back to operations in the UK (and vice versa). Under current EU practice, UK Alternative Investment Fund Managers and MIFID firms can both benefit from some tolerance for the delegation of portfolio management activities back to the UK by EU-regulated funds in the single market. These can be important for operational efficiency for groups operating in both markets.

On a wider level, the EU framework for commercial banking still allows individual member states some freedom to set the terms of importing some wholesale financial services. These operating channels depend on both supervisory confidence and political tolerance. Good working political relations do not guarantee either. But they are better than the alternative if the aim is to ensure that these kinds of operational integration and efficiency are not politicised and squeezed.

The third is in developing a genuinely strategic regional approach to financial services in a global context. EU-UK cooperation and alignment at the level of the BIS or FSB is an important way of asserting the prerogatives of two jurisdictions that are objectively well aligned in these fora. In areas like the development of green taxonomies in financial services there is obvious scope for collaboration and cooperation if the will is there. The same is true of big geopolitical issues like the future of international payments systems and the development of CBDCs. Neither side is yet willing to confront the basic question of a regional response to the growing strength of New York as a capital market, but any kind of regional approach will need a constructive relationship and a shared set of regional strategic priorities.

This all means that normalisation is unquestionably a good thing for financial services. A change of government in the UK in 2024 and a new European Commission will potentially both also help encourage the sense of a wider reset. But across most areas of the EU-UK relationship removing frictions in EU-UK trade is now a question of returning the UK to a degree of harmonisation with EU practice. This will be politically difficult in most areas, including financial services. The added dimension of EU strategic commitments to developing 'onshore' alternatives to London only compounds that political sensitivity. This means the basic distinction between close cooperation and accommodation and re-integration via cross border supply will remain central to understanding where normalisation might translate into a changed operating landscape, and where it probably will not.

A: 5 Welbeck Street, London W1G 9YQ
E: info@global-counsel.com
www.global-counsel.com
@global_counsel