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Moving apart – the financial sectors in UK and EU post-Brexit

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Brexit has created significant challenges for policymakers in the European Union (EU), particularly in the financial sector, as the UK is now outside its regulatory framework. The EU-UK Trade and Cooperation Agreement includes a very thin financial sector chapter and thus a limited basis for regulatory cooperation. This policy brief discusses recent trends in financial sector regulation in the UK, divergence between the EU and the UK, and the threats posed by this divergence for financial stability in the EU, based on a report for the ECON Committee of the European Parliament. In the medium to long term, the UK is expected to diverge actively from the EU regulatory framework, with a focus on flexibility, common law principles-based approach, competitiveness, growth, and innovation. Such divergence could deepen regulatory fragmentation and undermine financial stability. The brief also elaborates on ways to deepen regulatory cooperation.

Brexit poses unique challenges for financial sector policymakers in the European Union (EU) as the most important financial centre in Europe is now outside its regulatory framework (Beck and others, 2022). At the same time, the United Kingdom (UK) regards its financial sector as a potential growth engine and has been embarking on regulatory reforms to further strengthen the status of the UK as a global financial centre (Edinburgh Reforms, 2022 and TIGRR Report, 2021). In a recent report for the European Parliament, we summarise and discuss recent trends in financial sector legislation and regulation in the UK, divergence between the EU and the UK and threats from this divergence for financial stability in the EU (Petit and Beck, 2023). Critically, we assess the equivalence policy and strategy of the EU towards the UK and options to deepen regulatory cooperation while ensuring financial stability, market integrity and competitiveness.

A renewed regulatory approach in the UK

The UK's approach to regulation will lead to the transfer of most rules from statutory level to the regulators' rulebook, reinforcing the UK tradition of common law and principles-based approach to regulation. Greater responsibility for regulators is one important objective of the recently introduced Financial Services and Markets Bill that intends to amend, repeal or replace specific retained EU law that impacts financial services and insurance activities. This bespoke regulatory overhaul is led in parallel to the Retained EU Law (Revocation & Reform) Bill, a politically controversial bill, which might also raise implementation challenges considering the breadth of the thousands of acts to amend, repeal or replace. In addition, secondary objectives would be added for regulators to 'facilitate, subject to aligning with relevant international standards, the international competitiveness of the UK economy (including in particular the financial services sector) and its growth in the medium to long term' (Hunt, 2022). The secondary objectives of growth and international competitiveness would then differentiate the UK regulators' mandate from its EU counterparts that have a mandate for financial stability, market integrity and investor protection, while protecting the level playing field in the EU Single Market.

Divergence, but how much?

Divergence of UK regulation from EU regulation is almost a given outcome following Brexit. Active divergence would occur when the UK 'deliberately legislates to move away from retained EU Law' (Reland, Ritter and Menon, 2022 and see Table 1). Passive divergence would reflect a status of the UK not keeping up with EU legislative changes.

Table 1: Unchanged and changed retained EU laws (REUL) in the financial services sector

Total REUL	Unchanged	Amended	Repealed	Replaced
443	431	3	6	3

Source: adapted from UK Government, 'Retained EU Law Dashboard' (2023)[1], as of 30 January 2023. Petit and Beck, 2023.

[1] UK Government, "Retained EU Law Dashboard Updated 30 January 2023," Tableau Software, 2023, https://public.tableau.com/views/UKGovernment-RetainedEULawDashboard/Guidance?%3Adisplay_static_image=y&%3AbootstrapWhenNotified=true&%3Aembed=true&%3Alanguage=en-US&:embed=y&:showVizHome=n&:apiID=host0#navType=0&navSrc=Parse; together with data from UK Government, 'Retained EU Law Dashboard - Excel Sheet' (GOV.UK, 30 January 2023) <https://www.gov.uk/government/publications/retained-eu-law-dashboard> accessed 31 January 2023.

There are several areas where the UK has already taken initiatives that could result in regulatory divergence from the EU:

- Proposals for the implementation of the final Basel III reforms differ between the UK and the EU, with the latter deviating from the Basel III agreements with a number of adaptations based on proportionality concerns.
- Both the UK and the EU are considering reforms of the Solvency II regulatory framework for insurers with the objective of fuelling more equity investment by insurers, but through different regulatory adjustments.
- The UK aims at reforming different aspect of its wholesale markets regime and capital market sector, though these reforms are considered low impact for divergence across the channel.
- The UK aims at becoming a global centre for fintech and crypto assets, through a number of regulatory and supervisory initiatives, including a financial market infrastructure sandbox, a FinTech hub at the Bank of England and encouraging the development and use of stablecoins. This showcases a different approach from the EU and will lead most likely to active divergence (with markets in crypto assets regulated as of 2024 and further tightening of regulation expected in this field in the EU).
- The “Greening Finance: A Roadmap to Sustainable Investing”, published in 2021 sets out that UK Green Taxonomy will adopt the EU’s six environmental objectives. However, the UK government is yet to release details, but some divergence is to be expected from the EU green taxonomy.

While there has been thus limited divergence so far, we can expect substantial divergence across different segments of the financial sector during the next five to ten years.

Three scenarios

The degree of divergence can have important repercussions for future cooperation and access of UK-based financial sector providers to the EU Single Market and vice versa. We discuss three possible scenarios of divergence.

- Under low divergence, there will be adjustments to some UK regulations as well as other initiatives in line with increasing the ‘competitiveness’ of the UK as a financial centre, but there will not be major divergence, especially in areas with international standards, such as bank capital regulation.
- Under medium divergence, there will be more significant divergence and fewer attempts to converge on new rules such as in the area of green finance or crypto asset developments. Divergence will be more likely and more prominent in areas where international standards are less important and where the UK has not inherited any EU regulations such as in green finance and digital finance.
- Under high divergence, there would be a rather aggressive legislative and regulatory drive in the UK to diverge from EU rules. This would involve both replacing (or significantly amending) existing EU rules with new regulation and adopting divergent rules where such rules were not inherited. We expect such aggressive divergence especially in areas where UK authorities see growth opportunities and feel less constrained by international fora and cooperation initiatives, such as crypto.

A thin basis for cooperation

While an extensive Trade and Cooperation Agreement (TCA) was agreed in December 2020 between the UK and the EU, it includes a very thin financial sector chapter, with eight out of 783 articles directly covering this sector. Deeper cooperation in the financial sector has so far been held back by the stand-off over the Northern Ireland Protocol. The resolution of this conflict through the Windsor Framework might allow for closer cooperation between the UK and the EU in several policy sectors, but there are a number of impediments. While a Memorandum of Understanding that allows for regulatory cooperation on Financial Services, including the establishment of a Joint UK-EU Regulatory Forum (UK Government, March 2021), is now likely to finally go ahead, the European Commission has made it clear that it sees any action that allows access to the EU's financial market by third country providers as a unilateral decision, not subject to negotiation, as we will discuss in the following.

Equivalence regime

Since the end of the transition period on 31 December 2020, the UK is a third country and therefore subject to the existing provisions in EU financial services and banking regulation that may provide for equivalence with third country regimes. Such equivalence may give access to the EU market and foster cross-border activities as the EU recognises a partial or full equivalence of a third country's regulatory and supervisory framework (see Table 2). The European Commission bases its equivalence decisions on the principle of proportionality and a risk-based assessment (European Commission, 2017), but there is some degree of unilateralism and discretion, including political factors.

Table 2: "Routes" to access EU/Member States market

	Access to the whole EU market		*Access to Member States' market (national)*	
	Equivalence	**Legal entity**	**Third country branch (TCB)**	**National Regime**
Banking (lending, deposit taking)	No	Need to access the EU market	Possible authorisation required	Not specified in EU legislation
Investment services	Yes	Needed in the absence of equivalence to access the EU market	Possible authorisation required	Not specified in EU legislation (but no TCB more favourable treatment)
Alternative Investment Fund	Yes	"	Possible authorisation required	Marketing possible (national and EU Laws)
Market Infrastructure (EMIR)	Yes ESMA recognition (CCPs and Trade repositories)	"	Not specified in EU legislation	Not specified in EU legislation
Credit Rating Agencies	Yes ESMA certification	"	Not specified in EU legislation	Not specified in EU legislation
Central Securities Depositories	Yes ESMA recognition	"	Possible, specific CSDR requirements	Possible
Trade Repositories	Yes ESMA recognition	"	Not specified in EU legislation	Not specified in EU legislation
Financial Benchmarks	Yes ESMA register / Member State recognition	"	Not specified in EU legislation	Not specified in EU legislation

Source: adapted from EGOV Briefing (2019)[2]. Petit and Beck, 2023.

[2] J Deslandes, C Dias and M Magnus, 'Third Country Equivalence in EU Banking and Financial Regulation' (2019) PE 614.495 EGOV In-depth analysis.

In the case of granting equivalence to the UK, there is a trade-off: on the one hand, granting equivalence and thus allowing provision of financial services by UK based firms in the EU Single Market can have positive repercussions for efficiency and competition, safeguarding the level playing field. On the other hand, insofar as the control of risks rely on third country's regulators, there are clear stability concerns, including concerns on data exchange, supervisory cooperation and cooperation during crisis situations, and for the EU's strategic autonomy. In practice, one equivalence expired for Central Securities Depositories (CSDs) and one equivalence has been extended for UK-based Central Clearing Counterparties (CCPs) until June 2025, which is a very thin recognition of equivalence between the EU and the UK in the field of financial services. A similar equivalence has been granted to other third countries (see Table 3). The extension of CCPs equivalence worldwide demonstrates the EU effort to redirect clearing beyond the UK while the EU works on building its own infrastructures.

Table 3: Upgrade of equivalence regimes for third countries' CCPs (apart from the UK)

	Already granted between 2014 and 2021 (alphabetical order)	Newly granted in 2022	Amended
List of countries	Australia, Brazil, Canada, Dubai, Hong Kong, India, Japan, Mexico, New Zealand, Singapore, South Africa, Republic of Korea, Switzerland, and United Arab Emirates	Equivalence granted for CCPs in Chile, China, Malaysia, Indonesia and Israel (June), to Taiwan and Columbia (September)	US, South Africa and India

Source: Authors' own elaboration (as of December 2022). Petit and Beck, 2023.

One specific challenge for European authorities is the treatment of CCPs in London. On the one hand, there is the intention to build more clearing capacity with infrastructures within the EU, in particular with the legislative proposals from the European Commission to develop further the EU Capital Markets Union in December 2022 (European Commission, 2022).[3] On the other hand, there are financial stability concerns on having a large part of transactions be cleared outside the EU. Supervisory cooperation is therefore critical, but equivalence decisions are not exclusively driven by technical criteria but also by (legal/political) risks stemming from a scenario where such an equivalence would be withdrawn. All in all, equivalence decisions are contingent, limited in scope and require reciprocity. The 2022 legislative proposals from the European Commission show a tightening of equivalence regime in the financial sector.

Looking forward

The resolution of the conflict around the Northern Ireland Protocol with the Windsor Framework gives momentum for effective closer cooperation between regulatory authorities in the UK and the EU. However, it is clear that such cooperation will face limits and that divergence between financial sector regulation in the UK and the EU will happen through reforms on both sides. Regulatory cooperation, however, can limit any negative repercussions from such divergence, ultimately safeguarding the stability of the interconnected financial systems.

[3] European Commission, "Communication from the Commission to the European Parliament, the Council, the European Central Bank and the European Economic and Social Committee - A Path Towards a Stronger EU Clearing System," COM(2022) 696 final § (2022).

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