

Brexit and the implications for financial services

Edited by
Patricia Jackson

Introduced by
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1. BREXIT AND THE IMPLICATIONS FOR FINANCIAL SERVICES

Key insights from a SUERF conference hosted by EY London, 23 February 2017

Morten Balling¹, Ernest Gnan² and Patricia Jackson³

On 23rd February 2017, SUERF and EY organized a conference on “Brexit and the Implications for Financial Services” at EY’s offices, Churchill Place, Canary Wharf, London. While the outcome of the Brexit negotiations remains highly uncertain, the conference discussed the burning questions for financial firms, markets and regulators with a range of different viewpoints expressed on a number of important themes: the systemic risks from Brexit; the possible role of equivalence versus passporting to continue to facilitate cross-European financial transactions; the effects on the deep wholesale markets located in London and the question as to whether the sheer size and interconnectedness of London as a financial center implied that it would still act as a magnet for European business; the effects on Europe if the result created fragmentation of markets and CCPs; and the implications for bank, insurer and asset manager business models, in particular whether Brexit would act as a catalyst for restructuring and retrenchment from activity in the EU27.

1.1. THE ECONOMIC BACKDROP TO BREXIT AND THE IMPLICATIONS OF POLITICAL UNCERTAINTY

Peter Praet, Member of the Executive Board, European Central Bank presented his views on the economic backdrop of Brexit and the effects of political uncertainty. In terms of the current European economic prospects, Praet was positive. The euro area economy has been relatively resilient in the face of a number of risks and uncertainties at the global level. The ECB’s monetary policy measures have contributed to the positive economic developments. Measures of economic confidence have markedly improved.

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Nonetheless he highlighted the fact that political uncertainty, epitomized by Brexit, poses increasing concerns and creates downside risks to the economy. The outcome of the UK referendum in June 2016 can be partly attributed to the decades-long development and spread of negative popular narratives about European integration. Anti-establishment and anti-globalization movements have been very active.

This movement tends to overlook the fact that international trade and economic growth are strongly correlated. Multilateralism has been a cornerstone of economic expansion since World War II and the WTO legal framework for international trade has proved to be robust. Brexit could have a significant impact on European trade in goods and services with knock on effects on the economy.

Given the added risks, effective institutional structures are vital, which includes sound supervisory frameworks. The independence of central banks is also essential. For example, during the crisis, the ECB was an anchor of stability. The international institutional architecture has been strengthened and has also played an important role. In the euro area, the establishment of the Single Supervisory Mechanism and the Single Resolution Mechanism has strengthened the financial system. Anti-globalization and anti-establishment sentiments are likely to remain a factor. History has shown that attitudes toward openness to trade come in cycles with periods of protectionism succeeding periods of free trade. Brexit proves that there is a possibility for European integration to go into reverse and this could jeopardize economic prosperity. Monetary policy can do much but structural reforms are also required to ensure the full diffusion of economic gains and economic growth across the Single Market to maximize the benefits to all citizens.

Charles Grant, Director, Centre for European Reform, looking at political uncertainty, observed that Theresa May has set out her plan for Brexit: the UK will leave the single market and the customs union and seek a free trade agreement with the EU27-countries. It is, however, not certain that the country will succeed. The “article 50 divorce talks” may collapse in a row over money. Perhaps, the two sides will not be able to agree on the transitional arrangements that would lead to a free trade agreement. EU officials are pessimistic because they observe the pressure May is under to take a very tough approach to the negotiations, while there seems to be rather limited pressure for a softer Brexit.

Nonetheless he thought that several factors could favor a less-than-very-hard Brexit. A majority of Britain’s MPs want to retain close ties with the EU, as do business lobbies. An economic downturn (if it happens) could steer public opinion away from supporters of a clear break. However, other EU governments are mostly united in taking a hard line. They do not want populist leaders in other EU-countries to use Brexit as a blueprint and exiting the EU must be seen

to carry a price. The British Government has yet to decide, for instance, what kind of special deal, if any, it should seek for the City of London; and what transitional arrangements it aims for. Britain's strongest card is her contribution to European security but Britain's other cards are weaker. The country regards the City of London as a European asset that should be cherished by all – but this is not how most of the EU27 see it. Once Britain triggers article 50, the country will be in a weak position: It must leave within two years, and if it has not signed a separation agreement before doing so, it risks economic chaos. Whatever happens in the negotiations, Brexit will be difficult for the UK. Exiting and relying on WTO rules, or perhaps even falling out of the EU without any separation agreement would lead to very high legal uncertainty for companies and individuals. Britain's partners did not like the suggestion that Britain's free trade agreement could take in elements of current single market arrangements for the car industry and financial services, since this would amount to “cherry-picking”. The EU27, by contrast, views the single market as “all-or-nothing”. Even the best possible deal that is feasible will harm the economic well-being of all concerned. The UK will, however, lose more than the rest of the EU. It is doubtful whether the City can obtain a good deal. Grant concluded that the UK is in a weak position and that the Government does not fully appreciate this.

Assessing the status of the European financial system as the backdrop for Brexit, *Nicolas Veron*, Senior Fellow, Bruegel, believes that the European financial system is in better shape than it has been since the crisis 10 years ago. This year is the first without major pockets of fragility in the banking system – with the exceptions of Greece and Cyprus. Difficulties with specific banks in Italy and Portugal are expected to be settled soon. Plans still need to be finalised for addressing problems with these banks and ensuring that all viable banks have full market access, but the European financial system is now beyond country-wide system instability. While systemic risk is now largely reduced, the European banking system still needs to return to soundness. The process for doing so would ideally be as market-driven as possible, and involve a lot more M&A deals, sales of portfolios, restructuring, governance changes, changes in ownership structures, etc. But it is important that, should those changes occur, they will not be done under the threat of systemic risk and the imperative of addressing system-wide fragility.

Two further institutional considerations should be taken into account. The first one is the change made in the European parliament in 2014 that has led to the current expectation that Europe-wide lists will have a say in terms of the composition of the European Commission (EC). This is likely to change the dynamics of European parliamentary elections in 2019, and will reinforce the accountability and representativeness of the European Parliament. Second, the development of the European Banking Union and a single supervisory system led by the ECB have

largely been successful, and ECB banking supervision is demonstrably more demanding in every member state (save Finland) than the national authorities it replaces. Not everything is rosy as the increasing social and political fragmentation indicates, and Brexit is likely to expose important weaknesses in the EU framework, particularly regarding markets oversight and supervision. Nonetheless, the EU is undoubtedly better prepared to deal with such an event now than it would have been only a few years ago.

1.2. IMPLICATIONS OF FRAGMENTATION OF REGULATION AND MARKETS

Piers Haben, Director of Oversight at the European Banking Authority (EBA), set out the benefits of the integration in markets and regulation. A considerable amount of important work has been done since the financial crisis in terms of furthering international cooperation and agreement on common standards. However, much work remains to be done, for example to repair the still fragile EU banking sector, or to avoid further fragmentation of the EU's financial systems (as can be seen by higher sovereign and corporate credit spreads, and a drop in cross border lending). Fragmentation makes it harder for business and investors. Financial integration has contributed to the development of EU economies and the development of the single market, has incentivized the development of cross-border banking and supported the availability of finance for households and businesses. Further, having broadly similar rules and regulatory regimes is not enough given how different jurisdictions interpret and apply them – which can cause considerable uncertainty for banks and investors, and could create opportunities for regulatory arbitrage. In this context, and given London's importance for the EU's financial system, it is crucial that Britain's exit from the EU be as smooth as possible. Relying on an equivalence regime in and of itself will likely not be sufficient. For banking, equivalence is not about access but about rules – for example around confidentiality or consolidated supervision. Equivalence is perhaps broader under securities regulation while in banking an alternative to equivalence might be some form of mutual recognition agreement. However, it is unclear what exactly such an agreement would entail, and the practicalities of such assessments, not least for resources, should not be underestimated.

In contrast, *Jon Danielsson*, London School of Economics, looking at the systemic risk effects of Brexit reached a different view on the implications of divergence and fragmentation. Concerns have been raised about the financial stability consequences of Brexit, but in his view Brexit should not increase or decrease systemic risk. One might even argue that differences in regulations enhance financial stability, as they reduce synchronized reactions of financial firms, which are an important cause for systemic instability. The crucial question

to ask is what the unknown unknowns from Brexit are. Risks we know, we can manage. Very few mechanisms can cause a systemic crisis. For 30 years, investors have built their decisions on the assumption that the UK is part of the European financial market. The regulatory environment has several times been subject to “legal plumbing”, but that has not caused systemic risks. Since it is uncertain what a “Soft Brexit” would be, such a Brexit might be the most destabilizing outcome of the negotiations. One challenge put to Danielsson was whether fragmentation of markets and consequent loss of market depth post Brexit might lead to greater market volatility and hence greater systemic risk.

1.3. THE ‘SINGLE MARKET’ AND EQUIVALENCE FOR WHOLESALE MARKETS

Baroness Sharon Bowles, former MEP and chair of the European Parliament’s Economic and Monetary Affairs Committee, and currently a member of the UK’s House of Lords, distinguished between the different language used by the UK versus the continental countries in the original discussions on open European markets and the messages from that language of the actual focus of the different countries. The UK used the term “single market” thinking of it across Europe but as a platform to trade competitively outside Europe, whereas continental countries started by using the term “internal market” with a focus on internal rules. This had led in the negotiations to more emphasis on broader equivalence provisions for third countries by the UK, with resistance from other countries. The provisions are patchy because a general consideration was to protect retail customers – therefore equivalence provisions were not included in all parts of the legislation. But there was grudging agreement that for infrastructure and markets the EU did need to connect up to the rest of the world. Nonetheless even here there was quite a fight in the negotiations. Now though, if you try to imagine what the implications of lack of equivalence for CCPs would be, what it would mean in terms of the extra capital that banks in the EU would have to hold, it shows that the earlier discussions reflected some reluctance to recognize the practicalities. If you look at the Commission’s attitude in the past few years, it has been that equivalence should only be allowed if it is in the interests of the EU, rather than wider connectedness, which cuts across the liberal nature of articles 63 and 64. With regard to financial services there is an approximation to a single market rather than an actual single market. There are still national provisions and the ability to have individual arrangements in a way that you cannot with goods. This is one of the sources of friction between the UK and the rest of the EU. The UK has felt the EU hasn’t been a service based economy with provisions that enable full open access to services. In terms of the domestic political situation in the UK, the white paper on Brexit has large gaps – it does not mention risk, it does

not mention sufficient options. There is a feeling that the government has made choices that do not necessarily carry a majority.

John Armour, Professor of Law and Finance, Oxford University looked at the importance of the UK in particular in wholesale financial markets – with around 85% of EU hedge fund assets under management, almost 80% of EU FX trading, over 70% of EU OTC derivatives trading, and over 60% of private equity assets under management, compared with a share of around 18% of EU GDP. This reflected the fact that the UK financial system was traditionally more market orientated and benefitted from agglomeration effects. This made the UK markets important for the EU27 which internally tended to rely on bank finance.

This makes the issue of equivalence and broader integration of wholesale markets across Europe even post-Brexit, under equivalence rules for third countries, important. Equivalence is, however, not a general framework but a lattice of specifics and a moving target – importantly it is also reversible. There is a patchwork of equivalence decisions covering different aspects of the financial markets and market infrastructure taken by the European Commission covering countries ranging from Abu Dhabi to the US. Third country equivalence is about either supervisory coordination or market access – it is the latter which is important for Brexit. There are no market access equivalence provisions with regard to retail and commercial banking and for insurance it is limited to some aspects of reinsurance. But there are equivalence regimes for asset management and wholesale markets. The MiFIR passport scope covers brokerage, underwriting, market making, structured finance, M&A advisory, proprietary trading and M&A securities. Given the countries already covered by some equivalence provisions including Mexico, Hong Kong, Singapore and South Africa, the speaker could not see how the Commission could with a “straight face” decide that the UK, which has as the starting position the same regulatory framework as the rest of the EU, was not equivalent. The Commission must determine whether the country has equivalent rules, an effective supervisory framework and in some cases reciprocity provisions.

A larger risk is delay in decisions by the EU commission and the ongoing need to ensure continued equivalence. The credibility of the UK’s commitment to ongoing equivalence is key – otherwise firms would not want to invest. John Armour made the point that equivalence was clearly not a solution for access to European cross-border traditional banking. There, the use of subsidiaries by UK and inbound banks established in the UK would be important for the negotiation of passporting rights by the UK government.

1.4. THE EFFECT ON WHOLESALE MARKETS AND MARKET INFRASTRUCTURE

Franklin Allen, Imperial College London, focused on the effects of Brexit on markets. Today, New York and London are the world's largest financial centers by far. Agglomeration effects are very important for the development of such centers. One important factor is that English is the language of finance. Activities in Hong Kong and Singapore are also based on English. The interconnectedness of different aspects of the City of London is also important, for example, the availability of legal and accounting services as well as banking, insurance and markets. A well-educated workforce is also key. Taxation of income from shares and bonds for foreign investors and inheritance tax rules can also be relevant. It will be difficult for Frankfurt and Paris to develop agglomeration characteristics at par with those of current global financial centers such as London. It also needs to be borne in mind that electronic finance has loosened the connection between financial activity and geographic location. London is a leading center of Fintech. In Allen's view, Anglo-Saxon countries are also ahead with regard to the legal handling of financial crime, with a longer history of a tough stance on issues such as insider trading and market manipulation. As a result, Allen expects that New York and London would continue to dominate global financial markets even after Brexit.

A panel on stock exchanges and Euro clearing, derivatives, FX and bonds was chaired by *Tim Skeet*, Director, International Capital Market Association. He initially noted that the public suffers from misconceptions regarding the activities of the financial industry and its importance to the economy. Brexit and recent election results across the Atlantic reflect the fact that the benefits of international cooperation have not been properly explained to electorates.

Stephen Burton, Managing Director, The Association for Financial Markets in Europe (AFME), focused on the practical difficulties with clearing post-Brexit. CCPs would face a "cliff-edge" if they lost their equivalence post-Brexit as EU27 clients of UK CCPs would have to mark their risk exposure to a CCP at 100% for derivative transactions, rather than 2% or 4% under current requirements. This could pose a real systemic risk, and create opportunities for regulatory arbitrage. This is therefore an issue that must be carefully addressed, and which will require the UK government to think about how it will recognize CCPs in the EU. There is an urgency to the task, as AFME estimates that migrating CCP activities from the UK into the EU27 would take about 2 or 3 years of preparation time.

From a practical point of view, restricting Euro clearing to the EU would have deleterious effects – particularly on the position of the Euro as a global reserve

currency. It would cut across global practice because, for example, dollar contract are cleared outside of the United States. Many CCPs outside the EU27 have multiple portfolios with offsetting balances between euros and dollars. Taking Euros out of the equation would require calling for a lot more high-quality liquid assets as collateral, which are already in limited supply. CCPs would also have to be able to manage their risk, and have historical pricing on contracts they take on. Likewise, proposals to impose thresholds above which participants would no longer be able to clear as a CCP could back-fire, as firms might then decide to take the clearing back to the US, rather than migrating to Europe.

Anthony Belchambers, Member of the Financial Services Negotiating Forum, discussed the issues of equivalence and euro clearing in the context of Brexit. Taking it as a given that the UK will not have full access to the single market, he emphasized the need to recognize that equivalence is “the only game in town”. Therefore, the focus should be on strengthening and streamlining the current equivalence regime rather than thinking of time-consuming alternative solutions for structuring cross-border market activities. The experience of market infrastructures, which do not have a passport and rely instead on equivalence and recognition, show that despite its problems, an equivalence regime works relatively well.

Given that post-Brexit 75% of Euro clearing would take place outside of the EU, the ECB’s focus on systemic risk of the EU27 is appropriate. However, not only does relocating euro clearing in the EU27 carry potential risks for market economies and the international standing of the euro, it may also not be effective in mitigating systemic risk. A better approach would be through enhanced regulatory cooperation and supervision of CCPs – if only because it would avoid significant market and legal disruption. A recent IOSCO industry analysis showed that the main challenge to such cooperation is that regulators do not trust each other enough in order to outsource their public duty responsibilities among themselves, recognising that some functions could be carried out by other regulators and cooperating on who does what. One issue raised in the questions was whether, if grit was thrown into the wholesale market machinery by Brexit, would the markets just transform and flow round it. The speaker thought it was quite possible that synthetic instruments could be created to avoid the need for euro clearing.

Kathleen Tyson, Director, Granularity Ltd., examined the impact of Brexit on various market infrastructures. Post-Brexit, the UK will need to improve control of assets in CCPs in order to improve the UK’s position in resolution. Mandatory margining of OTC derivatives has made CCP asset holdings huge, and CCPs based in the UK may be forced to hold clearing assets/initial margins in overseas depositories – in both the EU and the US. Therefore, agreements with foreign

jurisdictions should ensure that CCPs in the UK retain residual control of surplus assets in foreign depositories to recover value for UK claimants in case of resolution.

Mandatory OTC margining now globally creates the risk of negative feedback as margin calls force selling in illiquid and volatile markets. For instance, shocks such as the Brexit referendum and the US presidential elections dislocated markets because intra-day margin calls forced immediate selling in markets that are less liquid than they were in 2008. More generally, the series of unexpected and poorly understood flash crashes since 2010 showed how vulnerable markets are. Developments such as quantitative easing, dealer disintermediation and hoarding by investors in anticipation of margin calls, have contributed to high quality liquid asset shortages.

Markets are becoming “seriously dysfunctional” given their lack of depth and limited use for price discovery. This is because harmonized transparency, order-driven markets and punitive capital requirements on trading books have discouraged market makers from providing liquidity or carrying inventory. In this context, Basel III, liquidity coverage ratios and leverage ratios are self-defeating, particularly if the consequence is that the value and marketability of assets is purely theoretical, and price discovery is becoming increasingly more questionable.

The world needs one deep, liquid financial capital, which London could become again, if it rejects “misguided” harmonization, goes back to having serious market makers carrying bigger transactions, and puts in place immediate trade reporting while delaying post-trade transparency to allow “jobbers” to make large deals. All this would give asset managers incentives to do business in London where they could get better, deeper, lower-cost liquidity than anywhere else.

1.5. IMPLICATIONS FOR BANK BUSINESS MODELS

In the afternoon, *Laurie Mayers*, Associate Managing Director, Moody’s analyzed pressures on bank business models. Global investment banks are already today faced with a number of challenges, in particular regulatory costs and declining returns on equity. Brexit will present a new challenge to pan-European business models. A likely effect will be increasing costs of doing business and more macroeconomic uncertainty. As a response to Basel III, banks have reassessed capital targets and client relationships. As a result, solvency metrics have materially improved and liquidity is now a strength. Cost cutting is important but expense cuts cannot keep pace with revenue declines. Declining

ROEs increase shareholder pressure for further business model re-engineering. Loss of access to the single market due to Brexit and loss of EU pass-porting represent new challenges with implications for business models. It is positive, however, that Moody's view is that banks likely to be more impacted by Brexit are well capitalized.

John Liver, an EY Partner, chaired a panel on the implications of Brexit for investment banks and commercial banks. *James Chew*, Global Head, Regulatory Policy, HSBC, remarked that the outcome depended on the nature of Brexit, the nature of a bank's business operations and its client base, how the bank is set up with branches or subsidiaries on the continent, interaction with other regulations and specific issues such as FTT and ring-fencing. The nature of Brexit was becoming clearer and it seemed unlikely that banks' ability to branch freely across the EU from London, using passporting, would remain. But there could be an asymmetric outcome with banks in the EU27 still able to branch into London. The timetable for Brexit was crucial to give financial institutions time to adjust. Without transition arrangements, changes in business models across Europe and structures could well be short-termist and inefficient. But the picture varied considerably across different activities. In retail banking there was little cross border activity, in practice even now subsidiaries were needed in the different countries in which a bank wished to operate. On the other hand, corporate activity in London funds international operations extending beyond the EU. The operation of markets is a much bigger question. If EU banks are allowed to continue to branch into London, this will support the continuity of markets such as FX. Other areas such as cross border capital raising, which involve access to the EU, could be more affected. Furthermore, if banks (UK and 3rd country incorporated in the UK) do have to locally incorporate in the EU, an issue will be critical mass – namely, can the costs of infrastructure, capital and liquidity be remunerated? Some banks will decide to no longer provide services to the clients in the EU, with a reduction in supply. These issues should not affect the supply of services in the UK and outside Europe.

Diederik Zandstra, British Bankers' Association, thought the world would change because of Brexit. EU customers procure a variety of services in London. Going forward, banks will have to think about which customers they are dealing with in Europe, and customers will have to think about which banks they use. Banks will have to change their operating models and there will be a period of uncertainty. Without passporting, to service an EU27 client base, banks would have to rely on national licensing, equivalence rules for some markets and subsidiarisation to get entry to the EU27, then branching. However, not all client bases will be equally affected. Larger EU27 customers could set up treasury operations in London to access London markets and services. Smaller customers would be more affected. Transition arrangements will be important to avoid a patchwork

of developments. Bank models will change, contracts will change and some services provided to the EU27 will stop. It is important that the world changes in a way that does not hamper trade in financial services. Transaction costs will rise with market fragmentation. Although smaller corporates will be more affected by certain services possibly being no longer provided, larger corporates in the EU27 would also be affected by changes in transaction costs.

Kinner Lakhani, Deutsche Bank, observed that investment bank profitability is lower in Europe than in the US. This is due to the fact that most US banks operate first and foremost in their domestic market, which is deep and sophisticated and this center of gravity gives them a cost advantage, overall giving better cost income ratios. Asia is fragmented across different geographies and regulatory structures. Europe sits somewhere between. The advantage Europe has is that London is a center of excellence and enables centralization of markets and services for Europe as a whole giving efficiency gains. The risk is that Brexit could lead to more balkanization, already in train globally since Dodd-Frank required intermediate holding companies in the US, trapping liquidity and capital. This has had a substantial negative effect on European investment banks. Subsidiarisation in Europe combined with ring fencing will pile yet more pressure on European banks.

1.6. BREXIT CHALLENGES FOR THE ASSET MANAGEMENT AND INSURANCE INDUSTRIES

Hugh Savill, Association of British Insurers, chaired the last panel on insurers and asset managers. *William McDonnell*, RSA Insurance Group, looked at the implications of the overall environment for insurance. Brexit is part of a wider range of populist moves in the US, Italy, France and Scotland for example. What lies behind it is a long period of low growth and rising inequality. It heralds the potential for damage to economic growth. For insurers this could be compounded by a fall in yields or yields staying low for longer. With this backdrop, insurers have to focus on underwriting profit and underwriting excellence. They also need to be best in class at the way they operate – digitization, pricing sophistication etc..

Looking forward, the effects of Brexit, in particular for FX and inflation, have to be considered. London is the leading global insurance market and this does mean that overseas earnings will be boosted by a fall in the pound. But this would be offset partially for general insurers as the cost of car parts etc. rises with the lower pound. Inflation is also a concern – the data and therefore the modelled results are based on low or falling inflation but an increase has to be stress-tested. In terms of structure for general insurers there is a diverse mix: single EU legal

entities with branches, Lloyds of London relying on freedom of services, and groups with a range of subsidiaries across the EU. Insurers doing business in the EU will need a subsidiary in the EU. This raises the specter of trapped capital. Harmonization across regulators will be important and insurers will be reliant on their home supervisor getting an effective college arrangement. The Industry wants Solvency II to be kept as the framework and this was the PRA goal as well.

Menno Middeldorp, APG Asset Management, feared that Brexit might be the beginning of a much larger de-globalization. For institutions with large portfolios, access to different financial markets is essential. As a very large Dutch asset manager, covering pension funds, his issue was not access from London to clients but access from the Netherlands to London markets. APG invest in the UK, use financial services and financial markets in the UK.

They need to be able to make very large transactions which they do through London. The concern was therefore what it would mean if the Brexit negotiations resulted in the fragmentation of markets given they were very dependent on access to deep and liquid markets. The outlook for risk and return from UK investments has been impacted negatively by Brexit but this is not the only consideration and they are continuing to invest in the UK. He summed up that fragmentation harms the asset management business across Europe.

A wider concern when he looked at developments in different countries and regions was whether there was a de-globalization trend (this was not about Brexit which was more about wider access). Protectionist moves would increase risk with the possibility of introduction of capital controls or expropriation of investment. This is important for Dutch asset managers because they tend to invest in long term illiquid projects. In a de-globalized world, returns would be lower and risks higher, at least in transition.

Responding Jon Danielson's argument that fragmentation meant lower systemic risk because of diversification, in fact for APG harmonization of interest rate regimes gave them a better scope to hedge the effect of interest rate change on their liabilities.

Jorge Morley-Smith, Investment Association, looked at the issues relevant for the UK fund management industry which is by far the largest in Europe – larger than the next three put together. 40% of assets under management were for overseas clients, of which half were for other EU citizens. The industry is truly global and operated in many markets without the passporting rights and protections of the harmonized EU market. It is important to recognize the diversity of the industry from small firms to huge international institutions and the issues to be solved are different. For those carrying out activities in the rest of the EU it depends if they are doing business with clients, European funds or distributing funds across

Europe. Restrictions on access to London managers by EU27 funds and institutions would cut across the global principle in the industry that a fund manager could delegate management of a portion of a fund to wherever globally it could be best managed. This would be to the detriment of the EU as well as the UK. In terms of supply of services into the EU27, the impact of Brexit depends on the final arrangements but also which market and which customers. Even today some EU countries are more open to the provision of services into their countries from outside than others.

1.7. BREXIT AS A TRIGGER FOR “CREATIVE DESTRUCTION” IN THE FINANCIAL INDUSTRY?

Ernest Gnan, SUERF Secretary General and Oesterreichische Nationalbank, closed the conference. He remarked, first, that currently a whole industry focusing on offering advice with regard to Brexit is mushrooming. At least, there are some winners from Brexit. Second, big institutional changes, such as international trade integration or the formation of a currency union, are usually associated with substantial costs. But these costs are accepted to reap the benefits of integration which are expected to more than outweigh these initial costs later on. By contrast, trade disintegration in general and Brexit in particular involves huge transitional costs, while not carrying the prospect of future economic gains; on the contrary, mainstream economic theory predicts economic losses from such disintegration. So the outcome can be expected to be costly in a double sense. Finally, it is often argued that populism is on the rise, and that the UK voted for Brexit, because the losers from globalization had been neglected by policy makers. It seems, however, doubtful that these globalization losers will be the ones to benefit from Brexit. Furthermore, there will be many losers from Brexit, both in the UK and in the other EU countries. There is no discussion so far about who will compensate these new losers. As a result, it is very conceivable that after Brexit there will be even larger shares of the population who are dissatisfied with politics and are thus ready to embrace populist calls. An advantage of Brexit for the financial industry may be that it may trigger overdue structural reforms that would otherwise have been delayed, thus fostering “creative destruction”.

2. CREATING STABILITY IN AN UNCERTAIN WORLD¹

*Peter Praet*²

2.1. RESILIENT RECOVERY IN THE EURO AREA

The economic recovery in the euro area is continuing at a moderate, but firming, pace, and is broadening gradually across sectors and countries. Real GDP growth has expanded for 15 consecutive quarters, growing by 0.4% during the final quarter of 2016 according to the Eurostat flash estimate. Economic sentiment is at its highest level in nearly six years and unemployment is back to single-digit figures. Looking beyond the euro area, the global economy, too, is showing increasing signs of a cyclical upturn.

The euro area economy has been resilient in the face of a number of risks and uncertainties at global level. One example of its improving resilience is the fact that domestic demand is now the mainstay of real GDP growth. Previously, growth in euro area was closely correlated with the strength of international trade, but that relationship has weakened recently; last year's growth would not have been possible in view of the lacklustre international conditions.

Our monetary policy measures have been a key contributor to these positive economic developments. The comprehensive set of measures introduced since June 2014 has worked its way through the financial system, leading to a significant easing of financing conditions for consumers and firms. Together with improving financial and non-financial sector balance sheets, this has strengthened credit dynamics and supported domestic demand.

The recovery has been accompanied by a broad-based improvement in measures of confidence. Measured confidence for industry, construction, services and households is in positive territory, and particularly strong for measures of future expectations. This is in line with the normally high correlation between measures of confidence and economic activity. Households and businesses which are confident about the future are more likely to spend and invest than those which are concerned.

Despite the resilient recovery in the euro area, and strong indicators of confidence across all sectors, measures of political and policy uncertainty have been rising recently, although asset markets are not significantly pricing in tail risks. The

¹ See for the original source of this contribution, <https://www.ecb.europa.eu/press/key/date/2017/html/sp170223.en.html>.

² Member of the Executive Board, European Central Bank (ECB).

recent bouts of uncertainty are a source of concern, and represent a downside risk to the economic outlook. Today I would like to discuss the potential impact of uncertainty on economic activity and the role of institutions in counteracting uncertainty and providing stability.

2.2. UNCERTAINTY AND ECONOMIC DEVELOPMENTS

The economic literature – both theoretical and empirical – finds a link between heightened uncertainty and lower economic activity in the short run. There are usually fixed costs involved with investment, from creating new capital such as building a factory to hiring new staff, which cannot be recovered if the investment decision is reversed. So faced with an increase in uncertainty, businesses pare back investment plans. Similarly, if households fear unemployment or lower income from employment in the future they may reduce consumption today³.

The literature uses a number of different measures of uncertainty. Such measures usually move with each other, and generally peak in recessions. At the current time, most measures of uncertainty for the euro area do not appear especially elevated. The economic recovery has been resilient and steady for a number of years, the financial sector is more robust than it was pre-crisis, and most measures of financial sector volatility are markedly below the peaks witnessed during the crisis.

The one indicator of uncertainty that appears elevated, and has been so since the UK referendum is political uncertainty⁴.

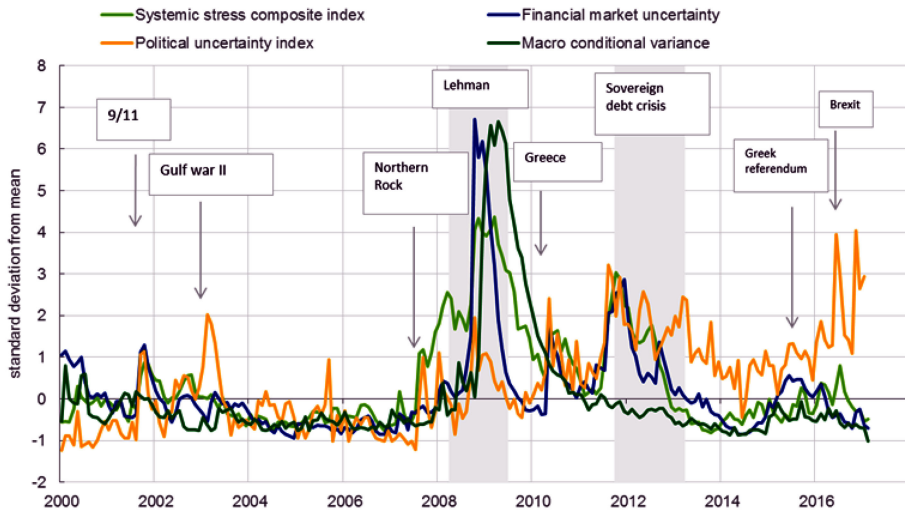
This measure counts how frequently newspaper articles cite “uncertainty”, “economy” or similar, and particular policy words, such as “deficit” or “regulation”. A number of recent events have sparked this rise in political uncertainty. Since the US elections, the outlook for that country’s fiscal policy and trade policy has been uncertain. In the run-up to the elections in several European countries, the headlines are reflecting political uncertainty about the future attitude of Member States towards European integration. Not to forget the process of withdrawal of the United Kingdom from the European Union and the significant uncertainty that inevitably surrounds the future relationship between the UK and the EU27.

These recent bouts of political and policy uncertainty have come on top of the existing and more enduring sources of “structural” uncertainty about the

³ For a more detailed discussion of the economic impact of uncertainty, see “The impact of uncertainty on activity in the euro area”, *Economic Bulletin*, Issue 8/2016, ECB and “Uncertainty about Uncertainty”, speech by Kristin FORBES, External MPC member, Bank of England, 23 November 2016.

⁴ This measure is derived from a method proposed by S. BAKER, N. BLOOM S. and DAVIS (2015), “Measuring economic policy uncertainty”, *NBER Working Paper Series No 21633*.

Chart 1: Measures of euro-area uncertainty



Areas in grey reflect euro area recessions as identified by the CEPR

Sources: ECB (for SSCI), Baker, Bloom and Davis (for EPU), BIS and ECB (for financial market uncertainty), European Commission, Eurostat and Haver (for macro conditional variance) and ECB calculations. CEPR for recession periods.

economic outlook in advanced economies. What do we really know about the impact of new technologies and innovation on tomorrow's economic landscape? Will secular stagnation be the new economic reality? Various authors have suggested that recent innovations have had only limited effect on productivity and growth in advanced economies. Others have expressed concern that these innovations may polarise societies still further and may even have negative effects on employment. Technology optimists meanwhile predict the advent of a bright future, with the diffusion of innovation bringing about significant productivity increases and high levels of well-being.

It is important for us economists to be humble when forecasting the future. Debating concepts such as 'secular stagnation' may be fashionable now, but we should remember only a decade ago it was fashionable to debate the 'Great Moderation'. By the same token, the observed resilience of a moderate economic recovery and strong confidence indicators should not lead to complacency. Respondents to survey questions can be influenced by what they consider to be a normal benchmark. If the new normal after the Great Recession is below its pre-crisis level, the same levels of confidence indicators can point to lower growth rates than before the crisis⁵.

⁵ European Commission, European Economic Forecast, Winter 2017. Box 1.2 "A 'new modesty'? Level shifts in survey data and the decreasing trend of 'normal' growth".

Indeed, measures of capacity utilisation are high in an environment of persistent economic slack. How resilient the recovery really is to policy uncertainty is also not known. The World Bank's Global Trade Watch⁶ report suggests that policy uncertainty is already weighing on world trade.

Of course, uncertainty about the future has always been with us. The incidence of natural disasters such as droughts, floods and earthquakes, the doubt of whether contractual promises will be honoured and the fear of your possessions being taken by force are all factors that can affect economic activity.

Humankind, over the millennia, has put in place various mechanisms to help cope with uncertainty. For example, putting in place narratives to filter and process the vast array of information available and arrange it in order – a cognitive trick to make sense of an uncertain world. Building institutions has been key to providing economic stability. Inclusive institutions are essential for economic development⁷.

2.3. THE IMPORTANCE OF ECONOMIC NARRATIVES

Following financial crises, political uncertainty is often elevated. According to a recent study⁸, votes for extreme parties can increase by on average 30%, while government majorities shrink, parliaments end up with a larger number of parties and become more fractionalised. Thus the political landscape becomes more gridlocked at precisely the moment when decisiveness is typically required.

This can delay necessary policy responses, such as cleaning up the financial sector, which prolongs the post-crisis recovery. And such uncertainty, reflected in the media, can gradually build a narrative of doom and gloom around the economy or around the existing institutions – a seeping pessimism, which over time alters investors' and consumers' expectations, and thereby their behaviour.

Robert Schiller⁹ has recently elaborated on the epidemiology of narratives relevant to economic fluctuations, ranging from the Great Depression of the 1930s, to the Great Recession of 2007-2009 and today's climate of political uncertainty. Popular narratives can drive economic developments. For example, when people hear stories of declining prices and then postpone their purchases: talking about deflation feeds deflation. But the relationship is more than just one way: actual events play some role in the development of popular narratives.

⁶ *Trade Developments in 2016: Policy Uncertainty Weighs on World Trade* by C. CONSTANTINESCU, A. MATTO and M. RUTA (2017).

⁷ On the importance of inclusive institutions, see D. ACEMOGLU and J. ROBINSON (2012), *Why Nations Fail: The Origins of Power, Prosperity and Poverty*.

⁸ M. FUNKE, M. SCHULARICK and C. TREBESCH (2016), "Going to extremes: Politics after financial crises, 1870-2014," *European Economic Review*, 88(C): 227-260.

⁹ Robert SCHILLER (2017) *Narrative Economics*, National Bureau of Economic Research Working Paper 23075.

Overall, popular narratives act as potent multiplier of economic shocks – the “animal spirits” of Keynes.

Today’s information and communication technologies have opened up a vast field of research into the role of narratives as determinants of economic developments. These technologies have also greatly accelerated the diffusion of narratives in our societies; it is surprising how easily fake news can flourish nowadays.

This is a serious matter. The outcome of the UK referendum can be partly attributed to the decades-long development and spread of negative popular narratives about European integration. More generally, the events I mentioned earlier are the culmination of a broader anti-establishment and anti-globalisation narrative that has gained more traction in advanced economies. As narratives often are key determinants of economic and political outcomes, it is important to be wary of them.

2.4. THE STABILISING ROLE OF INSTITUTIONS

Institutions contribute to stability, especially in times of uncertainty, and help anchor expectations. In times of political gridlock, effective institutions are vital since they can deliver their mandates decisively and outside of the push-and-pull of the political process. This in turn foreshortens the crisis and the self-fulfilling cycle of weak economic performance and gloom-and-doom narratives.

For example, while bank failures are always possible, the existence of appropriate institutions can mitigate their impact. A sound supervisory framework, for instance, makes failures less likely, while resolution plans contribute to seamless unwinding of failed institutions. This is also true of shocks exogenous to the economy. In the case of natural disasters such as earthquakes¹⁰, building standards – properly enforced – can reduce deaths, and disaster recovery plans can help after the event.

The move over recent decades to grant independence to central banks owes much to the problem of time consistency. When monetary policy was under the control of governments, there was always an incentive to “cheat” and deliver higher than expected inflation to temporarily increase output. The existence of this incentive, and the inability of governments to credibly commit to the right policy, gave rise to de-anchored inflation expectations.

Independent central banks with a clear mandate to maintain price stability have been successful in anchoring inflation expectations. Having an explicit inflation

¹⁰ NOY, ILAN, (2009), “The macroeconomic consequences of disasters”, *Journal of Development Economics*, vol. 88(2): 221-231.

objective provides its own stabilising narrative – people can trust the central bank to deliver inflation, and can base their economic decisions on that expected inflation rate. In recent years, the ECB has been an anchor of stability, creating an effective bulwark against deflationary narratives when they appeared in the euro area. By acting forcefully, the ECB has prevented deflationary dynamics from materialising.

But institutions need to be strong in order to deliver in the face of shocks. To put this in perspective, consider how two periods of global economic integration have fared under different institutions. Global economic integration has fluctuated over time and is now higher than at any time in the past. Another period of high integration, in the decades prior to World War I, ended abruptly as a financial crisis of global proportions, accompanied by a credit crunch, broke apart bilateral arrangements and paved the way for several rounds of retaliatory tariff increases.

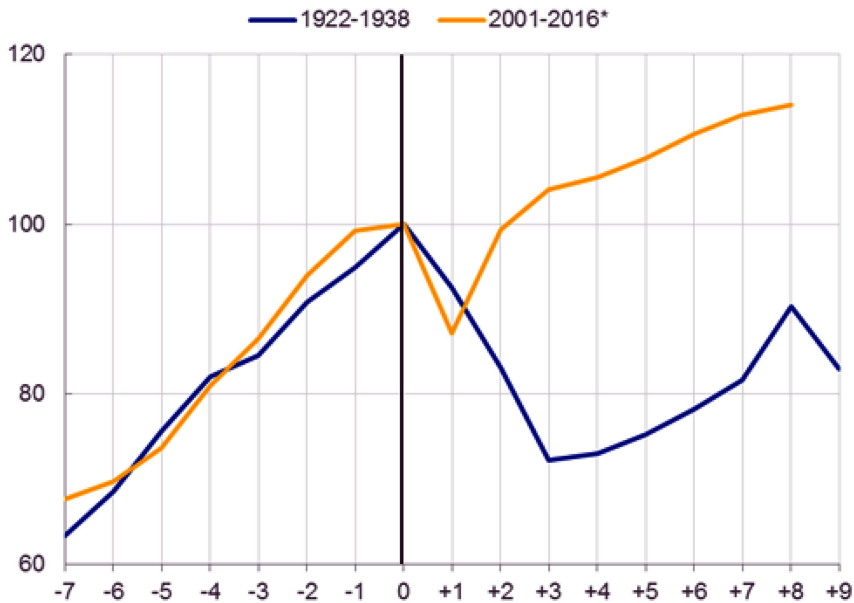
Multilateralism has been a cornerstone of economic expansion since World War II. The current legal framework for world trade, embodied in the multilateral World Trade Organization, has proven much more robust to the recent global financial crisis. It has played a key role in preventing the re-emergence of protectionism in the aftermath of the Great Recession.

Three stylised facts emerge from comparing the evolution of world trade in goods in the periods 1922-38 and 2001-16. First, the pre-crisis expansion was very similar in both eras. Second, world trade collapsed in 1930 and 2009, immediately after the two shocks, but the decline was sharper in 2009, even though the total decline in the 1930s was larger. Third, the subsequent recovery has been noticeably stronger in the most recent episode.

On both occasions, falling output was the main driver of the trade collapse, but protectionism after the Great Depression was largely due to the emergence of a new political constituency opposed to free trade which, in many cases, was able to develop convincing narratives for the continuation of protectionism even when the crisis was over.

Institutions provide stability by their very nature of being hard to change. But that inertia can lead them to lack the agility to deal with new challenges. Failure to react can fertilise counter-narratives. But there is also a chance for new institutions to be founded which improve on previous institutions. The Federal Deposit Insurance Corporation was created in the United States in 1933 to reduce the effect of failed banks on depositors. Following the recent financial crisis, the international institutional architecture was strengthened with the inauguration of the G20 summits and the creation of the Financial Stability Board. In the euro area, the establishment of the Single Supervisory Mechanism and the Single Resolution Mechanism has strengthened the financial system and made it more resilient to future shocks.

Chart 2. The evolution of world trade in goods during the Great Depression and the Great Recession
(volumes; 1929 and 2008=100, respectively)



Sources: ECB staff calculations based on data in Federico and Tena-Junguito (2016)^a and CPB Trade Monitor data.

Notes: The year 0 on the horizontal axis is 1929 in the case of the Great Depression (blue line) and 2008 in the case of the Great Recession (yellow line). 1922-1938 trade flows are constructed using current country borders. Data for 2016 are available until November.

a. G. FEDERICO and A. TENA-JUNGUITO (2016), "A new series of world trade, 1800-1938", *EHES Working Paper*, No. 93.

While the current multilateral framework has so far protected against rising protectionist sentiment, it is worth recognising that anti-globalisation and anti-establishment sentiments have not disappeared. There is an increasingly common belief that the benefits of globalisation have not been distributed widely enough and that it has reduced protection for workers. Let me take a few moments, then, to remind you of the successes of the post-war institutions in Europe.

2.5. THE EUROPEAN UNION AS PROVIDER OF STABILITY AND PROTECTION

The European Union and the Single Market have successfully delivered decades of peace and growing prosperity throughout Europe. There has been a steady process of strengthening trade and economic links, based on the foundations of

democracy, a strong social model and the rule of law. These institutions are Europe's answer to the questions posed by globalisation, a democratic way to reap the benefits of economic integration while still protecting consumers and workers.

The Single Market is more than just a customs union or a dense network of free trade agreements between countries. It is in fact an innovative forward step in economic evolution. It provides the legal framework for trade between Member States, underpinned by the four fundamental freedoms – free movement of goods, services, labour and capital.

This framework is vital to give companies confidence to invest and integrate across national borders. For trade to flourish, businesses need to be certain that contracts will be honoured, competition rules will be fairly enforced, property rights respected and standards adhered to. In ensuring the rule of law, the Single Market reduces barriers to trade, labour mobility and competition and increases technological diffusion between countries. Take as a recent example the abolition of mobile phone roaming fees across the Union, which was a decision based on the principles of the Single Market that protects consumers.

This is not to say that the European Union is perfect. Strong institutions should always strive to improve and make sure their policies bring more value to citizens. We should also be clear about what European institutions are and what they are not. There is a widespread narrative according to which Brussels imposes its decisions on Member States. Yet all regulations and directives adopted in Brussels are decided according to a political process involving the governments of all Member States, which are all represented in the Council, and elected representatives of all European citizens. The Union has built over time a set of strong institutions for Member States to decide together matters of common interest.

But it is important to recognise the tensions that exist between the individual priorities of nation states and the pooling of national sovereignty for mutual gain. The regulations for the Single Market need to be strong enough to promote innovation, but not so tight that they stifle it. By the same token, countries have to be able to pursue their own social agendas where these do not clearly clash with the principles of the Single Market. The principle of subsidiarity is important.

Take as an example the fiscal framework under the Stability and Growth Pact. There are important rules to ensure government finances are run in a sustainable fashion. Yet beyond the parameters for fiscal sustainability, the framework allows for wide divergences in aggregate tax rates, the share of the public sector in total output and for national priorities in public spending. These are at the discretion of each sovereign Member State.

2.6. CONCLUSION

Let me return then to my original observation of the apparent disconnect between elevated measures of political uncertainty on the one hand, and other measures of uncertainty at more benign levels and robust measures of confidence on the other hand.

One of the reasons why prevailing political uncertainties do not weigh on confidence is perhaps the existence of strong institutions at both national and international level. Markets continue to believe in the strength of the rules-based international order and its institutions. It has been a steady process of strengthening economic integration, and households and businesses demonstrate by their current decisions on consumption and investment that they believe that there will be no sudden reversal of this process.

This should however not lead to complacency. An alternative explanation is that adherents of the anti-establishment narrative truly believe that the future will be brighter once current institutions are swept away and are acting coherently with that world view. History has proven that accidents are possible, that protectionism can succeed periods of free trade. We should all be wary of the filters that our own narratives put on our ability to process information. Brexit proves that there is a possibility for European integration to go into reverse. A more widespread reversal of European economic integration would durably jeopardise economic prosperity.

Let me end on one final comment. The success of our monetary policy measures throughout the crisis has laid the ground for a new narrative, that of the ECB being the “only game in town”. We have proven able and willing to take the measures necessary to support a sustained adjustment of the path of inflation back to our objective. This new narrative deserves a word of caution: there is only so much monetary policy can do. Monetary policy alone cannot ensure all macroeconomic goals are met. It cannot by itself bring about any redistributive measures required to bring the benefits of globalisation to all. A greater contribution is required from other policies. Structural reforms are also required to build resilience to country-specific shocks and ensure the full diffusion of innovation across the Single Market to maximise the benefits to all citizens. Carrying out these reforms will continue the decades-long progress of European economic integration and ensure that the benefits of stability and protection will be maintained in the future.

3. MRS MAY'S EMERGING DEAL ON BREXIT

Not just hard, but also difficult

Charles Grant^{1 2}

Theresa May has set out her plan for Brexit: the UK will leave the single market and the customs union, and seek a free trade agreement (FTA) with the EU. But in Brussels key policy-makers worry that she may not succeed – either because the ‘Article 50’ divorce talks collapse in a row over money, or because the two sides cannot agree on the transitional arrangements that would lead to the FTA.

EU officials are pessimistic because they observe the pressure May is under from hard-liners to take a very tough approach to the negotiations. They see limited pressure on her for a softer Brexit. But several factors could favour a less-than-very-hard Brexit: a majority of MPs wants to retain close ties with the EU, as do business lobbies; and an economic downturn (if it happens) could steer public opinion away from supporting a clean break.

In May’s government, 10 Downing Street takes all the key decisions. The downside of this centralisation is that decision-taking may be delayed, and particular proposals may be tested on too narrow a circle of experts.

The outcome of the Brexit talks will be shaped to a large degree by the EU governments. They are mostly united in taking a hard line. Worried about the cohesion and unity of the EU, they do not want populist leaders to be able to point to the British and say, “They are doing fine outside the EU, let us go and join them.” Exiting must be seen to carry a price.

The British government has yet to decide what it wants on some key issues, such as: what sort of immigration controls should it impose? What kind of special deal, if any, should it seek for the City of London? What customs arrangements will it ask for? What sort of court or arbitration mechanism would it tolerate? And what transitional arrangements does it want?

Britain’s strongest card is its contribution to European security. The arrival of Donald Trump could help the UK, by giving continentals an extra reason to keep the UK engaged; but if the British become too chummy with Trump, they will lose the goodwill of EU governments. Britain’s other cards are weaker. It regards the City of London as a European asset that should be cherished by all – but that is

¹ Director, Centre for European Reform.

² Published in February 2017, info@cer.org.uk, www.cer.org.uk.

not how most of the 27 see it. Nor should the UK try to claim that since the 27 have a trade surplus with it, they need a good trade deal more than it does; the reality is that Britain depends more on EU markets than vice versa. Finally, May's threat to respond to a bad deal by transforming Britain into a low-tax, ultra-liberal economy lacks credibility.

There are only three possible outcomes of the Brexit talks: a separation agreement plus an accord on future relations including an FTA; a separation agreement but no deal on future relations, so that Britain has to rely on WTO rules; and neither a separation agreement nor a deal on future relations, so that Britain faces legal chaos and has to rely on WTO rules.

Once Britain triggers Article 50, it is in a weak position: it must leave in two years, and if it has not signed a separation agreement before doing so, it risks economic chaos. So if Britain wants a half-decent deal, it needs the goodwill of its partners. That means ministers should be polite, sober and courteous. Grandstanding and smugness will erode goodwill towards the UK. As for the substance of the negotiations, the more that Britain seeks to retain economic and other ties, the more likely are the 27 to offer a favourable deal.

Whatever happens in the negotiations, Brexit will be hard. That is because both the UK and the 27 are placing politics and principles ahead of economically optimal outcomes. In the very long run, once both the UK and its partners have understood that a hard separation is not in anyone's interests, serious politicians will start thinking about how to engineer closer relations.



Ever since the early 1960s, when Harold Macmillan sought to take Britain into the then European Economic Community, Britain has been locked into a never-ending series of negotiations with its European neighbours – for accession (twice), renegotiating the terms of membership (twice), major changes to the founding treaties (six times) and new laws (thousands of times). The context of all these negotiations was that Britain and the other members would move closer together, stay conjoined once differences had been settled, jointly plan the club's future or work on improving the rules for everyone's benefit. Britain and the others felt a commonality of interest that lubricated the negotiations and encouraged compromise.

But the Brexit talks are about divorce and very different. Rational minds will point out that, even when the British leave the club, they and the 27 will still have common interests – notably in terms of economics and security – and that they should wish each other well. But divorces often involve acrimony and a lot of self-righteous posturing.

Britain has decided that it no longer wishes to share its destiny with the continental nations. At a time of global uncertainty, exacerbated by the arrival of Donald Trump in the White House, Britain's decision baffles its partners. They feel snubbed, hurt and (at least in some cases) insecure. Many of the factors that would have pushed them to satisfy Britain's preferences during previous negotiations no longer apply. The Brexit negotiations will be the most difficult in the EU's history.

Theresa May does not like the term 'hard Brexit'. That is because a hard Brexit – meaning a withdrawal that cuts many of the ties binding Britain and the EU – will inevitably have negative economic consequences. And when considering key decisions on Brexit, the British prime minister has been unwilling to acknowledge the trade-offs between sovereignty and economic well-being. But speaking in Lancaster House in January, May was fairly clear about the kind of Brexit she wants, and she edged towards recognising the trade-offs.

May wants a hard Brexit: freed of the jurisdiction of the European Court of Justice (ECJ) and EU rules on free movement, Britain will leave not only the single market but also the essentials of the customs union – which means restoring customs checks on the EU-UK border. She wants “a bold and ambitious free trade agreement” (FTA). To govern the future economic relationship, and a “phased process of implementation” to cover the period between leaving and when the new arrangements take full effect.³

The prime minister does not want the very hard Brexit favoured by some eurosceptics, according to which the UK would leave the EU and simply rely on World Trade Organisation (WTO) rules. Nevertheless some key officials in Brussels and other capitals fear that Britain may face a much harder Brexit than May imagines: exiting to WTO rules, or perhaps even falling out of the EU without any separation agreement, leading to legal chaos for companies and individuals.

This pessimism stems from these officials' reading of UK politics. They note that the domestic political pressures on May are nearly all from one side, the shrill eurosceptic lobbies and newspapers that want a very hard Brexit. The officials worry that these pressures may prevent May from striking the kinds of compromise necessary – for example, over the money Britain supposedly 'owes' the EU – for a deal to be reached.⁴ They also fret that the British government is deluded over the strength of its negotiating hand; the reality, they (correctly) surmise, is that once Article 50 is triggered, determining that the UK must leave in two years, it is in a weak position. They fear that UK politics may drive May

³ Theresa MAY, 'A global Britain', speech at Lancaster House, January 17th 2017.

⁴ Alex BARKER, 'The €60 billion Brexit bill: How to disentangle Britain from the EU budget', CER policy brief, February 2017.

to walk away from the Article 50 negotiations and seek a bigger parliamentary majority in a general election.

Despite such worries, Britain's partners welcomed much of the Lancaster House speech, and the white paper that followed a few days later. They liked the clarity over Britain's intentions, and the warm words about the EU (which contrasted with the many rude things Donald Trump has said). But they did not like the suggestion that Britain's FTA could "take in elements of current single market arrangements" for the car industry and financial services. That sounded like 'cherry-picking' to the 27, who believe that the single market is all-or-nothing. Nor did they like May's comment that if the EU offered a punitive deal, the UK would walk away and turn its economic model into something akin to Singapore, with light-touch regulation and low taxes.

"That May proclaimed all could be done in two years makes Britain's partners worry 10 Downing Street is not in touch with reality."

The most alarming passage in the speech was the pledge to negotiate not only the Article 50 separation agreement within two years, but also the FTA and everything else required to govern future relations on security, research, migration, energy and so on. Britain's partners think that is bonkers, especially since there will be not much more than a year for real negotiations, between the formation of a new German government towards the end of this year and the need to start the process of European Parliament ratification in late 2018. FTAs normally take at least five years to negotiate and several more to ratify.

UK officials talk confidently of bringing "bold ambition" and "political will" to the negotiations. They say that because EU and UK rules are already aligned, an FTA can be sorted out quickly. Britain's partners beg to differ, pointing out Britain's desire to be able to change the rules, its focus on ensuring good access for service industries, and the need to sort out sensitive issues like state aid and competition policy, will make the negotiations fiendishly complex.

If all goes well, the 27 believe, two years could suffice for the completion of the Article 50 deal and a sketch of the future relationship in a political declaration. That would fit the wording of Article 50, which says the Union should write the withdrawal agreement "taking account of the framework for its future relationship with the Union". The details of the future relationship could then be negotiated during the transitional phase, after Britain leaves the EU. But the fact that May proclaimed that everything could be done in two years makes Britain's partners worry that 10 Downing Street is not fully in touch with reality. They wonder if, following the departure in January of Britain's EU ambassador, Sir Ivan Rogers – who annoyed some in the government by pointing to the many pitfalls that lie ahead – there remain enough officials willing to speak uncomfortable truths to power.

The biggest worry of Britain's partners is that London does not realise how weak its cards are. The strongest card – repeatedly mentioned by May in Lancaster House – is Britain's contribution to European security, via co-operation on policing, intelligence, defence and foreign policy. Any attempt by Britain to make its help in these areas conditional on a good trade deal would be viewed as cynical and damage its reputation. But handled deftly, Britain's contribution on security could help generate goodwill.

A related card cited by British officials is Donald Trump. His questionable commitment to European security, and the increasingly dangerous nature of the world, could make partnership with Britain more valuable to continental governments. But the Trump card could easily end up hurting the British. The more that British ministers cosy up to Trump, and avoid criticising his worst excesses, the more alien the British appear to other Europeans, and the more the UK's soft power erodes.

The British try to play the City of London as another card, claiming that it adds value to the entire European economy. Therefore, they say, the 27 should give the UK financial services industry a special deal, so that it can continue to do business across the EU. The British are right that the continent would incur an economic cost if it lost access to the City. Few EU governments, however, regard the City as a European jewel whose sparkle should be preserved. While some view it as a cesspit of wicked Anglo-Saxon capitalism, several others are keen to pick up the business that could leave the City post-Brexit.

May's threat in Lancaster House to turn Britain into a lightly-regulated, low-tax economy is a card that lacks credibility, given that in the same speech she spoke in favour of employee rights, workers on boards, industrial strategy and a fairer society. There is no majority in the Conservative Party or the country at large for creating an ultra-liberal economy, and the 27 know this.

Given the weakness of these cards, a half-decent deal will require the goodwill of Britain's partners. And that means that May and her ministers should conduct the talks in a sober, courteous and modest manner. She will help to foster a positive atmosphere if she seeks a relatively soft Brexit in some key domains, such as free movement of people or co-operation on security.

Some of the 27 are sceptical that the state of British politics will permit May to veer in a softer direction. But in fact May's political position is strong: the Labour Party is weak and divided, while hard-line Tory europhobes have been partially disarmed by her pledges in Lancaster House. However weak May's hand may be in Europe, in the UK she may be in a stronger position than she herself realises.

The focus of this paper is the future economic relationship between the EU and the UK. May's government will also have to negotiate on issues like foreign and

defence policy co-operation, counter-terrorism and policing, as well as research, universities, climate and energy⁵. Some people will judge Brexit for the impact it makes on migration. But as far as Britain's long-term economic health is concerned, the trade and investment relationship will be crucial in determining whether Brexit is a success or not.

The paper examines the pressures that may push May and her ministers towards a harder or a softer Brexit; how the centralisation of the British government may affect the negotiations; the priorities of the other member-states, and the EU institutions; the issues on which the British government has yet to make up its mind; the strength of the cards that Britain may be able to play; and the most plausible outcomes of the Brexit talks. The paper concludes by suggesting how the British government can achieve the best possible deal for the UK.

3.1. THE PRESSURES ON THERESA MAY

One of the reasons why Brussels officials expect a hard Brexit is that they observe Britain's domestic political debate. They may not be engaged in 'pre-negotiations' with their British counterparts, but they do read Britain's newspapers and the speeches of its politicians. Brussels officials see a lot of pressure on May's government for a clean break with the EU and considerably less pressure for maintaining close economic ties.

Britain's eurosceptic lobbies are certainly well-organised, well-funded and noisy, with many allies in the press. If they decide they want something, they can raise the pressure and make it hard for the government to resist. For example, hard-line Leavers wanted the scalp of Ivan Rogers, whom they believed to be insufficiently committed to making a success of Brexit. 10 Downing Street denied Sir Ivan its full support and he resigned.

"The arrival of President Trump has boosted the self-confidence of those who want to cut ties with the EU."

The arrival of President Trump has boosted the self-confidence of those who want to cut ties with the EU. They argue that with the UK becoming America's best friend in a renewed special relationship, involving a bilateral trade deal, good access to EU markets is now less important. The performance of the UK economy has also strengthened the hand of the 'clean-breakers': thanks to higher than

⁵ Charles GRANT, 'Theresa May's six-pack of difficult deals', CER insight, July 2016. See also Camino MORTERA-MARTINEZ, 'Plugging Britain into EU security is not that simple', CER bulletin 111, December 2016-January 2017.

expected consumption after the referendum, output grew at about 2 per cent in 2016, faster than any other G7 economy.

The way the prime minister has chosen to talk about Brexit reassures those who want it to be hard. Although she was a (reluctant) Remainer, May now presents herself as the voice of the 52 per cent who voted Leave, and of the 'left behind' people who want change. Her government's rhetoric is markedly less sympathetic to big business and the City than that of the Cameron government. The dictionaries of quotations will surely remember the key section of her party conference speech: "Too many people in positions of power behave as though they have more in common with international elites than with the people down the road. ... But if you believe you are a citizen of the world, you are a citizen of nowhere. You don't understand what citizenship means."⁶ The use of such words makes it hard for her to ignore the views of those – whether Brexiteer backbenchers or eurosceptic columnists – who claim to represent ordinary people against global elites.

Yet there are at least five reasons why May and her government may end up pursuing a softer version of Brexit than that desired by the hardest eurosceptics. These reasons, however, are unlikely to push the government towards the sort of Brexit that many businesses would like to see.

First, Britain's courts and Parliament have ended up playing a bigger role than May would have liked. May's starting position was that Parliament should not be involved in triggering Article 50 or in monitoring the negotiations. Then in January 2017 the Supreme Court ruled that the government must pass an act of Parliament before invoking Article 50. However, this ruling has not delayed the Brexit process. Although there is a House of Commons majority for a soft Brexit, a big majority of MPs voted in favour of the Brexit bill in early February. Indeed, many pro-Remain MPs are so scared of their voters – and the organised Brexit lobbies – that they were unwilling to make their support for the bill conditional on the government accepting amendments (one amendment, asking the government to guarantee the right of EU nationals to remain in the UK, came close to passing).

The House of Lords has an even stronger majority for Remain than the Commons, and may pass amendments to the bill. However, most peers are unwilling to be seen to block the popular will. The Commons would probably overturn any amendments passed by the Lords.

Nevertheless Parliament has gradually nudged the government to do things that it was reluctant to do. Most MPs wanted a white paper on the government's Brexit strategy, and they got one soon after the Lancaster House speech (though

⁶ Theresa MAY, speech to the Conservative Party conference in Birmingham, October 5th 2016.

the white paper added little of substance)⁷. MPs wanted the right to vote on the final deal, so the government ceded the point in order to smooth the passage of the bill through the Commons. It has promised to submit the “final draft agreement” to Parliament, before ratification by the European Parliament. This means that MPs and peers will probably vote on the terms of Brexit in the autumn of 2018.

“If MPs vote down the deal, the government may be obliged to return to the 27 and ask for a softer variant of Brexit.”

It is not clear how much of a concession the government has really made. On the one hand, ministers are adamant that if Parliament rejects the deal, they will not return to the negotiating table, and Britain will simply leave the EU without any agreement – a position which could make it very hard for Parliament to vote no. On the other hand, Labour’s Brexit spokesman, Keir Starmer, reckons that a parliamentary defeat would put strong pressure on the government to go back to the EU and seek to improve the terms. The significance of this concession will probably depend on the state of public opinion at the time of the vote. If voters have shifted towards regretting the referendum result, and MPs are emboldened to vote down the deal, the government may be obliged to return to the 27 and ask for a softer variant of Brexit. (It is virtually impossible to imagine circumstances in which Parliament would ask the government to revoke Article 50 and/or hold another referendum.)

The second reason why a softer Brexit is still possible is that business lobbies are getting their act together and speaking out more loudly in defence of their interests. Many businesses that said nothing during the referendum campaign are now trying to influence the government’s negotiating stance. For example, pharmaceutical firms are concerned that leaving the single market may endanger their right to sell drugs across the EU. Airlines worry about the consequences of the UK quitting the European Common Aviation Area. Car and aerospace manufacturers, as well as retailers, are worried about the impact of Britain leaving the customs union. Sometimes lobbying appears to work: Nissan demanded ‘reassurances’ before committing to new investments in Sunderland, and received a (secret) letter that persuaded it to go ahead.

Banks and other financial firms, realising that they have probably lost ‘passporting’ (the right for UK-regulated financial firms to do business across the EU), are hoping for provisions on ‘equivalence’ that allow them to retain access to EU markets (equivalence enables the EU to recognise a third country’s rules as similar to its own; financial firms based in that country may then do business in

⁷ ‘The United Kingdom’s exit from and new partnership with the European Union’, British government white paper, February 2017.

the Union). Many large financial firms have made it clear that they will shift jobs out of the UK if they are not given sufficient assurances (one recent study suggested that Brexit would lead to the City losing 10,000 financial jobs, and a further 20,000 in supporting business services)⁸. Their priority, like that of many other businesses, is for the UK to obtain a transitional deal that provides for a few years' continuity while they consider their long-term options.

The third reason is that the economy may start to turn down while the government is enmeshed in the Article 50 talks. If and when that happens, the Treasury and others who want to maximise ties with the EU will try to push 10 Downing Street towards a softer Brexit. Early in 2017, the resilience of the economy was delighting Leavers, although the fall of sterling was beginning to push up prices. In the long term, uncertainty about the future EU-UK relationship is bound to affect levels of investment and thus productivity and growth⁹. That may influence public opinion.

Fourth, a hard Brexit would increase the chances of Scotland leaving the UK. The Scots voted to stay in the EU by 62 per cent and many in the Scottish National Party (SNP) hope for a second independence referendum, so that a solo Scotland can join the EU. Yet Scottish opinion has not shifted significantly towards independence since June 23rd, mainly because of concerns about the economic consequences: Scotland exports four times as much to England as to the 27, and new barriers on the border between them could endanger some of that trade¹⁰.

However, the SNP is already making the case that Conservative England – with very little opposition from the Labour Party – is pursuing a hard version of Brexit that will harm Scotland. If in the long term Brexit is seen to damage the Scottish economy – for example through job losses to the financial services industry, or labour shortages in tourism – support for independence may rise. And then the need to placate the Scots would be another reason for London to pursue a softer Brexit.

Fifth, senior figures in the British government are gradually learning more about the EU. Many of them are starting from a low level of knowledge, but officials report that ministers are taking home and digesting long briefing notes.

May herself has a track record of being empirical on Europe. In 2013, when the government exercised its right under the Lisbon treaty to opt out of all existing justice and home affairs laws, the then Home Secretary had to decide which areas

⁸ André SAPIR, Dirk SCHONEMAKER, Nicolas VERON, 'Making the best of Brexit for the EU-27 financial system', Bruegel policy brief, February 2017.

⁹ Simon TILFORD, 'Britain's economy: Enjoy the calm before the storm', CER bulletin 112, February-March 2017.

¹⁰ Some Scots also hesitate over going for independence because of the low oil price, and the EU's insistence that Scotland would have to sign up for the euro before acceding.

Britain would opt back into (even though doing so would mean accepting the jurisdiction of the ECJ). May listened to the advice of the police, the security services and other experts and chose to opt back in to key measures like the European Arrest Warrant, Europol, Eurojust and the Schengen databases – much to the annoyance of hard-line sceptics. The more the prime minister and her aides and ministers understand how the EU works – and the domestic politics of the other member-states – the more likely they are to set objectives that are realistic and economically less harmful for the UK.

3.2. THE CENTRALISATION OF THE BRITISH GOVERNMENT

Ever since June 24th, the UK's partners have worried about the capacity of the British government machine to deliver a coherent strategy on Brexit, and to manage the complex negotiations that will unfold after Article 50 is triggered. They have probably been right to worry. These talks may prove to be the most difficult and complex negotiation conducted by a British government since the Congress of Versailles after World War I.

During the autumn of 2016, there was talk in Westminster and Whitehall of the government struggling to get a grip on the Brexit dossier. In November, a leaked memo from the Deloitte consultancy said that the government had no plan for Brexit, that it would take another six months for it to decide on its priorities, that civil servants had had little guidance on what to work on, that an extra 30,000 civil servants would be needed to make Brexit happen, that ministers were divided and that 10 Downing Street took all the key decisions.

“Despite his swashbuckling manner and long-standing euroscepticism, Davis is becoming an increasingly serious figure.”

The surprise resignation of Ivan Rogers, the UK Permanent Representative to the EU, in January, did not help the government's image elsewhere in the EU. In his leaked farewell letter to his staff, Sir Ivan wrote that “the structure of the UK's negotiating team and the allocation of roles and responsibilities to support that team need rapid resolution”, implying that the UK Representation in Brussels – with its in-depth knowledge of the views of the other 27 – was playing a less central role than it should. And Sir Ivan urged his colleagues to “continue to challenge ill-founded argument and muddled thinking [and] to never be afraid to speak the truth to those in power.”

Given the mammoth and unprecedented task of Brexit, and the creation of two new ministries – the Department for Exiting the EU (DExEU) and the Department for International Trade (DIT) – some delay in formulating objectives, and a certain amount of chaos, was to be expected. By the early months of 2017 the

government appeared to be getting its act together. Nevertheless the way that May has organised her government has in some ways added to the confusion.

The most striking feature of the May government, compared with its predecessors, is the centralisation of power in 10 Downing Street. Under Tony Blair, Gordon Brown's Treasury was an important rival centre of power. When Brown became prime minister, his government was more centralised, but senior ministers such as Alistair Darling, Alan Johnson and David Miliband also had clout. Under David Cameron, George Osborne's Treasury was a second, though not necessarily rival, locus of power.

On Brexit, as on most other key issues, the big decisions are taken in No 10 by May and her closest advisers. The most important are Fiona Hill and Nick Timothy, who worked with her in the Home Office. The most influential ministers on Brexit questions are David Davis in DExEU and Philip Hammond in the Treasury. Of the 'three Brexiteers' (the others being Foreign Secretary Boris Johnson and DIT Secretary Liam Fox), Davis has the most at stake in the outcome of the negotiations, and seems to have established a good working relationship with 10 Downing Street. Despite his swashbuckling manner and long-standing euroscepticism, Davis is becoming an increasingly serious figure in the government. Hammond is the leading voice for moderation. He has also long been sceptical about the EU, but came out for Remain during the referendum campaign. He is an economic liberal who listens to the voices of business. He has known May since they were at Oxford University and is trusted by her, though he is a weaker chancellor than Brown was to Blair or Osborne was to Cameron.

The views of Boris Johnson also count, because he sits on the cabinet committee that deals with Brexit and because of his popularity in the Conservative Party and the country. However, his relationship with No 10 is tense at times and, as an institution, the Foreign and Commonwealth Office (FCO) has been marginalised on Brexit. Liam Fox appears to be outside the innermost circles of decision-making.

The most important official working on Brexit is Olly Robbins, who doubles up as permanent secretary in DExEU and the prime minister's personal adviser on Brexit. Sir Tim Barrow, the career diplomat who has replaced Ivan Rogers, is playing a major role (he has worked in the past on Russia and security policy as well as the EU). Sir Jeremy Heywood, the cabinet secretary, is also closely involved in Brexit matters. Peter Storr, a former Home Office official, and Denzil Davidson, a longstanding Conservative special adviser, are part of the Europe Unit in 10 Downing Street that advises May. Chris Wilkins, head of strategy in No 10 and a former Conservative official, plays a big role in the key speeches.

There may be upsides to the centralisation of decision-making in 10 Downing Street. By confining the decision-making on key issues to a small circle of trusted

allies, the prime minister can ensure that sensitive discussions do not leak. And when the prime minister decides what she wants, she should be able to execute her wishes quite quickly, with minimal foot-dragging from other Whitehall departments. But there are evidently downsides. People in the inner circle may become over-stretched, so that important decisions are delayed. And centralisation may discourage the tapping of outside expertise. In May's government, there appear to be relatively few people at a very high level with significant expertise in areas such as the EU, diplomacy, economics, financial markets or business (many of her inner circle have a Home Office background). If too small a group of people is involved in decision-making on Brexit strategy, policies may emerge that are not viable. One example is the commitment in the Lancaster House speech to negotiate not only the Article 50 deal but also the future EU-UK arrangements on trade and everything else in just two years.

3.3. WHAT THE 27 WANT

The kind of deal that Britain ends up with will depend, to a large extent, on what the EU is prepared to offer. So far, the member-states and the institutions have achieved a unity and strength of purpose that has surprised many of them – as well as British officials. The mainstream view, set by the Germans, the French and the Brussels institutions, is to be tough on the British. There can be no negotiations until Article 50 is invoked. And given that Britain wants to restrict the free movement of EU workers, it cannot remain in the single market. Most governments also insist that they will not deal with the UK bilaterally, and that it must talk to the EU as a whole.

Then there are some specific issues on which the EU will be very tough. The 27 are demanding that Britain hand over a large sum – perhaps as much as €60 billion – before it leaves. The greater part of that figure stems from Britain having committed to support many EU projects on which the money has not yet been spent. The 27 also want Britain to pay towards future pension payments to EU staff, and any contingent liabilities that may turn sour (for example, EU loans to Ukraine or Ireland)¹¹. The Commission, and some of the 27, are adamant that unless Britain agrees to hand over most of this money – allowing progress to be made on the Article 50 separation talks – they will be unwilling to start talks on the future relationship. The European Parliament supports this hard line. However, many EU governments reckon that in practice the Article 50 talks will have to run in parallel to those on the future.

¹¹ Alex BARKER, 'The €60 billion Brexit bill: How to disentangle Britain from the EU budget', CER policy brief, February 2017.

The EU will be tough on the transitional arrangements that Britain will ask for. If Britain wants to remain in aspects of the single market after it leaves, it will be asked to accept both free movement and the rulings of the European Court of Justice – and perhaps also to pay into the budget.

The 27 will also be obdurate on financial services. They have no desire to give the British a deal that would allow the City of London to emerge unscathed from Brexit. Few of the 27 view it as a European asset that should be preserved. Some see it as a malignant entity that has the potential to destabilise the eurozone.

Wolfgang Schäuble, the German finance minister, talks with a softer tone: “London offers financial services of a quality that one doesn’t find on the continent.... That would indeed change a bit after a separation, but we must find reasonable rules here with Britain”¹². Such views, however, are not common among EU leaders, or even in Germany.

A hard EU line on such issues could provoke a crisis in the Brexit talks. Europe’s leaders, however, are not very scared by the prospect of an acrimonious Brexit. They believe that though the severing of economic ties would cause the 27 some harm, the UK would suffer much more, given its greater dependency on EU markets than vice versa.

In any case, for Angela Merkel and for most other leaders, politics matters more than economics. They do not want populist eurosceptics in countries like France, Italy or the Netherlands to be able to profit from Brexit, by saying to voters “Look at the Brits, they are doing fine outside the EU, let us go and join them!” EU leaders also worry about some parties in power. For example, in France one hears concerns that Poland’s nationalist government could use the example of a successful Brexit to argue that the Poles would also be better off out.

“Merkel’s key concern is to maintain the strength and stability of the EU, and to keep the 27 together.”

Thus most of the 27 do not want the British, in the words of Boris Johnson, to be able to “have their cake and eat it”. The French say this more directly than the Germans, as when President François Hollande said of the Brexit talks last October: “There must be a threat, there must be a risk, there must be a price”¹³. But Berlin, too, thinks that the British have to be seen to be worse off out.

Most EU governments want to prevent not only contagion to other member-states but also the institutional unravelling of the EU. If the British were given a special deal that allowed them to stay in the single market without having to

¹² Interview with *Tagesspiegel*, February 5th 2017.

¹³ Speech at the Hotel de Lassay, Paris, October 6th 2016.

accept all the rules, other countries – inside or outside the EU – might demand similar provisions, and then the institutional strength and the coherence of the Union would be undermined. The governments claim an economic rationale for this political point: once the British are allowed to pick holes in the single market, it will be harder to stop others erecting barriers.

The Brussels institutions are particularly sensitive to innovations that could weaken their role. There is a profound institutional conservatism in the thinking of many EU leaders and officials, which is one reason why David Cameron found it so hard to engineer serious reforms during his renegotiation. Although the ‘indivisibility’ of the four freedoms – of goods, services, capital and people – is a dogma in Brussels, there are sound arguments behind it. Economically, free movement makes the single market fairer and more efficient (many services cannot cross frontiers unless people are free to move), while politically, it is widely viewed as a great achievement rather than a problem to be managed¹⁴.

What matters most is not what the institutions think, but rather the views of France and (especially) Germany. They will want to ensure that they keep a close eye on the Commission as it leads the negotiations. In December, the European Council decided that a representative of Donald Tusk, its president, should take part in the negotiations – and also that the rotating presidency of the Council of Ministers should send an official to join the Commission team. The European Parliament has so far failed to win the right to take part in the Brexit talks, though it will have to approve the final deals¹⁵.

Merkel’s key concern is to maintain the strength and stability of the EU, and to keep the 27 together. That means considering the interests of the entire Union as much as what is good for the German economy. Britain’s departure leaves Germany more dependent on France; Germany must therefore respect and to some degree go along with France’s desire for a hard line on Brexit. Merkel often repeats that the four freedoms are indivisible. Many British eurosceptics wrongly imagine that Germany will allow its narrow economic interest in close ties with the UK to determine its strategy¹⁶.

Once the negotiations begin, it may be harder for the 27 to remain united. A disparate collection of countries may be tempted to cut bilateral deals with the British: Poland and Hungary, which share some of their euroscepticism and hostility to Brussels institutions; Ireland, which is particularly worried about the impact of Brexit on its economy and the Northern Irish peace process; and

¹⁴ Camino MORTERA-MARTINEZ and Christian ODENDAHL, ‘What free movement means to Europe and why it matters to Britain’, CER policy brief, January 2017.

¹⁵ Agata GOSTYŃSKA-JAKUBOWSKA ‘Parliamentarians in Brexit talks: Bulls in a china shop?’, CER policy brief, February 2017.

¹⁶ Charles GRANT, ‘Why the 27 are taking a hard line on Brexit’, CER insight, October 2016; and ‘Brussels prepares for a hard Brexit’, CER insight, November 2016.

perhaps Sweden, whose leaders think like the British on economic issues such as free trade and the single market. But as one German diplomat points out: “The British should be careful what they wish for; the more disunited the 27 become, the more that will delay negotiations, and increase the risk of Britain crashing out with no deal.”

In any case, the views of Dublin or Warsaw are unlikely to push the EU's centre of gravity far from the line established by Berlin, Paris and Brussels. Nor should the British expect this year's French and German elections to lead to more UK-friendly policies.

Unless Marine Le Pen wins in France (which appears unlikely at the time of writing), the next French president is likely to maintain Hollande's tough line, because that is what the French establishment considers to be in the French national interest. The independent candidate and current favourite, Emmanuel Macron, says he will be “pretty tough” on the UK because the EU must “convey the message that you cannot leave without consequences”¹⁷.

If Merkel remains Chancellor after the general election in Germany, its policy on Brexit will not change. And if Martin Schulz caused an upset by stealing her crown, a government led by the Social Democratic Party, which is keener on EU integration than the Christian Democrats, would be tougher on the British.

3.4. THE KEY DECISIONS THAT MRS MAY STILL HAS TO MAKE

May's Lancaster House speech, and the white paper that followed, left several crucial issues open. What sort of migration regime will she seek? What will she propose for EU citizens living in the UK? Will she try to stay in parts of the EU's customs union? Will she prioritise a special deal for the City of London? What kind of judicial or arbitration mechanisms will resolve disputes between Britain and the EU? And, perhaps the most difficult of all, what kind of transitional arrangements will she ask for?

The most contentious issue for many Britons will be how May restricts migration from EU countries. This need not be negotiated with the EU – it is a sovereign decision for the UK to make. Nevertheless the model that Britain chooses will influence the stance of the 27 in the Brexit talks.

“Officials suggested that limits on migration must be tough enough to bring about a significant fall in the number of EU migrants.”

¹⁷ Interview with the UK's Channel 4 News, February 13th 2017.

Neither May nor her ministers have said much in public on the scheme they want to adopt. However, key officials have suggested that the limits must be tough enough to bring about a significant fall in the number of EU migrants. (Ironically, some of the most senior Leave ministers, such as Brexit Secretary Davis, and Foreign Secretary Johnson, probably favour a more liberal regime than the prime minister, who voted Remain.)

Some system of work permits, with numerical quotas set for particular sectors, is likely. The government has yet to decide whether to have similar or different systems for skilled and unskilled labour, and whether to distinguish between EU and non-EU nationals. But some ministers have hinted that both skilled workers and EU nationals will be treated more leniently. The white paper suggested that it may take several years to introduce the new rules.

One issue that will feature prominently in the Article 50 talks is the 'acquired rights' of the nearly three million EU citizens living in the UK, and of the roughly one million British citizens living in the 27. This subject need not be controversial in terms of British domestic politics. Not only Remain politicians, but also virtually all those who led the Leave campaign want EU citizens in Britain to be allowed to stay – irrespective of what reciprocal rights are offered.

In December 2016 the British government sought a provisional accord on this point, speaking to many member-states individually. The EU rebuffed the British, because their initiative raised fears of a divide-and-rule strategy, and because they seemed to be attempting a 'pre-negotiation' before triggering Article 50. This rebuff was unfortunate, since it made the EU appear dogmatic and indifferent to the real insecurities of continentals living in the UK (but to many of those EU citizens, May's government also appears indifferent, in resisting the pleas of British politicians to guarantee unilaterally their right to stay).

In any case May and her ministers will prioritise the issue of EU citizens in the UK when substantive talks commence, and the EU will probably do the same. But it remains far from clear how the rights of EU nationals in the UK will be guaranteed. Presumably they will need to register and provide proof that they have lived in the UK for a certain period of time. But will the cut-off point be the date of the referendum, or of Article 50's triggering or of Brexit – or some other day? The EU will surely say that people who move to the UK before the day of Brexit are exercising their legal right to do so and should be allowed to stay¹⁸.

EU officials fear that, even with goodwill on all sides, the technicalities involved will make this a difficult negotiation. For example, the definition of a 'resident' is different in Britain and in France. What kinds of family member would an EU

¹⁸ Camino MORTERA-MARTINEZ AND John SPRINGFORD, 'Britain will struggle to make EU migrants 'go home'', CER insight, August 2016.

citizen living in Britain be able to bring into the country? And what kinds of welfare and healthcare would residents be entitled to (these issues are largely the responsibility of national governments, which may encourage the UK to seek bilateral deals with particular capitals)?

The only substantially new announcement in the Lancaster House speech was the decision to leave the essentials of the EU customs union, namely the Common Commercial Policy and the Common External Tariff. Britain's manufacturers, retailers and farmers – as well as the Treasury – had been hoping Britain would stay in, so that UK-EU trade could remain free of tariffs, bothersome rules of origin and customs procedures. The recent House of Lords report on trade criticised the government for not having done enough work to quantify the cost of leaving the customs union¹⁹.

But staying in the customs union would prevent Liam Fox from striking trade deals with other countries. It would also require some mutual recognition of things like product standards and safety requirements (and this could, arguably, give the ECJ an indirect role). The British would have to adopt not only European tariffs without having a vote on them, but also some European regulations²⁰.

Yet there was some ambiguity over the customs union in the Lancaster House speech. May said she wanted a customs agreement with the EU and asked whether Britain could “become an associate member of the customs union in some way, or remain a signatory to some elements of it ... I have an open mind on how we do it”.

The prime minister has said that the issue of the customs union is not a binary decision, which might be taken to imply that certain industries could stay in the union and others leave it. But that would breach WTO rules, which state that a customs union, like an FTA, must apply to substantially all trade in goods between two entities. Nevertheless in the speech she singled out the car industry for special treatment in the FTA that she will seek with the EU.

“The British and Irish governments may be obliged to restore customs posts between Northern Ireland and the republic.”

She may have meant that if Britain and its partners agreed to recognise each other's regulations on cars and their components, customs controls could be minimal. The more that the UK and the 27 can strike mutual recognition agreements, the less there is a need for customs checks. But with Britain outside the common commercial policy and external tariff there would still have to be checks

¹⁹ House of Lords, European Union committee, ‘Brexit: the options for trade’, December 2016.

²⁰ John SPRINGFORD, ‘Customs union membership is no way out of the Brexit trap’, CER insight, December 2016.

for tariffs (when tariffs apply) and rules of origin (lest goods made in the UK with a high proportion of non-EU components 'escape' the EU's external tariff).

That is a particular problem for the Irish. With Britain out of the customs union, the British and Irish governments may be obliged to restore customs posts between Northern Ireland and the republic (passport controls will probably not be needed, since the UK is unlikely to require EU citizens to obtain a visa before visiting). The appearance of customs posts could be a provocation to terrorists. There is a strong desire in Dublin, Belfast and London to find some clever system which would obviate the need for customs controls on the border. The good news is that Michel Barnier, the Commission's chief Brexit negotiator, is very keen to help. The less good news is that nobody has yet found the clever system that will solve the problem.

The Lancaster House speech also singled out the freedom to provide financial services across borders as another objective for the FTA. The British government is resigned to losing 'passporting', since the 27 consider it part of the single market. 'Equivalence' could be another way of enabling UK-based firms to access European financial markets from outside the EU. But equivalence is very much a poor man's substitute for passporting: it does not operate in some financial sectors, like commercial banking and certain sorts of insurance; the Commission decides whether to grant it; and the Commission may revoke equivalence at 30 days' notice.

The big financial firms in London are not sure how much May really cares about their fate. Of the 78 pages in the white paper on Brexit, only one covers financial services, one of Britain's strongest economic sectors. Philip Hammond and the Treasury have certainly listened to the City's concerns. But to judge from her public comments, May is less of an enthusiast for the City than her predecessors Tony Blair, Gordon Brown and David Cameron. Paying particular attention to the fortunes of over-paid foreign financiers would hardly fit with her narrative that the government is focused on the 'just about managing' classes.

Nevertheless the government will surely not ignore this industry in the Brexit talks; it contributed £70 billion in taxes last year, and ran a trade surplus of £63 billion. The Treasury hopes for an FTA that will provide something better than the current system of equivalence. It would be happy if the UK and EU both undertook to abide by globally-agreed standards; if each of them started out by recognising the other's rules as equivalent; and if and when either wanted to change its rules, a joint committee decided whether they remained equivalent. It would also hope for equivalence to become a legally watertight concept, rather than one which can be revoked at the whim of the Commission. However, the EU is unlikely to agree to a deal that implies equality of status in rule-making between the 27 and the UK, and it will want the ECJ to play a role in arbitrating disagreements.

Indeed, dispute settlement may well cast a long shadow over much of the negotiations. The government appears to recognise this, having added a four-page annex covering various types of dispute resolution mechanism to the white paper. Ever since her party conference speech in October, May has singled out the avoidance of ECJ rulings – alongside restrictions on free movement – as her top priority for the Brexit deal. But some British officials wish she had been less categorical and that she had left herself some space for an ECJ role in arbitration.

It is true that the EU's FTAs with other countries include arbitration mechanisms that do not involve the ECJ, and the UK will presumably ask for similar provisions in its own FTA. But when the UK requests special arrangements that resemble single market membership, or other sorts of very close relationship – as it may do on financial services, or data transfers, or aviation, or the European Arrest Warrant – the EU will insist that its court be the arbitration body.

The British are thinking about other models of arbitration that could be adapted, such as the EFTA court, which polices the rules of the European Economic Area for its three non-EU members – Liechtenstein, Norway and Iceland. The court is based in Luxembourg and its judges are nominated by those three countries. The court follows ECJ jurisprudence where it exists, but has more latitude in cases where there is no relevant ECJ ruling²¹. But if the UK were to ask for something similar, it would have to contend with the strong belief in Brussels and many members-states that the authority of the ECJ should not be diluted.

“The most difficult part of the negotiation may be over the transitional arrangements that the British will request.”

The most difficult part of the negotiation may be over the transitional arrangements that the British will request. May said in her Lancaster House speech that the entire future relationship could be worked out in two years, alongside the Article 50 negotiation. But the view of nearly all officials, in London, Brussels and the member-states, is that an FTA between the UK and the EU will take much longer than two years to sort out. All the experts giving evidence to the House of Lords' EU committee, for its recent report on trade, said that two years would be impossible²². The Canada-EU FTA took seven years to negotiate and a further three to ratify.

Businesses want a transitional deal to provide regulatory stability during the period between when the UK leaves the EU, probably in spring 2019, and whenever the FTA enters into force. Without a transition, they would face a 'cliff-edge', falling out of the single market with only the rules of the World Trade

²¹ Alan DASHWOOD, 'EEA could be good model for dispute resolution post Brexit', InFacts, February 2017.

²² House of Lords, European Union committee, 'Brexit: the options for trade', December 2016.

Organisation to protect them – meaning tariffs on many goods, very high tariffs on some farm exports and sharply reduced market access for many service industries.

After taking some time to acknowledge that it will need transitional arrangements, the government has come round to the idea. The white paper says that after leaving the EU, a “phased process of implementation” could cover “immigration controls, customs systems or the way in which we co-operate on criminal and civil justice matters. Or it might be about the future legal and regulatory framework for business.” The white paper then says that some of these interim arrangements will need to last longer than others²³.

Both what Britain will ask for on the transition, and how the 27 will respond, remain uncertain. It seems unlikely Britain will want to stay in the single market during this phase – and if it did, the EU would insist on free movement, payments into the budget and the ECJ, which May could probably not accept. A transition that retained the customs union for a period would be easier to agree upon, but by no means easy; the EU could still insist on a role for the ECJ.

The precise timing of the talks on the transition will be particularly contentious. The UK will want interim arrangements to be fixed as soon as possible in the separation talks, to dissuade footloose companies from quitting the UK. But the EU may well exploit this British requirement by demanding concessions in other parts of the negotiation. In any case, EU officials see strong reasons to leave the transition talks until near the end of the two-year Article 50 process: it would not make sense to talk of a transition without knowing the outlines of the future FTA. Yet there will not be time to grapple with the FTA, they say, until difficult Article 50 issues are sorted out (such as budget contributions, the rights of EU citizens in the UK, giving certainty to legal contracts, and so on).

It is because the negotiation of the transition is likely to be so fraught that a smooth Brexit, leading to an FTA, cannot be taken for granted.

3.5. HOW STRONG ARE BRITAIN'S CARDS?

Once Article 50 is triggered, Britain has just two years to strike a deal. Technically, that period can be extended, but only by unanimity, and given that most of the 27 are firm on the two-year period, an extension is unlikely. The clock will be ticking and if there is no deal at the end of the period, companies and individuals would face great uncertainty and there would be legal chaos. As far as many EU

²³ ‘The United Kingdom’s exit from and new partnership with the European Union’, British government white paper, February 2017.

governments are concerned, this puts the British in a weak position: the pressure of time running out may force May's government to accept a deal on the EU's terms.

The response of many Britons is: "But that would damage our and your economies, which is not in your interests." However, as this paper has argued, the 27, like the British, are not being driven primarily by economics. The best-informed British officials understand that the UK will be in a weak position during the Brexit talks. But there is a risk that those who are brave enough to explain this fact will be attacked by newspaper columnists or in social media as "remoaners", "defeatists" or "people who talk their country down".

"Because of the patchy expertise in London on EU matters, there is a risk that the British will overplay their hand in the negotiations."

Because of the patchy expertise in London on EU matters, there is a real risk that the British will overplay their hand in the forthcoming negotiations. Many British eurosceptics are convinced that May can achieve a good deal because, they believe, she has many strong cards to play. They mention Britain's contribution to European security; the arrival of Donald Trump in the White House; the strength of the City of London; the UK's large trade deficit with rest of the EU; and the threat to turn the UK into a low-tax, deregulated Singapore-style economy. Some of these cards could help Britain in the forthcoming talks, but only if handled deftly, and none of them gives it a great deal of clout.

The strongest card is Britain's contribution to European security, a point mentioned several times in the Lancaster House speech. It has a permanent seat on the UN Security Council, skilled diplomats, capable armed forces, effective intelligence services and considerable expertise on fighting terrorism and organised crime. A leading member of NATO, Britain is one of the few countries to meet that alliance's 2 per cent of GDP target for defence spending. It recently sent about 1,000 troops to Estonia and Poland. Given this contribution to European security, some government advisers have suggested, EU member-states – and especially those in Central Europe – should go the extra mile to give the UK a generous exit settlement.

However, this argument, if handled unsubtly, could backfire on Britain. Some Baltic and Polish politicians who heard it last summer were miffed, saying they had thought the UK was sending troops because it cared about their security; but it now appeared to be a cynical move to ensure better terms on a trade deal.

So the British should not seek a trade-off between security and trade. Rather, they should appreciate that the more they contribute to European security, the more that generates goodwill, and – in the long run – that should help them secure a favourable trade deal. May got the tone right in Lancaster House, saying that she

wanted “practical arrangements on matters of law enforcement and the sharing of intelligence material with our EU allies” and “to work closely with our European allies in foreign and defence policy”.

Some Britons believe that the election of Donald Trump strengthens Britain's security card. Given Trump's ambiguous attitude to NATO and his softness towards Russia, many Central Europeans and others are fearful. Therefore, the thinking in London goes, the continentals need the UK's contribution to their security more than ever. There is some merit in this argument, but the British need to be careful about the way they play the Trump card. If the UK is seen as too friendly to the new president – a point discussed in the penultimate section – its attractiveness as a partner diminishes.

A third card, often cited by eurosceptics and those more favourable to the EU, is the strength of the City of London. They argue that since the City benefits Europe as a whole, the EU would be silly to harm it – for example, by preventing London-based firms from serving EU clients, or by forcing the clearing of euro derivatives into the eurozone.

The Bank of England's governor, Mark Carney, has argued that a bad deal for the City would lead to a greater risk of financial instability on the continent than in the UK²⁴. That assertion is over-the-top, but the fragmentation of Europe's financial markets would raise the cost of capital for many continental companies. They depend on the City to raise money, trade currencies, hedge risk and provide financial expertise. Some 8,000 continental financial firms benefit from passporting into British markets, compared to the roughly 5,000 which passport out of the UK into other EU countries (though the latter do a lot more business than the former). The Bank of England is probably right to argue that if business left the City, as much of it would relocate to non-European centres (such as New York or Hong Kong) as to rival European cities.

But that is not how it looks to a lot of top EU politicians and officials. They do not want to give the City special treatment. Indeed, some of them laugh when they hear the argument that hurting the City could rebound on the 27. Some European politicians blame the City for the financial crisis of 2008, viewing it as a haven of crooked Anglo-Saxon finance capitalism; others are intent on attracting City business to their own financial centres. The 27 are firm that the UK should lose passporting, and as for equivalence, the Commission recently launched plans to make the rules more onerous, so that the UK would find it harder to meet standards set by the EU. France, Germany and the European Central Bank are strongly committed to shifting the clearing of euro derivatives

²⁴ Evidence to the House of Commons Treasury select committee, January 11th 2017.

from London into the eurozone. It will be very difficult for the UK to achieve any kind of special deal for the City.

A fourth card, often cited by eurosceptics, is Britain's trade deficit with the EU. In 2015, the last year for which full figures are available, the UK exported goods and services worth £222 billion to the EU, and imported £290 billion worth from it, leaving a trade deficit of £68.5 billion. Therefore, eurosceptics have said again and again, the EU has much more to lose than the UK in any trade war.

“The UK is much more dependent on trade with the 27 than vice versa, and will therefore be hurt more in any trade war.”

Trade deficits are not particularly problematic, so long as the country concerned can finance them sustainably. From an economic perspective, the benefits of free trade accrue mostly to consumers, who get better and cheaper products thanks to imports. But if one wishes to focus simply on the relative dependency of the British and EU economies, the 27's exports to the UK account for 3 percent of their GDP, while British exports to the 27 make up 13 percent of its GDP²⁵.

The UK is much more dependent on trade with the 27 than vice versa, and will therefore be hurt more in any trade war. It is true that the Germans will not want to endanger their car exports to the UK. But a UK-EU free trade agreement is likely to eliminate tariffs on goods, which will make life easy for German manufacturers. The problem for Britain is that its greatest strength is in services, which are not covered by traditional FTAs; zero tariffs on goods do nothing to help the City of London.

The final card comes in the form of a threat. The British know that their partners are worried that they might steal business by cutting social and environmental standards, or tax rates. The government therefore keeps threatening to turn the economy into something resembling Singapore in the North Atlantic. Philip Hammond has hinted at this in several speeches and the prime minister repeated the threat at Lancaster House. She said that in the event of being offered “a punitive deal that punishes Britain” she would consider no deal to be better than a bad deal. “We would be free to set the competitive tax rates and embrace the policies that would attract the world's best companies and biggest investors. And, if we were excluded from accessing the single market, we would be free to change the basis of Britain's economic model”²⁶.

²⁵ Crude trade balance figures include exports that contain inputs imported from elsewhere, so a more accurate measure is the share of total domestic value added (the basic ingredient of GDP) that is exported to the other side. The latest OECD figures, for 2011, put the domestic added value contained in the EU's exports to the UK at 2 per cent of the total; meanwhile for the UK the equivalent figure is 11.7 per cent of its total domestic value added.

²⁶ Theresa MAY, speech at Lancaster House, January 17th 2017.

There are three problems with this threat. First, it undid some of the good that May's positive and courteous tone had achieved in the first three quarters of the speech. Second, threats that lack credibility sound hollow. And given that May, earlier in her speech, had praised employee rights, workers on boards, industrial strategy and a fairer society, her brand of Conservatism is clearly distant from the kind of libertarian Thatcherism that she was threatening to establish.

And third, the 27 have been warned and are preparing counter-measures. Lodewijk Asscher, the Dutch deputy prime minister, has written to fellow Socialist leaders, warning of the dangers of May's government creating an ultra-liberal economy: "Let's fight the race to the bottom for profits taxation [which harms] our support for our social security systems." He wrote that they should not sign an FTA with the UK unless "we can agree firmly on tackling tax avoidance and stopping the fiscal race to the bottom"²⁷.

Several governments say they would veto any trade agreement that permitted the UK to engage in excessively competitive tax cuts. Commission officials claim that they are already preparing mechanisms that would allow the EU to curb access to European markets or raise tariffs, if the British went for social or fiscal 'dumping'. But the EU could find that difficult: Ireland already has corporation tax of 12.5 per cent (on trading income), while Britain's main rate of 20 per cent is due to fall to 17 per cent by 2020. The EU could insist that the FTA commit all parties to respecting international rules on unfair tax competition, and the provisions on state aid and competition policy could seek to prevent the British behaving in ways that distorted the single market. But the EU can hardly punish Britain for setting a rate of corporation tax that is higher than Ireland's. So perhaps the counter-measures are not much more credible than the threat.

3.6. WHAT KIND OF BREXIT DEAL IS LIKELY?

Only three possible options remain for Britain's future relationship with the EU: an Article 50 agreement, including transitional arrangements that lead to an FTA and other deals covering future relations; an Article 50 agreement that merely leads to reliance on WTO rules; and no Article 50 agreement, plus reliance on WTO rules. Of the three options, an FTA would be by far the best for the UK economy²⁸. With luck, an FTA would provide for low or zero tariffs on industrial goods, and remove some farm tariffs. A conventional FTA would not require the UK to accept free movement or the authority of the ECJ (though all FTAs establish dispute settlement procedures or special arbitration courts). The

²⁷ Cited in Dan BOFFEY, 'Netherlands will block EU-UK deal without tax avoidance measures', *Guardian*, January 14th 2017.

²⁸ John SPRINGFORD et al, 'The economic consequences of leaving the EU', CER report, April 2016.

problem with FTAs is that, traditionally, they do not do a great deal to open up services markets (a British strength) or remove non-tariff barriers to trade.

The deepest FTA that the EU has hitherto negotiated, with Canada, takes some tentative steps to open up telecom, postal and shipping services, and parts of public procurement, but leaves out financial services, aviation, audio-visual media and many other services. If Britain does request an FTA, it will certainly hope for a better deal than Canada. But it should not assume that it will succeed, given that several UK industries are stronger and more threatening to their EU competitors than are Canada's (for example, finance, consulting, law, accounting, airlines and outsourcing). Furthermore, Canada needed the deal far less than the UK will need its FTA. In negotiating the deal, the EU may demand greater budgetary contributions – and fewer restrictions on free movement – in return for market access in particular sectors.

“Those talks could collapse over, for example, the EU’s insistence that Britain pay the €60 billion it claims is owed.”

As already explained, an FTA will require a transitional deal, given the time that the former will take to negotiate. If the UK and the EU find the difficulties of negotiating a transitional deal too great to overcome, Britain will face an abrupt exit from the EU, falling back on WTO rules. Those rules set maximum tariff levels for goods. Britain would face the EU's common external tariffs on its exports. While quite low for many products, they are high for others – 10 per cent on cars, 12 per cent on clothing, 20 per cent for beverages and confectionery, and more than 40 per cent for many kinds of meat. Moreover, WTO rules do virtually nothing for services: the General Agreement on Trade in Services (GATS) is a WTO treaty that sets general principles and provides some transparency and legal predictability, but it does not open markets.

Some hard-line British eurosceptics favour the WTO option, on the grounds that it would be quick and simple, and obviate the need for years of complex FTA talks with the EU bureaucracy. They are confident that new FTAs with emerging powers and English-speaking countries will soon make up for lost EU commerce. But some recent economic research suggests that new trade deals will do little to compensate for the loss of EU trade that will stem from Brexit²⁹. Furthermore, some eurosceptics oppose the principle of a transitional deal per se, because they worry that interim arrangements could drag on for many years, or perhaps forever, with the result that the UK would never properly leave the EU. They also

²⁹ Monique ABELL estimates that an FTA with the EU would in the long term cut the UK's total trade by 22 per cent. Meanwhile new trade deals with the five BRICS countries, as well as the US, Canada, Australia and New Zealand, would boost British trade by 5 per cent. See her 'Will new trade deals soften the blow of hard Brexit?', National Institute for Economic and Social Research, January 27th 2017. See also John SPRINGFORD et al, 'The economic consequences of leaving the EU', CER report, April 2016.

fear that the EU may extract a high price for the transition, such as free movement and the jurisdiction of the ECJ.

One particular group of libertarian Brexit economists, led by Patrick Minford, a professor at Cardiff Business School, argues that once it has left the EU, Britain should unilaterally remove all tariffs (as well as scrapping many taxes, and social and environmental rules)³⁰. That policy would take away the UK's bargaining chips in future negotiations on FTAs; but these libertarians are not particularly bothered whether Britain achieves FTAs with other countries. Turning the UK into an Asian tiger in the North Atlantic would, they argue, generate a massive boom in economic activity, with or without trade deals. Minford admitted during the referendum campaign that such a course would eliminate much of Britain's manufacturing industry. It would also finish off many British farmers. However, May's government is unlikely to go down such a controversial path. There is no majority in the Conservative Party for Minford's ultra-Thatcherite medicine.

One outcome that would cause even more economic damage than the WTO option remains possible. That would be a breakdown of the Article 50 talks followed by WTO rules.

Those talks could collapse over, for example, the EU's insistence that Britain pay the €60 billion it claims is owed. If May stormed out of the negotiations, perhaps to fight a general election on a eurosceptic platform, Britain might then leave the EU without any agreement at all. This would create great legal uncertainty for companies and people who have invested, traded or moved across borders. There would be arguments over which law applied to contracts. Maritime commerce and aviation between the UK and the EU might be disrupted, at least in the short term. An enormous number of lengthy and complex legal cases would clog up international courts, covering issues like budget payments, pensions and residency rights, as well as regulatory and trade questions. It is highly unlikely that financial markets would react calmly.

Such an outcome would cause huge damage to the British economy and some damage to the rest of the EU. But that does not mean it cannot happen. Some of the most senior EU officials think it possible, because – in their view – the British over-estimate the strength of their cards, and are being driven more by eurosceptic emotion than economic self-interest. Ivan Rogers shared some of these concerns and thought that a breakdown of the talks was possible.

³⁰ Patrick MINFORD, 'Unilateral free trade is far more attractive than membership of the single market', BrexitCentral, September 21st 2016.

3.7. HOW TO GET A GOOD DEAL

Given the weakness of May's hand, a half-decent agreement will require the goodwill of Britain's partners. Some of the government's conduct has eroded that goodwill. To generate goodwill, May and her ministers need to think carefully about their style and tactics, and then come up with requests on the substance of the negotiations that generate a relatively warm response.

Ministers should be serious and courteous, while avoiding anti-EU rhetoric. To quote a senior official in one northern capital, "if you want a good deal, keep the negotiations boring and technical. The more your ministers grandstand, the more we become defensive and unhelpful."

"Ministers should be serious and courteous, while avoiding anti-EU rhetoric ... smugness and bravura should be avoided."

To be fair to May's government, many of its senior figures are gradually getting the message. But not all of them. When Boris Johnson said in November that the idea of free movement being a founding principle of the EU was "a total myth" and "bollocks", he was not only factually wrong but also offensive. The Foreign Secretary was at it again in January, when President François Hollande said that Britain's Brexit deal would have to be worse than membership. Johnson quipped that Hollande wanted "to administer punishment beatings to anyone who wishes to escape, rather in the manner of some World War Two movie" – humour that did not travel well.

Smugness and bravura should be avoided. Speaking to the Corporation of London in November, David Davis said that he was "not really interested" in a transitional deal, but that since the UK's sudden departure could harm the EU's financial stability, he would "be kind" and agree if the EU asked for a transition³¹.

Ministers should also consider how their chumminess with certain governments may affect attitudes in Berlin, Paris, Brussels and other key EU capitals. Theresa May's welcome of the Polish and Hungarian prime ministers to 10 Downing Street was frowned upon, since their governments' track record on the independence of state media and the judiciary has made them the black sheep of the European family (it is unusual for a British prime minister to pick up a visitor from the airport, as May did for Poland's Beata Szydło).

More problematic has been London's attitude to the election of Donald Trump. Johnson's enthusiastic response in November, telling EU leaders to "snap out of the general doom and gloom about the result [and the] collective whinge-o-

³¹ Alex BARKER, 'David Davis rebuffs City hopes for a transition deal', *Financial Times*, December 9th 2016.

rama”, and his boycotting of an EU dinner to discuss the president-elect did not enhance his already shaky relations with fellow EU foreign ministers. Then in January, shortly before Trump’s inauguration, Johnson shunned a conference of 70 nations in Paris that reaffirmed support for the two-state solution to the Palestine problem. He subsequently vetoed a motion in the EU’s foreign affairs council that backed the conference. The Foreign Office pointed out that it had not changed its policy on Palestine and that the timing of the Paris event had been provocative to the incoming US administration. Nevertheless the British moves reinforced the impression that Britain was more concerned to curry favour with Trumpians than stand by its European allies.

Of course, for the UK to court the incoming US administration, and potential friends in Budapest and Warsaw, is legitimate and rational; it needs all the allies it can find. But British ministers should be aware that there are potential costs, particularly if they mishandle the theatre of diplomacy. With the Trump administration, in particular, some British politicians seem unaware of the potential downsides of cosying up.

During May’s trip to the US, at the end of January 2017, she generally got the balance right. Speaking to Republicans in Philadelphia, she said there was “nothing inevitable” about an eclipse of the West, and that its values must be upheld. The European project was vitally important: “It remains overwhelmingly in our interests – and in those of the wider world – that the EU should succeed”³². And when she went on to Washington she persuaded Trump to agree with the statement that he was 100 per cent behind a strong NATO. But then when she came home to the news that Trump had banned visitors from seven Muslim countries, she was slow to say she disapproved.

Trump’s behaviour will present the British with constant challenges. If the way May handles Trump implies that Britain shares significant parts of his worldview – despite his line on Russia, Palestine, Iran, climate and trade being radically different from British (and European mainstream) policy – she will do great damage to Britain’s reputation. There is a real risk that, as the British government attempts to straddle the widening gap between the two sides of Atlantic, it may fall down the middle.

“May and Merkel have reacted to the election of Trump in different ways, which has not made their relationship easier.”

Britain’s image in the EU would benefit from the prime minister making a big speech somewhere on the continent, setting out a positive vision for what the UK could contribute to Europe post-Brexit. For example, she could build on her

³² Theresa MAY, ‘Speech to the Republican Party’, Philadelphia, January 26th 2017.

Lancaster House and Philadelphia speeches by offering to make Britain's expertise on foreign policy, defence, counter-terrorism and policing available to the EU, in pursuit of common policies and objectives. She could offer ships and border guards for policing and strengthening the EU's external frontier – goals which would evidently benefit Britain. She could aspire to make Britain a closer partner of the EU on security policy than any other non-member – and come up with some concrete proposals on how to achieve that.

On the future economic relationship, May would impress the 27 if she aimed for a high level of integration, within the parameters set out in Lancaster House and in the white paper. She might signal a willingness to accept the authority of some judicial body that was similar to but not the ECJ, in a dispute settlement mechanism.

She could offer money for the funds that support the development of poorer EU members. The Central Europeans will probably lose out from Brexit, since richer states will be reluctant to replace Britain's contribution to EU regional funds. Such a financial offer could reduce the scale of the 'Brexit bill' (consisting mainly of unspent budgetary commitments) that the 27 expect Britain to pay upfront. It could also spur the 27 to offer Britain a more generous FTA.

As for free movement, if May proposes less stringent controls on EU citizens than those from other continents, she will earn some goodwill. But if the new regime cuts the numbers of EU migrants sharply, goodwill will be lost.

In addition to reinforcing British soft power, May and her ministers need to think hard about how best to use the Whitehall machine. Lord Kerr, a former permanent representative to the EU (and the current chairman of the CER), had some trenchant advice in a recent article. "The first rule of good policy-making is rigorous pre-launch testing", he wrote. He suggested that ministers should convene a wide circle of experts to consider the practicalities of, and possible objections to, each policy proposal. "Keeping the circle too small leads to disasters like Mrs Thatcher's poll tax". He emphasised the importance of understanding how the 27 would react to British ideas. "To dismiss realism as defeatism, and damn dissent as disloyalty, is to court disaster"³³. It is perhaps surprising that as the government has prepared its strategy for Brexit, it has seldom sought the advice of Lord Kerr or other former permanent representatives to the EU.

The EU will get annoyed if the UK regularly seeks to bypass the official negotiations by talking informally to particular governments. But there will be occasions when the British need to do this. They should certainly nurture informal channels

³³ John KERR, 'Honest advice is a tradition worth preserving', *Financial Times*, January 7th 2017.

with Berlin – a capital where May and her ministers probably need to invest more. There is a view in May's government that David Cameron over-emphasised the importance of Germany: in the end Merkel failed to stop the appointment of Jean-Claude Juncker as Commission president, or to give Cameron as much as he wanted in the renegotiation of February 2016. Cameron may have counted too much on the German relationship, but May – to the alarm of some British officials – seems to have under-invested in Berlin³⁴.

May and Merkel have reacted to the election of Trump in different ways, which has not made their relationship easier. But even though Germany does not control the EU, it remains more influential than any other country and will be crucial in corraling support for a final deal with the UK. London needs to focus not only on Merkel but also on Martin Schulz and other leading Social Democrats. Schulz rose to prominence as president of the European Parliament. That should remind May's government not to ignore that powerful institution, which can veto all the Brexit agreements. Ministers should be in Strasbourg as well as Berlin.

3.8. CONCLUSION

Although an acrimonious divorce that damages all parties is possible, the UK and the 27 may in the end agree on some kind of FTA, with transitional provisions. One of May's strengths is that at least some of the time she believes in evidence-based policy-making. If she concludes that the national interest requires it, she may find the courage to break with the hard right and go for a not-so-hard Brexit.

But even in the most optimistic scenarios, the Brexit deal will be fairly hard. One reason is that the British government's strategy is not about achieving economically optimal outcomes. The prime minister will prioritise restricting free movement and excluding the European Court of Justice, whatever the economic price. For the British government to pursue such a strategy is perfectly legitimate, though it has – unsurprisingly – been shy of admitting the likely economic costs.

The second reason is that the 27, too, are being driven more by politics than economics. Many EU leaders are rather franker than the British government on this point. They say that the cohesion, unity and strength of the EU count for much more than the loss of some trade with the UK.

Neither side seems particularly bothered that even the best possible deal that is feasible will harm the economic well-being of all concerned. Such views are

³⁴ Peter FOSTER, 'Exclusive: Brexit alarm in Whitehall over Theresa May's 'almost non-existent' relationship with Angela Merkel', *The Telegraph*, January 4th 2017.

unlikely to shift in the next year or two, especially since the atmosphere in the divorce talks will probably be fraught.

In the very long run, however, a better deal, giving Britain many though not all the benefits of membership, could become more plausible. A group of eminent analysts outlined such a model in a paper published by the think-tank Bruegel in August 2016 – suggesting that Britain and other non-members could participate in the single market, be consulted on its rules and be excused freedom of movement, so long as they accepted the ECJ³⁵.

Such a model is not politically acceptable in either the UK or the EU at present. In the longer term, however, when Britain has experienced the chill winds of solitude; when its erstwhile partners see the potential economic benefits of drawing the British closer; and when the EU itself is more open to reform and new ideas, then schemes such as those promoted by Bruegel may return to the agenda.

Thinking about issues other than economics could help to bring about a reconciliation between the British and the EU. Given the unstable neighbourhood surrounding the EU, and the many threats to the continent's security, the 27 could benefit from the UK providing resources and expertise. That is why Theresa May was right to talk about security in her Lancaster House speech. Her government should come up with concrete proposals for the role that Britain could play in European foreign, defence and security policy. Working together in these areas could help to establish a climate in which closer economic relations become imaginable.

³⁵ Jean PISANI-FERRY, Norbert RÖTTGEN, André SAPIR, Paul TUCKER and Guntram WOLFF, 'Europe after Brexit: a proposal for a continental partnership', Bruegel, August 2016.

4. REGULATORY CONVERGENCE AND FINANCIAL MARKET INTEGRATION

Piers Haben^{1 2}

In these short remarks I highlight the importance of international cooperation and agreement on common minimum standards. These are a necessary condition for international finance to support stable economic growth and we should be alarmed at any threat to such agreements. I then identify some priorities for the EBA in the single market context, regarding the need to remove final obstacles to a level playing field and avoid regulatory arbitrage. Finally, I touch on issues relevant for understanding the possible approaches to third country regimes in the context of the UK leaving the single market. I look at the challenges of equivalence and mutual recognition in particular.

4.1. THE GLOBAL PICTURE AND THE NEED TO MAINTAIN INTERNATIONAL RULES

The G20 reforms are largely achieved and the banking sector is much stronger than previously. Global agreement on rules has allowed us to press ahead without undue regulatory competition beating back reforms. We have been proportionate.

Global agreement and cooperation remains vitally important and we should not take the BCBS for granted. Recognising all the lessons from the global financial crisis we must also recognise the benefits that have been achieved in support the growth of global trade, and with it global cooperation and improving living standards. Therefore any sign of mistrust in international standards and cooperation is extremely worrying.

Practical cooperation has also been important and new impediments to practical global cooperation, by effective ring fencing should give us cause for reflection. Now reciprocal legislation by the EU which effectively undermines mutual recognition of equivalence of consolidated supervision is being considered, which is intended to strengthen the resolution of third country groups.

A breakdown of global rules would risk a world where capital cannot be deployed efficiently, we risk a race for the bottom in global rules, and a

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² The opinions expressed are those of the authors and do not necessarily reflect those of the EBA or its Board of Supervisors.

breakdown in trust amongst supervisors, which would heighten the risk of global financial instability and disorder in the face of crisis.

4.2. THE SINGLE MARKET – PRIORITIES FOR THE 27

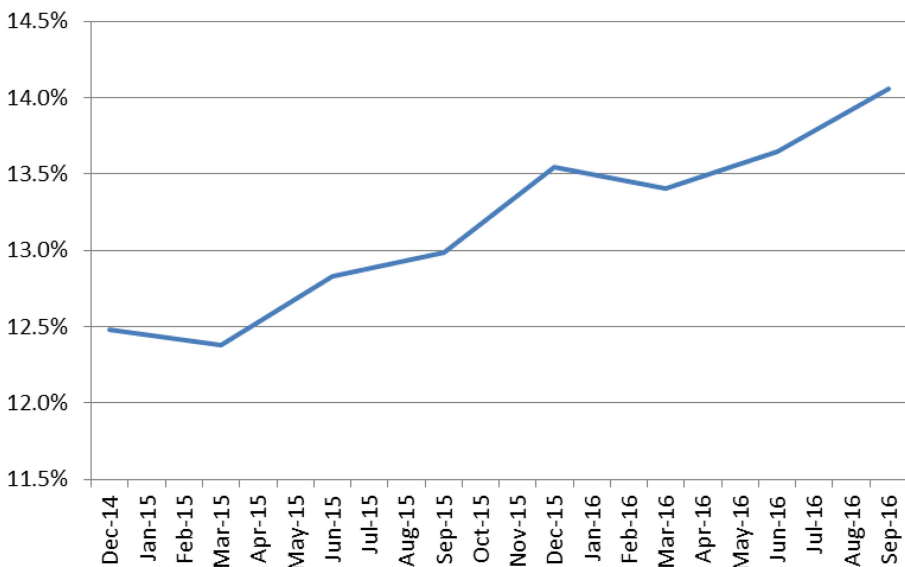
The EBA is responsible for designing the single rule book, ensuring its implementation and promoting convergence in supervisory practices. We produce standards and guidelines and assess their implementation as well as mediate between parties when there is disagreement. In addition to taking forward the rules from the G20 response to the crisis, two key concerns have driven us since our inception

- a) The need for *ongoing repair* of the EU banking sector post crisis.
- b) The risk of *fragmentation*, setting back the progress made on building the single market for banking services.

4.2.1. Ongoing repair

On the first, supervisors across the EU have worked hard to build up capital post crisis, (from less than 9% in 2011 to over 14% CET1 today). We are currently focused on tackling the outstanding stock of legacy assets and see a significant effort to addressing this trillion euro problem. Supervisors will then need to assess other challenges to banks profitability, and long term sustainability.

CET1 ratio (weighted average)

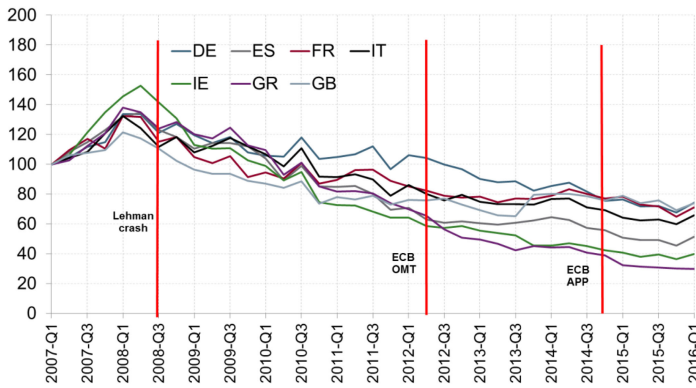


4.2.2. Fragmentation

On the second, fragmentation, post crisis has seen some setbacks. Financial integration has contributed significantly to the development of EU economies and the progress of the Single Market. It incentivised cross-border banking and supported the availability of finance for households and businesses, also reducing the spreads in the cost of funding across jurisdictions.

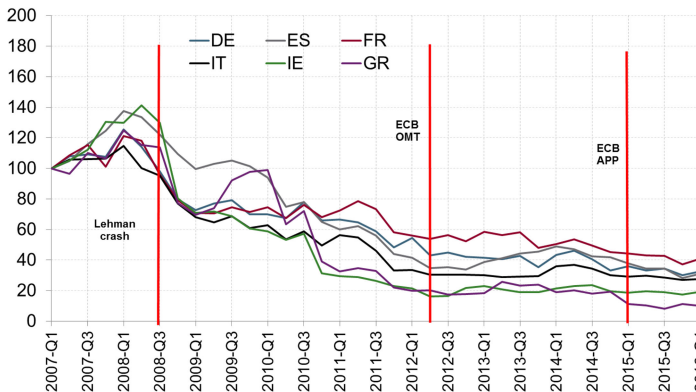
Post crisis, fragmentation has materialised through higher sovereign and corporate credit spreads and a drop in cross border lending.

Consolidated Total foreign claims (ultimate risk basis) of reporting european banks vis-à-vis selected countries, 2007 Q1 = 100
(Domestic banks, excluding domestic positions)



Source: BIS

Consolidated bank foreign claims (ultimate risk basis) of reporting european banks vis-à-vis selected countries, 2007 Q1 = 100
(Domestic banks, excluding domestic positions)



Source: BIS

At the end of 2011, the spread of Italian and Spanish 10y government bonds with the German Bund were six times higher than at the beginning of 2010, increasing respectively by 450 and 350 bps. While borrowers benefited from historically low interest rates on average, financial fragmentation led to high interest rate dispersion for firms and households across the euro area countries.

As banks de-risked and retrenched, and fragmentation took hold the EBA identified potential implications particularly for economies heavily reliant on banks from across the EU. The EBA pushed hard to ensure that, for example, our recapitalisation recommendation³ was met with new capital and did not lead to disorderly retrenchments – a point facilitated by ongoing supervisory discussion in colleges. The Vienna 2 initiative was also instrumental in avoiding disorderly or large scale withdrawal of banking activities in host markets.

The EBA has also worked hard to ensure that cross border banks can truly operate across the single market. The EBA has overseen the roll out of joint risk assessments and joint decisions in colleges, and we have mediated where supervisors have disagreed on outcomes.

The reason to reflect on these issues at this juncture is that the single market goes beyond simply rules and we need to understand actions and implications. The EBA has a mandate to look beyond rules, to their application. In this regard we take our convergence agenda very seriously and pursue compliance with the rules, comparability of approaches and consistency of outcomes. This is key for a level playing field, proper coordination between supervisors, and orderly oversight of cross border banking groups.

The EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) have significantly contributed to a common understanding and more consistent use of Pillar 2. Based on our assessment of the convergence of supervisory practices, most authorities established processes that – while cognisant of the specificities of local markets – are broadly in line with our guidance⁴.

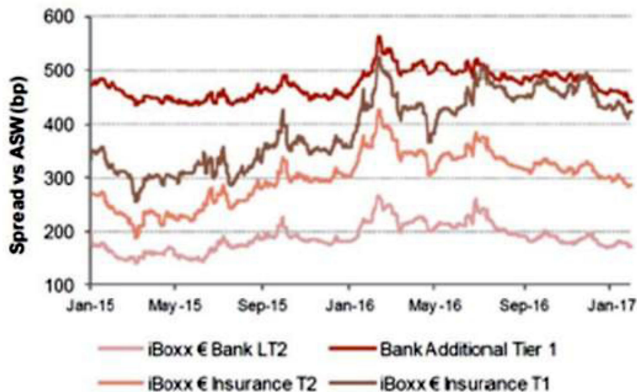
There are, however, areas where authorities still face challenges to converge, for instance with regard to the setting of institution-specific capital requirements. Divergences in supervisory approaches towards the nature and level of capital requirements, as well as in the application of automatic restrictions on distributable amounts – partly due to the lack of clarity in the relevant regulation – generated uncertainty among institutions and investors and, in some cases, temporarily affected capital planning and investment decisions. In the first half of

³ <https://www.eba.europa.eu/-/the-eba-publishes-recommendation-and-final-results-of-bank-recapitalisation-plan-as-part-of-co-ordinated-measures-to-restore-confidence-in-the-banking>.

⁴ EBA (2016), Report on the convergence of supervisory practices.

2016, the market for additional Tier 1 instruments (AT1) came to an almost complete halt, following the widespread uncertainty on supervisory approaches adopted by different competent authorities for the automatic restrictions to distribution and AT1 payments, known as maximum distributable amount (MDA). This is a good example of a topic that – despite being addressed in the common legislation – might be subject to interpretation and different supervisory practices. It also shows how differences in supervisory practices may have far-reaching effects, not only for banks subject to different supervisory treatment, but also for other stakeholders, including the investor community.

Subordinated debt instruments: secondary pricing



Source: Bloomberg & EBA calculations

For this reason, we have put significant emphasis on Pillar 2 topics and on the implementation of our SREP Guidelines. Our opinion on MDA addressed some of the most urgent concerns related to the stacking order and the role of Pillar 2 capital requirements in the MDA framework, but we have also urged the Commission to clarify this point in the incoming revision of the CRD.

The challenges we face in the SREP process are being replicated in the assessment of recovery and of resolution planning, in resolvability assessments and in the setting of total loss absorbing capacity (TLAC) and minimum requirement of own funds and eligible liabilities (MREL). To some extent, I would argue that success in establishing consistent practices in this area is even more essential for restoring financial integration. As a matter of fact, ring fencing measures come as a natural response when authorities are concerned that a crisis at a branch or subsidiary of a foreign institution would impact the local safety net.

I note these challenges fully alive to changing institutional structure in the EU. The EBA has tended to act as a bridge between the Banking Union ins and outs. This is reflected in our rather complex voting arrangements, QMV with double

simple majority, to ensure a balance in decision making on rules. It is also reflected in our approach to supervisory convergence. However, the single market without the UK effectively contains only pre-ins for the Banking Union. In this regard some may argue that our work to ensure convergence in rules and practice in the single market starts to resemble more closely a transition path to full banking union in the EU.

Thus, under any circumstances, one key focus for us will be to step up our work to enhance the single rule book with supervisory convergence and this will be our focus, in prudential regulation as well as consumer protection and the supervisory treatment of financial innovations. For example, bail in rules and subordination of capital is subject to differing national rules meaning different hierarchies in the single market. This makes the pathway to effective MREL challenging. And differing approaches to fit and proper make a mockery of a single authorisation regime in the banking union. Such harmonisation will also be important to avoid any inadvertent regulatory arbitrage emerging, not only globally as mentioned above, but within the EU, for example in an effort to attract new business from third countries.

4.3. THE REGULATORY AND SUPERVISORY LANDSCAPE IN RELATION TO THIRD COUNTRIES

There remains significant work to do to strengthen the single market. But we recognise that we will have to also spend time reflecting on future interactions with third countries. The EBA is neutral on the future relationship with third countries including the UK, other than that relationship should be orderly and the transition should be reached with minimum disruption. I will address these, from a banking system perspective, in terms of transition and steady state.

4.3.1. The scale of the challenge

On one hand we must consider there is a significant adjustment issue given the scale of the challenge. The single market in financial services is highly interconnected and much of that interconnection is highly reliant on passporting.

The EU financial sector has over 6042 credit institutions or 6918 if investment firms supervised by the United Kingdom's FCA are included. This number includes all the institutions that are subject to the CRR in 27 out of 28 EU Member States and Norway. Most institutions are concentrated in Germany (24.1%), and the United Kingdom (15.6%), followed by Italy (9.2%), Poland (8.9%), Austria (7.8%), and France (6.1%), which together account for 71.7%

of the number of institutions. Together these institutions have approximately EUR 37.4 trillion of total assets.

Most of these assets are concentrated in France (23.7%), the United Kingdom (21.5%) and Germany (19.3%), which together account for 64.4% of total assets in the EU financial institutions. Out of 6918 institutions, 76.8% are CRR credit institutions and the remaining 23.2% are investment firms. 58% of the number of credit institutions (that is 44% of the total) are co-operative banks. The next biggest categories are savings banks (13.2% of credit institutions) and local universal banks (10.2%). Total assets however are concentrated in cross-border universal banks (34.8%) and local universal banks (18.3%), which also reflect more generally their larger average size.

Put more simply, we must be alive to the fact the majority of EU investment banking is head quartered in London and more than a third of payment and electronic money institutions are also here. According to AFME 78% of EU FX trades are conducted in the UK, and 46% of the EU's equity capital is raised in the UK, and 74% of interest rate derivatives trading is here. Half of EU fund management activities take place in the UK. Whilst we see differing views as to whether there would be a sufficient breadth and depth of financial services offerings if there were barriers between the EU and UK financial services markets, there would surely be transitional issues if access was suddenly impeded. To that end we should be acutely aware of the challenges to a smooth transition to the new setting. As the UK government's white paper notes, in its first point, certainty and clarity are key. That applies as much to how we get to, as what happens in, steady state. The BBA in its quick brief #6⁵ notes that any sudden change will be disruptive to businesses and their customers and some transition is needed for banks and their customers.

4.3.2. Transition

On the plus side, at the date of exit of the UK from the EU, one would not expect there to be any imminent dramatic changes to the UK regulatory framework, because, firstly, public and private entities are bound by EU law – including the technical standards developed by the EBA – until the last day of the UK's membership in the EU. Secondly, the EBA has developed these standards jointly with the 28 national authorities, including with those from the UK, such as PRA, the FCA, and the Payment Systems Regulator. In any case many come from the BCBS which the UK will continue to adhere to. The UK government has also said that, “wherever practical and appropriate, the same rules and laws will apply on

⁵ <https://www.bba.org.uk/landingpage/brexit/>.

the day after the UK leaves as they did before” in its white paper. This would suggest that there will be at least some degree of continuity.

However, we acknowledge, of course, that the environment is dynamic and that the view in the UK may change over time. If any sudden changes are needed, we should not underestimate the practical challenges.

There will be physical bottlenecks during any agreed transition in the form of (i) licensing processes (ii) model validation approval. Both of these will slow down movements and relocation.

Banks internal restructuring will pose challenges all of their own. AFME have looked into the operational impacts of wholesale banking and note the range of practical challenges beyond simply working out who can do what where and getting a licence for it. The practicalities of moving or finding skilled staff, finding professional services support and finding premises are huge and will certainly take longer than two years.

AFME note that many banks are proceeding with two-year tactical plans to maintain continuity of service. However, these plans “are likely to be sub-optimal for clients and market effectiveness”, and will be dependent on reaching agreement about an interim business model that is acceptable to their new EU27 regulators and can be put in place before the UK leaves the EU.

There’s a host of other practical considerations such as *the use on ratings of ECAIs currently registered/certified by ESMA* – absent some transitional arrangements, UK CRAs will become third country CRAs that need to be certified by ESMA (which will require the UK to set up a domestic authorisation scheme and have a COM equivalence decision), or will have to have their rating endorsed by an ESMA-authorised ECAI.

Finally it seems unlikely that quick fixes will be available by simply moving a few staff. Supervisory judgement on whether mind and management is present in the relevant jurisdiction also means it would be hard to simply set up front offices inside the single market. As Gerry Cross from the CBI noted in January “*Where we are asked to consider the authorisation of a firm in Ireland, we will want to be satisfied that we are authorising a business or line of business that will be run from Ireland and which we will be effectively supervising. We will expect there to be substantive presence here. In general, we would expect that the Board and the management of the entity are located in Ireland such that that the business is run from here. We will want to be satisfied that the ymind and management of the entity are located here and decisions are taken here.*”⁶

⁶ <https://www.centralbank.ie/press-area/speeches/Pages/RemarksbyGerryCrossatBrexitandAsiaImplicationsforFinancialServicesinIreland.aspx>.

4.3.3. Steady State

In steady state it is useful to reflect on the options available for engagement. I will look mostly at banking and reference other areas of heightened interest in particular in relation to capital markets activity, although that is primarily an area of responsibility for my colleagues in ESMA.

The three options we see most commonly talked about are the following:

- a) Passporting under some special single market access agreement. This now looks increasingly remote given the white paper ruling out single market membership. Such a view also appears increasing reflected in various industry reports and I will not go into this further here, recognising of course that the full range of agreements remain possible.
- b) Equivalence has been talked about as a possible option and I would like to explore more fully the current status of equivalence assessments with regards to banking.
- c) Mutual recognition seems increasingly offered as a sort of super mutual equivalence. I will briefly note some issues around such a regime without pretending to do justice to the important questions it throws up and will not comment on either the possibility or desirability of such an outcome.

4.3.4. Equivalence

Equivalence under the current regime does not provide access to the single market in banking services. In banking, equivalence is limited to three key areas: confidentiality, lower risk weights; consolidated supervision.

- Article 55 and article 116 (6) of the CRD covers the Equivalence of confidentiality regimes. The EBA coordinates such assessments and their conclusions provides for the rather thrilling agreement on the provision of the exchange of information and participation in EU supervisory colleges.
- Articles 107, 114, 115, 116, 132, 142 of the CRR assess the equivalence of third country legal and supervisory regimes. The EBA provides technical advice on this and the outcomes is that EU institutions can apply the same, often more favorable treatment to certain categories of third country credit risk exposures than those applied to EU exposures. This has a positive effect on capital requirements and large exposures for EU institutions.
- Article 127 of the CRD provides for an assessment of the equivalence of consolidated supervision. If a third country consolidated supervision is assessed as equivalent, Member States do not have to apply EU consolidated supervision *mutatis mutandis* to the EU institutions (under third country consolidated supervision). This of course may be threatened by IHO rules.

So current equivalence assessments on banking offer no specific market access⁷. Moreover, equivalence assessments can be withdrawn at short notice making it extremely difficult to do business under.

4.3.5. Mutual recognition

Instead is some sort of mutual recognition agreement a likely outcome? I'm not sure what this would entail but presumably some sort of ongoing joint equivalence assessments. I cannot offer a view on the likelihood or feasibility of such an outcome. But I would note the following points:

Assessments of equivalence are time consuming and hard. Last year the EBA assessed a number of third countries just for confidentiality purposes. Many of them were small, it took a significant amount of time. And in one case we are still being inundated about a dispute over the correct name of the country in question. Steven Majoor has noted some other issues⁸, in fairness in an entirely different context as he was talking about current equivalence of EMIR where ESMA has already recognised more than 20 CCPs from outside the EU and are processing 25 other applications. He is worried that not all other countries also have recognition, thereby potentially risking the possibility for any one country, even a close one. And he questions how we can have sufficient assurance that risks of the third country infrastructures' activities in the EU are adequately assessed and addressed by the home regulator in the third country. An issue especially relevant the more important the role of the third country in the EU's financial system.

At present, equivalence assessments can change very quickly – this would either have to change or life would be very difficult for business planning. In addition, we should acknowledge that equivalence and access is not driven just by high level rules. Supervisory practices and outcomes are also important for a level playing field and therefore mutual confidence. The EBA is tasked with ensuring compliance with the rules; comparability of approaches and consistency in outcomes. Within the single market we know the costs of inconsistent outcomes. As I noted, a glance at February 2016 will show the disorder in the AT1 market from uncertainty and different interpretations of the application of MDA. Moreover, we have on a number of occasions had to mediate between differing supervisory authorities. The task of assessing not only rules but their practical application in the pursuit of unfettered access would be a new world and a challenging one.

⁷ For banking there are differing views on whether market access is needed if you take the view that many financial services are performed where they are carried out (rather than where the customer is based).

⁸ https://www.esma.europa.eu/sites/default/files/library/esma71-844457584-329_prime_finance_conference_-_keynote_address_by_steven_maijor.pdf.

Possibly it is not banking services that are the main concern. Capital market issues could be to the fore, in which MiFID and EMIR would be key. I look to others to comment on these where there are interesting areas of more relevant equivalence. Moreover, in banking services, the issues raised to achieve some form of recognition are not insurmountable. But they would mean some fundamental rethinking around such assessments, including the resources they would absorb, how to deal with both rules and outcomes, and associated mediation, and the long term feasibility of such assessments. All this at a time when scarce supervisory and regulatory resources are urgently needed elsewhere.

5. THE SYSTEMIC RISK CONSEQUENCES OF BREXIT

Jon Danielsson¹, Robert Macrae² and Eva Micheler³

With less than two years until Britain leaves the European Union, Brexit will certainly be disruptive for the efficiency of financial markets. However, the question of whether Brexit significantly affects financial stability does not have a clear answer. The two most relevant central bankers have reached opposite conclusions, with Mark Carney worried and Mario Draghi more sanguine. Broadly line with Draghi, we think Brexit should mostly decrease systemic risk, albeit with some potential for an increase. When it comes to systemic risk the bar is quite high.

5.1. SYSTEMIC RISK IS ENDOGENOUS

Systemic risk is the unlikely eventuality that key parts of the financial system fail, spilling over to the entire financial system, culminating in a financial crisis and potentially a real economy depression. Such systemic crises are not frequent. The IMF crisis database (Laeven and Valencia (2012)) suggests one happens once every 42 years on average for OECD countries, and even that is an overestimate because it includes relatively innocuous, purely financial events. A true systemic crisis is more like a once-in-a-lifetime event.

For Brexit to have systemic risk consequences, including increase the likelihood of a serious financial crisis, we therefore need to focus on events that are very unlikely but if they happen are quite serious. Large and even very large losses, or significant disruption to the operations of financial markets do not by themselves constitute systemic risk. More is needed, and the most obvious types of risk might not be systemic. For example, if we take two identical losses, one for the US stock market and the other in US subprime real estate, their impact is very different. A \$200 billion loss in the stock market passes without barely a ripple, while an identical in magnitude loss in subprime results in the biggest financial crisis in a generation.

The difference is the unknown unknowns. We anticipate and prepare for the stock market loss, the subprime loss came as a complete surprise to most of us. Even those that believed it might happen were incapable of taking appropriate precautions due to institutional constraints and competitive pressures. Risk we

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know can be reduced and prepared for so long as we have the ability to do so. We cannot do the same for unknown unknowns.

Most analysis of financial risk treats risk as exogenous, an external shock we react to but cannot influence. While a convenient assumption that facilitates modeling and decision-making, an assumption of exogenous risk is not appropriate for systemic risk, which arises endogenously from the interaction of economic agents, all with their individual and evolving situations, objectives and information, as discussed e.g. in Danielsson, Shin and Zigrand (2009). Endogenous risk is often revealed when we question the hidden assumptions or practices that have worked for a long time. The extent of market reliance on the “Greenspan put” or the liquidity of AAA rated CDOs is hard to observe.

For endogenous risk to strike we need something within the system to change sharply – some assumption or belief to be violated – so that positions that had been willingly taken, come to be seen as highly unattractive and to be sold at almost any price, culminating in firesales and illiquidity spirals. To create such a sharp re-evaluation it helps to start in a position with high confidence, leverage, liquidity, trust and internationalism, such as provided by the European common market.

If there are systemic consequences from Brexit, positive or negative, that is where they will be found. While Brexit certainly has the potential for creating very large losses for individual market participants, and may have significant economic consequences, that by itself does not constitute systemic risk consequences.

5.2. THE GOOD NEWS

The good news is that Brexit will reduce systemic risk, primarily via two channels. First, it will increase uncertainty and fear, and when market participants are scared they look hard for problems and operate cautiously. The financial sector is already anticipating many Brexit-related problems and making energetic preparations to deal with them, so the emergence of new ones will surely not come as a shock. That makes it unlikely they can cause systemic problems.

Second, Brexit increases fragmentation. Highly integrated systems with unified rules and low frictional costs have many vulnerabilities. They result in long chains of intermediation with many interdependencies that make it easier for local problems to spread system-wide, and tend towards monoculture where whatever business model is best adapted to the regulatory environment squeezes the others out. Such systems, especially when coupled with barriers to entry such as high regulatory fixed costs, encourage the creation of too-big-to-fail entities.

Taking Britain out of Europe leaves both financial systems weaker and less efficient, but all the wasted effort and barriers to trade will also make it less likely that both financial systems fail at the same time and, so long as the barriers are not too high, will also help to maintain diversity within both systems. While fragmentation is undesirable from an efficiency point of view, systemic risk is decreased.

5.3. THE BAD NEWS

Brexit might also cause systemic problems, if, despite all the fears, planning and precautions, at some stage during the process some new fear suddenly arises or confidence in the ability to offset or hedge some risk suddenly disappears. If this comes is enough of a surprise and pervasive enough it could conceivably result in a systemic crisis if earlier fears had been directed towards the wrong targets.

Two areas appear to be of concern, legal plumbing and equivalence. We do not think either is likely to cause problems, but systemic risk is about unlikely but serious events.

Could some boring, totally mundane function such as settlement or rehypothecation have its post-Brexit legal status questioned? Obviously, there is a well established basis in Europe, and another in US, and 40 years ago there was a third in UK but when the Acquis is nationalised – transplanted whole into British law – is there any potential that something will be broken in the move?

Brexit will almost certainly reveal new problems within well-established contractual relationships, just as the Lehman insolvency led to some aspects of ISDA being construed in court in a way many parties had not expected. The real question is over whether any problems will be of sufficient magnitude to cause a systemic event.

It is reassuring that the rules will be applied by regulators whose intent is to make things work as before. Courts are sensible; the intent of nationalising the Acquis is not to change things and courts will be strongly influenced by this. Provided sufficient time is available, sensible solutions can be found. Set against this, no burden of proof is required for uncertainty to explode into a crisis. All we need is a credible question being raised over the legal basis of some activity and we might see all market participants prudently and immediately stop carrying out the affected activity until sufficient reassurance can be provided.

Such jumps in expectations and behaviour has been at the heart of many systemic crises, including 2008, when the fear that further insolvencies might follow AIG and Lehman was sufficient to shut down lending to finance-sector counterparties

until adequate reassurances were given that no more banks would fail. Unfortunately, legal timescales are long, so if the legal plumbing does threaten to fail, then the UK and EU governments may need to find some way to underwrite the affected activity until the leak can be fixed.

Another potential avenue for systemic crisis is equivalence, the treatment of foreign institutions and regulation as functionally equivalent to domestic institutions and regulation.

As long as Britain is a member of the European Union, financial institutions can safely assume that rules in one country apply in all member states. It is not possible to have a special set of rules for a subset of countries. If a financial institution complies with British regulations, it complies everywhere in the Union.

When Britain leaves, this permanence is gone, replaced by equivalence agreements. The European Union can choose to recognize compliance with British rules as being equivalent to complying with European rules, and vice versa. However, by its very nature, such agreements are transient. Equivalence could in principle be revoked with a few months' notice. If financial institutions operate on the assumption of permanent equivalence and equivalence is revoked or found to have a hidden weakness that is only exposed in a time of stress, or even just if market participants fear such an eventuality, then financial institutions could find themselves in unexpected difficulties.

The need to avoid excessive reliance on equivalence is fundamentally at odds with the desire to make the concept at all useful, and so there is potential for problems, even though all involved are highly aware of the issue. We expect both European and British authorities to handle termination of equivalence agreements with considerable care.

5.4. CONCLUSION

Systemic crises happen when we suddenly question our existing assumptions for how the world works and don't like the answer. We might get there with Brexit, perhaps via plumbing or equivalence.

However, on balance Brexit seems unlikely to increase systemic risk. It is a very visible problem increasing uncertainties, fragmentation, frictional costs and mistrust. All of these are stabilising, and so are systemic risk reducing however costly they are in other economic terms.

Among all the competing commercial, national and regional interests in the Brexit negotiations, financial stability and systemic risk appear to us to be relatively unimportant.

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6. BREXIT AND FINANCIAL SERVICES: THE SIGNIFICANCE OF ‘THIRD COUNTRY EQUIVALENCE’

*John Armour*¹

6.1. FINANCIAL SERVICES IN THE UK AND THE EU

‘Financial services’ comprise all the activities undertaken in the financial system – the sector that channels savings from consumers toward firms and households that need finance for investment or current consumption. It includes banks, asset managers, financial markets, and insurance. Financial services are a very important sector of the UK’s economy, accounting for 7-12 per cent of GDP, 11 per cent of gross tax receipts, and 7-12 per cent of employment (HOUSE OF LORDS EU COMMITTEE, 2016, p. 5; OLIVER WYMAN, 2016)². Financial services also provide the largest trade surplus for any sector of the UK economy, valued at £72 billion in 2014, of which £19 billion is with the rest of the EU (THECITYUK, 2016).

Table 1: EU component of UK financial services revenue, by sector (2015, £ billion)

Sector	Banking	Asset management	Insurance	Market infrastructure	Total
Intra-EU revenues	27.00	6.00	5.00	12.00	50.00
Total revenues	117.00	23.00	42.00	26.00	208.00
EU fraction of total sector revenues	0.23	0.26	0.12	0.46	0.24
Sector fraction of total EU revenues	0.54	0.12	0.10	0.24	1.00

Notes: Revenue data are from a study conducted by Oliver Wyman (2016, p. 6). ‘Intra-EU revenues’ comprise UK financial services revenues from international and wholesale business related to the EU; ‘Banking’ includes investment banking; ‘Insurance’ includes reinsurance; ‘Market infrastructure’ includes other financial services.

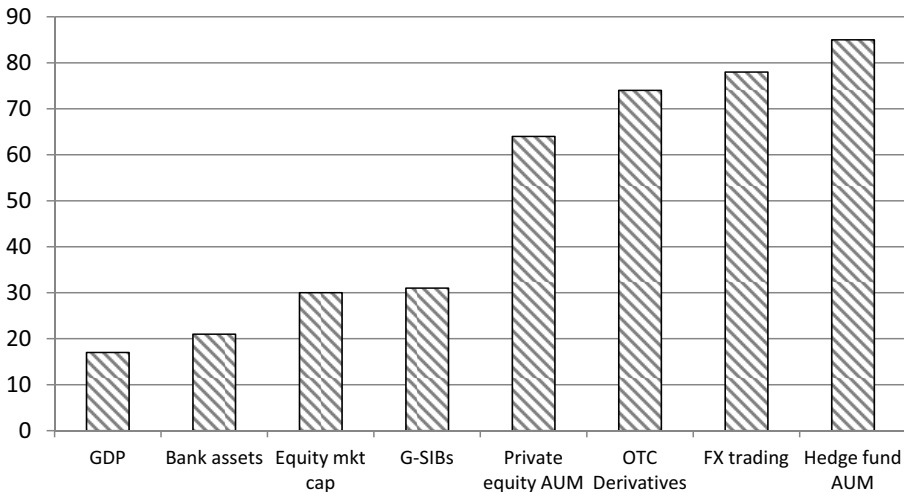
¹ Hogan Lovells Professor of Law and Finance, Oxford University. This chapter is a substantially modified version of ‘Brexit and Financial Services’ (2017) 33 *Oxford Review of Economic Policy* S54-S69, available at https://academic.oup.com/oxrep/issue/33/suppl_1, and is reprinted with permission. I am grateful to Veerle Colaert, Luca Enriques, Jeffrey Gordon, and an anonymous referee for thoughtful comments on the original version, and to Dan Awrey for helpful discussions. This chapter also benefited from feedback following presentations at the Blavatnik School of Government in Oxford, the Oxford Review of Economic Policy/British Academy Conference on Brexit, the SUERF Conference on Brexit at EY London and a Roundtable on Negotiating Brexit at St Hugh’s College, Oxford. Remaining errors are my own.

² Although it is common to think of this as an issue for ‘the City’, two-thirds of these employees are based outside London.

Table 1 reports UK revenues for different types of financial service during 2015, and the component of these generated by intra-EU international business. As can be seen, banking is by far the largest sector overall and accounts for 54 per cent of intra-EU financial services revenue. However, it is notable that a smaller proportion of the UK’s total banking revenues are intra-EU (23 per cent) than for market infrastructure (46 per cent) or even asset management (26 per cent).

Sectoral differences also matter from the perspective of the EU, as Figure 1 illustrates. This shows the proportion of total EU28 activity of various types taking place in the UK. As a baseline, the UK accounts for 17 per cent of the entire EU GDP. This is closely tracked by the fraction of EU bank assets held by UK banks (21 per cent). However, the UK’s share of total EU activity grows as we move to the right of Figure 1, encompassing equity market capitalization (30 per cent), numbers of globally systemically important banks (31 per cent), and especially wholesale market activities. Table 1 and Figure 1 together suggest that while banking is the largest component of the UK’s intra-EU financial services revenues, the UK’s greatest intra-EU comparative advantage lies in asset management and wholesale markets.

Figure 1: Percentage of EU-wide activity taking place in UK, by sector (2015)



Notes: GDP and equity market data are from the World Bank. Bank asset data are from the European Central Bank (ECB) and the Prudential Regulation Authority (PRA). Data on G-SIBs (global systemically important banks) are from the Financial Stability Board (FSB). Data on private equity assets under management (AUM), over-the-counter (OTC) derivatives transactions, foreign exchange (FX) trading, and hedge fund AUM are from TheCityUK.

The outsize representation of the UK in the EU’s financial market activity reflects the traditionally more market-oriented focus of the UK’s domestic financial

system than those of its continental European neighbours (CARLIN and MAYER, 2003; RAJAN and ZINGALES, 2003). However, the almost total dominance of the UK in certain wholesale market sectors is also consistent with the existence of agglomeration externalities (SASSEN, 2001; CLARK, 2002). That is, the co-location of providers yields spillover benefits through the availability of a deep and liquid pool of human capital and more rapid circulation of innovations and tacit knowledge. More specifically, there are complementarities in the co-location of wholesale market clearing infrastructure, because these permit net, rather than gross, exposures to be carried on participants’ books (WOOD, 2007; CUNLIFFE, 2016). Importantly, there are also likely to be significant complementarities between the UK’s financial regulators – the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) and the operation of the financial sector (see JACKSON and ROE, 2009). These regulators have developed expertise in the regulation of wholesale financial market activities on a scale that is not replicated elsewhere in Europe.

Conversely, financial market activity is under-represented in the rest of the EU, as reflected in the EU’s assessment of its priorities for the financial sector. In 2015, the European Commission announced an ambitious programme of reform known as the Capital Markets Union (CMU), intended to spur the growth of capital markets throughout the EU (European Commission, 2015). This is motivated by concern that the EU’s financial system is excessively dependent on banks, which is thought to have an adverse impact on the financing of innovation, and to render the system very dependent on the stability of large financial institutions (ESRB, 2014; LANGFIELD and PAGANO, 2015).

Thus, the financial services nexus between the UK and the rest of the EU is of strategic importance to both sides. It is a particularly successful UK export industry, and – at least as regards wholesale markets – also vitally important for the EU’s diversification away from reliance on banking.

6.2. FINANCIAL SERVICES AND EU LAW

The financial sector is one of the most globally interconnected components of most economies. It is at the same time one of the most heavily regulated sectors, the intensity of which has further heightened since the financial crisis (ARMOUR *et al.*, 2016). The legal starting point, however, is that firms engaged in international activity must comply with regulation separately in each country in which they operate. There is a wide carve-out under the World Trade Organization (WTO) rules that gives governments power to restrict cross-border financial services on the basis of prudential controls³. This consequently increases the cost of cross-border capital flows, with firms often needing to incorporate a subsidiary

in each of the other jurisdictions in which they wish to operate, to ensure that each entity is compliant with the local regulatory regime.

A very different legal regime operates within the EU. The member states have agreed to a common corpus of financial regulation, which since the financial crisis is written through EU-level sectoral agencies (LAMANDINI and MUÑOZ, 2016; MOLONEY, 2016b). In return, financial services firms that obtain authorization within this single rule-book from the national competent authority (NCA) in their country are then free to offer services throughout the EU member states without any need for further local authorizations. This is known as the ‘financial services passport’. Technically, there are many separate passports available under different pieces of financial services legislation, but they operate in an additive way, and EU law encompasses so much of financial services, that from most firms’ perspective, the consequence is simply that whatever they are locally authorized to do, they are authorized to do throughout the EU⁴. The potential loss of this ability to ‘passport’ services throughout the EU is at the centre of the financial sector’s concerns over Brexit.

Another important way in which the financial services sector relies on EU law is through the free movement of workers (see PORTES and FORTE, 2017; SUMPTION, 2017). It is easier to develop and maintain a deep pool of human capital if meritocratic recruitment is possible from as wide a range of candidates as possible. The absence of immigration restrictions within the EU facilitates such recruitment; their imposition once again, as regards the UK, will surely hinder it. To be sure, it seems likely that the UK government will adopt a regime that facilitates access for financial services professionals, but this will probably still impose additional process costs on firms, not to mention relocation difficulties for dual-income families where the second earner falls outside the privileged categories.

6.3. BREXIT AND FINANCIAL SERVICES

Versions of Brexit in which the UK leaves the EU but remains a member of the European Economic Area (EEA), hence enjoying continued access to the single market and permitting UK-authorized financial services firms to keep their EU passporting rights, appear now to be politically unlikely. This is because EEA membership entails acceptance of the ‘four freedoms’ including continued free movement of persons, which has been ruled out by the UK Government. Never-

³ General Agreement on Trade in Services, Annex on Financial Services, para 2(a).

⁴ The FCA reports that vastly more (a ratio of 14:1) passporting rights are relied upon by UK financial services firms doing business in the rest of the EU (outbound passports) than by EU-based firms doing business in the UK (inbound passports). However, if one looks at the numbers of *firms* relying on one or more passports, inbound outnumber outbound by a ratio of 1.5:1 (HOUSE OF LORDS EU COMMITTEE, 2016, p. 11). It is hard to know how to interpret these data as neither measure necessarily captures the economic significance of the activity in question.

theless, given the level of UK–EU activity described above, there are clear benefits to both sides in coming to some sort of bilateral agreement regarding financial services (RINGE, 2017). At this stage, little can usefully be said about the likely scope of such an agreement. In the remainder of this chapter, we focus on three cognate issues: (i) possible precedents; (ii) the ‘outside’ option for the UK if no agreement is forthcoming; and (iii) the desirable scope of such an agreement.

The existing precedents for bilateral agreements with the EU do not look promising. Switzerland and the EU have agreed a wide-ranging bundle of bilateral measures (Swiss Federal Department of Foreign Affairs, 2016). These cover free trade in goods, but generally not services, although there are particular measures on certain financial services, including non-life insurance. However, the price for these agreements is that the EU requires Switzerland to accept the free movement of EU citizens, which would be problematic as a matter of UK politics. In contrast, the recently negotiated Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU does not entail any commitment on Canada’s part to free movement of persons, but its provisions on financial services do not extend anywhere near the ‘passport’ recognition enjoyed by firms authorized within the EU (CETA, ch. 13). Moreover, CETA took 7 years to negotiate, and notoriously nearly failed to be ratified by EU member states.

However, the UK’s bargaining position is quite unlike that of Switzerland or Canada, so these precedents are not especially illuminating. It is perhaps more helpful to consider the impact on financial services if the UK simply leaves the single market without any such agreement. This will help to identify what is at stake if agreement is not reached, and the strength of the parties’ bargaining positions.

6.4. THIRD COUNTRY EQUIVALENCE

The cessation of EU membership will mean that the UK immediately becomes a ‘third country’. The entitlements of the UK and its citizens under the EU Treaties *qua* EU member state will cease. This will mean that UK firms will no longer be able to rely on the freedom of establishment, or on EU passporting rights under financial services legislation⁵.

Except where specific arrangements have been made, the European single market is largely irrelevant as respects third-country firms. That is, such firms must obtain authorization under the regulatory regimes of each member state in which

⁵ At the same time, any access to non-EU financial services markets that UK firms currently enjoy under EU-negotiated arrangements will also cease, and so will need to be separately renegotiated (FERRAN, 2016). For the purposes of this discussion, we focus on the effects on UK-EU activity.

they wish to operate: a decentralized model of state-by-state authorization⁶, very much like before the EU existed. EU law only intrudes in a negative way: most EU financial services legislation contains provisions prohibiting member states from offering more favourable treatment to third-country firms than is provided for under the EU regime for member state firms. Thus, the EU law rules provide a floor for third-country firms’ compliance obligations, preventing any member state from offering a lax ‘back door’ to the single market. Yet there is nothing to stop member states from discriminating *against* third-country firms by imposing more exacting standards than for EU firms.

One area in which such discrimination might plausibly occur is in relation to the clearing of Euro-denominated derivatives contracts. In a notorious 2011 policy statement, the ECB announced that owing to concerns about financial stability, it considered that all euro-denominated payment transactions should be settled by institutions within the Eurozone (ECB, 2011). This would have required clearing houses to move within the Eurozone. The UK successfully challenged this in the EU General Court on the basis that the policy overreached the ECB’s statutory competence, which does not extend to securities and clearing houses⁷. However, the Court noted that there is a mechanism for amending the ECB’s statutes, which might in principle be used to broaden them to give it the necessary competence to regulate clearing. When the UK has left the EU, it will no longer be able to object to such an amendment⁸.

This rather unpromising terrain has been reshaped quite considerably, however, since the financial crisis. This period has seen a ramping-up in both the scope and intensity of international norms in financial regulation (BRUMMER, 2015). There has also been a shift in emphasis in financial regulation toward financial stability (ARMOUR *et al.*, 2016). Because the preservation of financial stability necessitates international cooperation, and because differential regulation increases the costs of trade under a traditional decentralized authorization framework, there has been a parallel shift to multilateral production of new standards, through a new international organization established by the G20, the Financial Stability Board (FSB). As a by-product, firms in third countries compliant with FSB guidance are now subject to rules that are substantially similar to those in the EU.

⁶ One apparent exception is the right to free movement of capital, which the EU Treaty expressly extends to movements between member states and third countries: Treaty on the Functioning of the European Union (TFEU), Art. 63. However, this provides no real benefit to third-country financial services firms, because the provision has been interpreted narrowly by the Court of Justice such that where it overlaps with other treaty freedoms – such as the freedom of establishment – that do not extend to third countries, precedence should be given to the narrower provision (SCHÖN, 2016). Consequently, financial services firms cannot rely on the free movement of capital to conduct business in the EU, as this activity is covered by the freedom of establishment, which does not extend to third-country firms: Case C-452/04, *Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht* [2006] ECR I-09521, ECLI:EU:C:2006:631.

⁷ Case T-496/11 *United Kingdom v ECB* (2015) ECLI:EU:T:2015:133.

⁸ This would also be the case under a, soft, Brexit, whereby the UK left the EU but remained in the EEA.

These developments have also given the EU reason to rethink its traditional decentralized authorization model for third-country firms. Increasing the level of required scrutiny brings increased costs for each national authorization, and decentralized decision-making makes it harder to control systemic risk (CUNLIFFE, 2016; GLEESON, 2016). The result has been an emerging, and still-evolving, body of rules known loosely as ‘third-country equivalence’ (or 3CE) provisions (QUAGLIA, 2015; FERRAN, 2017; EUROPEAN COMMISSION, 2017). In essence, these provide for centralized authorization decisions for third-country firms as regards certain aspects of the EU’s financial regulation regime. Relevant third-country firms are thereby exempted from national authorizations with respect to rules covered by the relevant 3CE framework.

Three general points should be made about the application of 3CE. First, it is not so much a general framework as a lattice of many specific regimes that operate together. Second, the scope of, goals for, and associated processes for making relevant determinations differ from regime to regime: the devil lies in the detail. The European Commission maintains a list of current 3CE determinations, which details 39 different equivalence regimes under 14 different pieces of EU financial services legislation (EUROPEAN COMMISSION, 2016). Third, 3CE is a moving target. New provisions are continually being added, and the way in which the 3CE processes are framed is also developing over time. In February 2017, the Commission announced a review of the way in which 3CE regimes operate. The associated Commission Staff Working Document studiously avoids mentioning Brexit, but, perhaps ominously for the UK, emphasises the importance of equivalence determinations as a means of ensuring financial stability and not simply open markets (EUROPEAN COMMISSION, 2017). Together, these features make understanding the likely post-Brexit 3CE picture a complex and fast-changing endeavour. With these caveats in mind, it is worth making a few general observations about the likely operation of 3CE. We begin with the process of making a determination, and then turn to the scope of the relevant effects.

6.5. DETERMINING EQUIVALENCE: PROCESS

The key precondition to the application of a 3CE regime is that there must be an authoritative determination that the third country’s regulatory regime is *equivalent* to the EU regime⁹. This is generally done by the Commission, increasingly following an assessment by the relevant European Supervisory Authority. Under the investment services regime, for example, such an equivalence determination has three components: (i) *substantive equivalence*: that the third-country rules

⁹ Markets in Financial Instruments Regulation (MiFIR), Arts 46(2)(a).

have equivalent effect to the relevant EU law rules; (ii) *compliance*: that the legal and supervisory arrangements in the third country ensure that firms authorized there actually comply with the legal rules there; and, in some cases, (iii) *reciprocity*: that the third country’s legal framework provides for reciprocal recognition of EU firms¹⁰.

The UK government has announced that it plans a wholesale enactment of all previously-binding EU law into domestic UK law. It follows that, at the point of exit, the UK will have in place a body of financial regulation that necessarily will be substantively equivalent to EU law¹¹. The UK’s FCA and PRA have larger enforcement budgets than many other EU member states’ financial regulators, which should suffice to meet the Commission’s enquiries regarding compliance (JACKSON and ROE, 2009). And it will naturally be in the UK government’s interests to agree, where necessary, to reciprocity for EU financial services firms wishing to do business in the UK.

There is a widely held fear that the process of determining equivalence may become politicized in the context of a messy Brexit negotiation. How politicization might creep in may be illustrated by imagining what would happen were the ECB to reinstate its 2011 policy of requiring euro-denominated transactions to be cleared within the Eurozone. As we have seen, once it is outside the EU, the UK would not be able to stop such a policy from being implemented. And yet, equally, it would have no binding obligation to comply with such a policy. Here is it is possible to see there might be pressure on the Commission to treat a failure by the UK to comply with such a policy as grounds for non-‘equivalence’.

Ironically, this fear of politicization likely under-appreciates the merits of leaving decisions to technocrats, which is precisely what the democratically opaque structure of the Commission, and *a fortiori* the delegation of the initial assessment to the European Supervisory Authorities (ESAs), is intended to achieve (MOLONEY, 2016*b*). Table 2 shows the third countries for which equivalence determinations have been made by the Commission as regards a range of existing 3CE regimes. As can be seen, the lists consist largely of subsets of G20 countries and international financial centres. Each of these countries has a common interest with the EU in the relevant sectors. While bureaucrats at the Commission are unlikely to feel much sympathy towards the UK, it would surely

¹⁰ *Ibid*, Art. 47(1).

¹¹ There will nevertheless be an enormous amount of legal work necessary simply to ‘convert’ the EU legislation to a format that will function on a stand-alone basis. This will include relatively straightforward but high-frequency matters such as changing the identity of rule-making and supervisory bodies (e.g. from the European Securities and Markets Authority (ESMA) to the FCA) and changing the applicable procedures for implementing secondary legislation. It should also include responses to some rather more profound challenges, such as the introduction of a parallel domestic mechanism for responding to, and where appropriate implementing, post-exit updates to the EU regime, and the status and effect of post-exit Court of Justice of the European Union (CJEU) decisions on domestically internalized rules.

Table 2: Third countries for which equivalence determinations have been made

Sector	Measure	G20 countries	Financial centres/other
Banking	CRD IV/CRR	Australia, Brazil, Canada, China, India, Indonesia, Japan, South Korea, Mexico, Saudi Arabia, South Africa, USA	Hong Kong, Singapore and Switzerland
Insurance	Solvency II	Australia, Brazil, Canada, Japan, Mexico, USA.	Bermuda, Switzerland
Prospectuses	PD	Turkey	Israel
Credit Ratings	CRA Regulation	Argentina, Australia, Brazil, Canada, Japan, Mexico, USA	Hong Kong, Singapore
Derivatives (CCPs)	EMIR	Australia, Brazil, Canada, India, Japan, South Korea, Mexico, South Africa and the USA	Dubai, Hong Kong, New Zealand, Singapore, Switzerland and the UAE.

Notes: CRD IV/CRR is Capital Requirements Directive IV 2013/36/EU and Capital Requirements Regulation (EU) No 575/2013; PD is Prospectus Directive 2003/71/EC; CRA Regulation is Credit Rating Agencies Regulation (EC)_No 1060/2009, as amended by Regulation (EU) No 462/2013; EMIR is European Market Infrastructure Regulation (EU) No 658/2012.

be inconsistent with both the EU’s interests and the vision of the EU project for them to treat the UK appreciably differently to this list of existing partners. This means that moves, for example, to repatriate euro clearing could not credibly be directed only against the UK, but would need to be of general application. As euros are also cleared in the US and Asian jurisdictions, this would likely trigger a round of costly retaliation.

A more plausible concern is whether the Commission will have completed the necessary equivalence determinations by the time the UK’s 2-year Article 50 period is completed. Neither a third country, nor its firms, have any right to compel the Commission to start the process of making an equivalence determination, even if the third country would manifestly meet the criteria. For example, the very earliest equivalence decisions under EMIR – Australia, Hong Kong, and Singapore – took 2 years from when the legislation came into force, and it took 4 years for the EU to accept the equivalence of the US regime on central counterparties for derivatives.

As well as an equivalence determination from the Commission, there must be *cooperation* agreements in place between the third country’s authorities and both the relevant ESA and relevant NCAs in EU member states¹². The UK can take the

¹² See, for example, MiFIR Arts 39, 46(2)(c), 47(2).

initiative in seeking to expedite such arrangements pre-emptively during the Article 50 negotiating period, however.

A third concern relates to the future beyond the short term. Equivalence must be reviewed periodically, and an initial decision in favour of the UK may be withdrawn by the Commission at will. While the regimes will be equivalent on exit, they may rapidly diverge. The EU has produced new legislation governing the financial sector at an astonishing rate since the financial crisis. On ceasing to be hardwired into the system, the UK will rapidly fall behind unless it adopts a mechanism for automatic implementation of new EU financial regulation initiatives into domestic law.

The increasing growth in coordination of international standard-setting through the FSB means that if the UK maintains strong links in that forum¹³, it may be able to continue to influence the regulatory agenda – no longer through the EU process directly, but at a level above the EU. Of course, the EU may decide to ‘gold plate’ FSB standards in ways that the UK does not wish to follow – as has happened recently, for example, in relation to bank executive compensation (ARMOUR *et al.*, 2016, ch. 17). Some commentators have floated the idea of a ‘parallel regime’ within the UK, one EU-compliant and one not (FERRAN, 2016; 2017) – an approach currently being pioneered by small jurisdictions such as Guernsey.

6.6. WHAT COULD EQUIVALENCE COVER?

If the process of third-country equivalence is workable, what would be the scope of its effect? As we shall see, there is alignment between the breadth of 3CE regimes and the areas in which the EU’s financial sector currently labours under a comparative disadvantage. The 3CE regimes are most extensive for wholesale financial markets, and least extensive for commercial banking, with retail markets and insurance falling in between (see generally, FRESHFIELDS BRUCKHAUS DERINGER, 2017).

6.6.1. Retail markets

Retail markets comprise those financial products and services that may legally be offered to retail investors or consumers. There is very little scope for 3CE in retail financial products: not for banking services, nor for investment funds or products, nor for investment advice, nor even brokerage services. This reflects in

¹³ Mark Carney, the Governor of the Bank of England, is currently also Chair of the FSB.

part the political sensitivity of access to EU retail investors, and in part the fact that there is, even within the EU, little in the way of cross-border retail financial service provision. For example, Santander Group, a Spanish-headquartered bank, operates a large retail banking business in the UK through a locally capitalized subsidiary, Santander Bank plc (SANTANDER UK PLC, 2016; SANTANDER GROUP, 2016)¹⁴.

6.6.2. Commercial banking

EU legislation on banking regulation provides only very limited scope for 3CE, and does not provide for any direct access to the EU by third-country firms. There are 3CE provisions providing for coordination of supervision and for ‘prudential equivalence’. However, none of these 3CE frameworks covers the provision of lending services by third-country banks within the EU. Nor do they cover the operation of payment systems, or the operation of bank resolution and insolvency.

As we saw, banking is currently responsible for over half of the UK’s intra-EU exports of financial services. This would likely be substantially impaired by Brexit, absent a change in the 3CE regime. City practitioners quantify the at-risk revenues at £20 billion – that is, most of the intra-EU exports detailed in Table 1. However, a significant component of the activity listed in Table 1 as ‘banking’ – perhaps as much as a third – could be capable of falling within 3CE regimes for wholesale markets¹⁵. The big question going forward would be the extent to which the resources currently supporting intra-EU banking in the UK could be redeployed to other areas such as wholesale markets. Most obviously at risk would be the component of the UK banking sector made up of non-EU-headquartered banks that have established a UK subsidiary in order to benefit from the EU banking passport. These firms, which in 2015 had UK assets of £1.32 billion, or 14 per cent of the UK banking sector, would see their reason for being in the UK vanish¹⁶. Their parent companies would likely relocate these operations to other EU member states, such as Ireland or Luxembourg.

¹⁴ The one exception to this picture is retail investment in securities listed on regulated markets. The prospectus regulation framework makes provision for 3CE with respect to prospectus disclosure requirements. Under the current legislation, this operates in a rather more decentralized way than other 3CE regimes.

¹⁵ The OLIVER WYMAN data include within ‘banking’ subcomponents of ‘investment banking’ and ‘sales and trading’, accounting respectively for 10 per cent and 26 per cent of total banking revenues (OLIVER WYMAN, 2016, p. 4). Most of these activities could be conducted within the remit of the MiFID II 3CE, discussed below. Unfortunately, the intra-EU components of these activities are not reported.

¹⁶ Non-EU firms are make a particularly significant contribution to the conduct of wholesale banking activity in London – approximately half of such activity (SAPIR et al, 2017). However, many of the wholesale banking activities, as explained in the text, may be able to benefit from 3CE (see also FRESHFIELDS BRUCKHAUS DERINGER, 2017). Most at risk of repatriation are non-EU commercial banks.

6.6.3. Insurance

EU insurance legislation contains an earlier and less elaborate 3CE framework than is featured in many subsequent legislative instruments. This reflects the fact that disagreements between the US and Europe over insurance regulation mean that there is not yet international consensus in the area (EVANS, 2016), so the drivers for change discussed above have had less effect.

Like banking, the insurance 3CE provisions focus on supervisory coordination, especially the recognition of third-country group supervision arrangements. Analogously to banking, it does not provide a framework for the provision of insurance services by third-country firms into the EU. However, it does do so for reinsurance, through providing a 3CE mechanism for reinsurance supervision.

Unlike banking, the insurance industry already largely operates through subsidiaries in other European jurisdictions (SCARPETTA and BOOTH, 2016). This means that the sector would have less to lose from hard Brexit. One exception is Lloyd’s of London, which operates directly in other EU jurisdictions, and estimates that up to 11 per cent of its revenues, or £3 billion, is at risk (EVANS, 2016).

6.6.4. Wholesale financial markets

Most importantly, the MiFID II legislation coming into force at the beginning of 2018 (the Markets in Financial Instruments Directive II and associated Regulation) will introduce a so-called ‘third-country passport’¹⁷. This will mean that eligible firms that register a branch in one EU member state will be able to provide investment services and activities to sophisticated clients throughout the EU without any need for further authorization¹⁸.

The third-country passport will only cover transactions with sophisticated clients¹⁹. For such persons, it will extend to all core investment banking activity, including brokerage, underwriting, mergers and acquisitions (M&A) advisory work, market making, and proprietary trading²⁰. It will not, however, cover regular commercial lending, except insofar as this constitutes an ‘ancillary service’ to investment services and activities of these sorts²¹. A potential

¹⁷ Markets in Financial Instruments Directive II (MiFID II) and Markets in Financial Instruments Regulation (MiFIR).

¹⁸ There will be registration requirements associated with establishing such a branch (MiFID II, Art. 39), including minimum capital requirements and the need for a bilateral cooperation agreement between the third country and the EU ‘home branch’ NCA.

¹⁹ MiFIR, Art. 46(5).

²⁰ MiFID II Annex I, Section A. See also *ibid*, Section B.

²¹ This means that while prime brokerage lending would be covered (as the loan is to a brokerage client to facilitate trading), the provision of loans to finance an M&A transaction would not be (whereas underwriting a junk bond issue to finance an M&A transaction would be covered).

drawback for firms using this regime is that they must offer clients the opportunity to have any legal disputes arising resolved in an EU member state²².

Alongside MiFID II, there is already in place a series of 3CE frameworks under regulations introduced to govern various aspects of 'market infrastructure', including derivatives trading (on-exchange) and clearing (for OTC derivatives), securities financing transaction trade repositories and reporting requirements, and central securities depositories. There is also, in theory, a parallel 3CE regime for alternative investment fund managers (covering all non-retail investment funds), although it has not yet been implemented.

6.7. CONCLUSION

Brexit seems to spell the end of the EU passporting regime for UK-based financial services firms. The best outcome for the UK, absent breaking the deadlock on free movement, would be for a negotiated agreement on financial services that offers something more than the patchwork of 3CE provisions discussed above. The UK would want such an agreement to (i) provide a more enduring foundation for access by its firms than a unilateral equivalence determination by the Commission; (ii) to cover, in addition to wholesale markets, and in order of priority: payment services, banking activity, and wholesale insurance. How far the UK gets towards this goal in the negotiations will likely depend at least in part on its outside option – reliance on 3CE.

The breadth of the 3CE regimes in wholesale markets matches the UK's comparative advantage, and the EU's corresponding comparative disadvantage, as respects financial services. There is consequently a clear mutual interest for both the EU and the UK in continued connectivity using this framework. There are, however, real risks. The most immediate relate to the process of determining equivalence. The logistics are such that the necessary assessments by the Commission are unlikely to be completed by March 2019. Moreover, despite its technocratic composition, the Commission may to some degree be influenced in its conduct of these assessments by other factors in the Brexit negotiations.

Even assuming 3CE determinations are achieved, there are further risks going forwards. First, the 3CE regime for wholesale markets could serve to open the UK up to competition from other third countries. If the 3CE regime permits US – and perhaps Asian-based – firms to provide such services into the EU, then the EU's need for UK wholesale services would be significantly weakened. The UK has breathing space here, at least as regards the US, because of the requirement for

²² MiFIR, Art. 46(6).

reciprocity of treatment that is included in recent 3CE regimes, including the very important MiFID II third-country passport. At present, there is no comparable mechanism by which EU firms offering investment services can obtain exemption from compliance with US regulation on the basis that the EU rules are equivalent²³.

Second, the recent nationalistic turn in US politics bodes ill for the continued significance of the FSB and, with it, the UK’s chances of influencing the EU from ‘above’. The US has been an important player in ensuring the success of the FSB. Should the US, as seems likely, move from a role akin to global policeman for the FSB’s standards – implicitly threatening non-compliant states – to one of open recalcitrance, then the FSB’s credibility will be greatly undermined. A weakened FSB would reduce the UK’s ability to influence EU regulation through this channel.

As a result, the worst-case outcomes might be very bad indeed, especially for the UK. It seems highly desirable that the parties agree a transition period pending at the very least completion of equivalence determinations and more usefully, the conclusion of a suitable bilateral agreement.

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²³ Such ‘substitute compliance’ frameworks, as they are known in the US, currently only operate to a very limited extent in relation to derivatives and not at all for investment services ‘inbound’ to the US (COFFEE, 2014; ARTAMONOV, 2015; ARMOUR et al, 2017).

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7. EFFECTS ON FINANCIAL MARKETS OF BREXIT

*Franklin Allen*¹

One of the most important aspects of Brexit is the effect it will have on financial markets in London and the UK. At the present time there is a great deal of uncertainty about the outcome of the negotiations that will take place and the effect these will have on the financial services industry. Here I focus on three factors that are important that I think have not received the attention they deserve in the discussion.

7.1. AGGLOMERATION EFFECTS

In financial services agglomeration effects are enormous. Today there are two major financial centres, namely New York and London. While Tokyo was the dominant financial centre in Asia for many years, this is no longer the case. Hong Kong, Singapore and Shanghai, among other cities, are now vying for the position of the third global financial centre.

London and New York have great breadth and depth in terms of financial markets and financial institutions. This provides strong incentives for firms to locate in these two cities. While Brexit may lead to the relocation of some people as a result of the UK no longer being an EU member, it is unlikely to stop London being a global financial centre. There are a large number of advantages that London has, particularly compared to other EU cities that are vying for its business.

- Language is one. The predominant language of finance all over the world is English. There are many reasons for this. History is one. London was the most important global financial centre during most of the nineteenth century and New York was for most of the twentieth century. Another is that a large proportion of the major financial institutions are American or British. Perhaps the most important is that today London and New York are the main centres and two of the three Asian centres vying for pre-eminence, namely Hong Kong and Singapore, are English-speaking. This means that people coming from the other centres find relocation for their families considerably easier than to places where the main language is different from English. Finally, perhaps due to their education systems, people from the US

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and UK are not renowned for their ability to speak languages other than English.

- Labour laws are another important factor. In both London and even more so in New York, it is relatively easy to fire people at will. Given how highly paid people are in the financial services industry, this is an important factor if they start to underperform or if there is a downturn in the industry. In some places like Amsterdam, Frankfurt or Paris, that are vying to take away London's financial services roles, it is very difficult to lay people off. Once jobs are created in these places they are costly to terminate.
- An important aspect of agglomeration is the fact that it is easy to hire people in the industry and also in the support industries such as the provision of legal and accounting services. Academic institutions in both London and New York are also strong so that there is a steady flow of qualified people into the work force.
- People in financial services are highly compensated and particularly those who have been in the industry for some time are fairly wealthy. The existence of non-domiciled tax status in the UK makes it relatively simple for them to move to the UK. In particular, this means they are only taxed on their UK income and their income and assets in other parts of the world are not taxed by the UK. They are not subject to UK inheritance tax on their non-UK assets. This is a significant advantage as inheritance tax rates in the UK are fairly high. Many other countries do not have a similar tax regime.
- Finally, London and New York are relatively nice places to live provided your income and wealth are sufficiently high as they are both very expensive. However, people working in finance are very well compensated and so they are both attractive places.

7.2. FINTECH AND THE LOCATION OF FINANCIAL SERVICES

One of the issues that the EU has raised with respect to Brexit is the requirement that clearing and settlement of euro derivatives and some other transactions be located in the EU. When clearing and settlement were paper-based, the location of a financial transaction was fairly clear. But more and more of these functions are done electronically using computers. This raises the question of the location of the service. Is it where the computers are located or where the people operating them are or where?

An interesting illustration of this issue is provided by a recent case in the US². The

² See WATERS (2016) for an account.

FBI were trying to obtain access to the e-mails of a drug dealer that they were trying to prosecute. The Appeals Court ruled that since the messages were stored on a computer in Ireland they did not have jurisdiction in the case and that it was up to the Irish courts to give access. If the computers for settlement and clearing of a financial transaction are in Ireland would this mean that the transaction took place in Ireland? EU authorities have indicated that it will be necessary to move people who undertake transactions to the EU but what exactly will this entail and what level must they be?

Fintech is short for financial technology and refers to the rapidly increasing automation of the financial services industry. It is often argued within the industry that blockchain and distributed ledger technology will make much of the current role of the back offices of financial institutions redundant in the next few years. Essentially the jobs currently done will be automated. Distributed ledger technology by its very nature means that the records of transactions are stored in different places and quite possibly in different countries. This makes the location of the transaction particularly problematic.

The other aspect of the fintech revolution automating many of the jobs in clearing and settlement in a few years' time is that this will make it particularly difficult for jobs to be moved shortly to places like Frankfurt and Paris where it is difficult and costly to fire people. One of the major effects of Brexit may be to provide impetus to fintech to proceed more quickly. To the extent it doesn't then subsidiaries located in EU countries where jobs are moved to will either bear substantial costs from eliminating positions or will quickly become uncompetitive. Since the US dollar remains the preeminent currency in global finance and many financial transactions involve dollars at some stage, one of the main beneficiaries of attempts to remove financial services from London may be New York rather than EU cities.

So far there has been little discussion in the press and elsewhere of the effect of fintech on Brexit and the location of financial services. This seems an important omission that both the UK and EU negotiators will need to take into account when formulating their Brexit negotiation strategies.

7.3. LEGAL AND REGULATORY FRAMEWORKS

One of the great advantages of the UK as a financial centre is that its legal and regulatory frameworks and institutions are high quality and well suited to the financial services industry, particularly for financial markets. These kinds of factors take many years to develop. One of the reasons that the Eurozone countries are so bank-based rather than market-based is that they lack these regimes.

One example that illustrates this issue well is that of market manipulation. In the late nineteenth century and twentieth century stock price manipulation and in particular short squeezes and corners were a major problem. The New York Stock Exchange implemented rules and regulations against these kinds of abuses in the 1920s. With the foundation of the Securities and Exchange Commission in the 1930s legal prohibitions against manipulation and the requirement for clear disclosures were introduced. This drastically reduced the scope for manipulation and has helped foster strong stock and other financial markets.

The regulation and legal frameworks in many continental European countries have lagged significantly behind. A good example is provided by the attempt of Porsche to take over Volkswagen in the mid-2000's.³ In particular in the 2007-08 period, Porsche had acquired a large number of shares in Volkswagen both directly and synthetically through various options strategies. In October 2008, a few weeks after Lehmann Brothers defaulted stock markets were in turmoil and Porsche came under heavy margin pressure as a result of its option strategies involving Volkswagen shares. On Friday 24 October 2008 Volkswagen shares closed at 210€. If the shares had fallen significantly below this level then Porsche would have been bankrupted as a result of margin calls. On Sunday 26 October 2008 Porsche made a press announcement indicating that they owned far more of the Volkswagen shares than the market realized. This implied that the floating supply was much smaller than was generally thought by market participants. Many hedge funds and other traders had taken short positions as they believed that at around 200€ a share the stock was overvalued. After the press announcement these short sellers realised that they would have trouble covering their positions. On the Monday and Tuesday following this announcement there was a short squeeze and the price of Volkswagen stock rose to a peak of around 1,000€ a share and Volkswagen briefly became the most valuable listed company in the world as the short sellers scrambled to cover their positions. On the Wednesday Porsche made another announcement that they would sell stock into the market and this increase in supply led to a fall in the price from its peak early in the week.

In the US and UK this kind of behaviour would have led to serious legal problems and most likely conviction for Porsche employees or the company itself. However, although the German authorities prosecuted two employees there were no convictions for market manipulation. The result of this kind of episode is that market players are reluctant to engage in short positions that allow efficient market pricing. Effective regulation and legal frameworks means that there are considerable incentives for firms and investors to issue and buy stocks in London and

³ For an account of this, see ALLEN, HAAS, NOWAK and TENGULOV (2017).

New York rather than in other markets. These incentives will not be affected by Brexit.

In conclusion, there are at least three reasons that many financial markets will have strong incentives to be based in London after Brexit. These are financial agglomeration effects, fintech and its implications for the location of financial services, and finally the legal and regulatory framework in the UK. These factors need to be much more widely considered in the debate on the effects of Brexit.

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8. BREXIT: TIME TO GET SERIOUS

Anthony Belchambers¹

8.1. BACKGROUND

On 29th March this year, the Government followed through on the outcome of the June 2016 Referendum by giving formal notice of the UK's intention to leave the EU in accordance with Article 50(2) of the Treaty on European Union. The notice, which took the form of a six-page letter from the Prime Minister, Theresa May, to the President of the European Council, Donald Tusk, triggered the 2 year timetable for negotiating the terms of exit.

Given goodwill and determination, it should be possible for the EU and UK negotiators to achieve political consensus over at least the heads of agreement within that timescale. However, a post Brexit transitional period will still be necessary to finalise all the technical detail, enable both EU and UK firms to restructure their businesses against a known outcome to the negotiations and smooth run the process of exiting the EU.

Unfortunately, to date there has been little evidence of goodwill on either side. Member states, in particular, felt betrayed by the UK's decision to leave the EU and were unanimous in their anger towards the UK for publicly challenging the viability of a united Europe in this way and energising the EU's devolutionary movements. Talk of "hard" landings for the UK and a "hard" Brexit from the EU were rife then but are damaging now. Pulling up drawerbridges and restricting market access is not what Europe wants or the international community expects.

It is clearly time for both sides to abandon the grandstanding and the politics of confrontation in favour of a more pragmatic approach – and that might just be happening! The recent Government White Paper referred to "*good neighbourliness*", a "*new strategic partnership*" and the need to address the rights of the 2.8m EU nationals in the UK as being a "*high priority*". President Juncker has emphasised that the upcoming talks should be "*friendly and firm*" and, in an interview with the BBC, that there would be "*no sanctions, no punishment*". As the leading German MEP, Marcus Ferber, recently put it "*we are dependant financially on the City and this interdependence has to be agreed in the future*" and a recent leaked report of the European Economic and Monetary Affairs Committee emphasised that it was "*...critical that a workable agreement is achieved*". On the face of it, this should all make a pro Europe and pro business outcome to the

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negotiations more rather than less likely. After all, the UK may be leaving the EU, but it remains firmly in Europe with common values, shared strategic objectives and a mutuality of interest in fostering growth. Both sides need to remember that going forward!

The problem is that this remains an intensely political dialogue and consensus will still be difficult to achieve. There are real tensions over the scope and sequencing of the dialogue, the exit budgetary contribution to be made by the UK and the scope and conditions of any continuing rights of cross-border access in goods and services. At the same time, these are also difficult times for the EU27. It is facing many internal problems with the migrant crisis, the continued fragility of the eurozone, the Italian banking crisis, populist resistance to “ever closer union” and now the controversy of a multi speed EU. All this – and the potential for disagreement among the 27 individual member states of the EU (and even between the EU institutions) over a Brexit deal – could still result in a “hard” Brexit ie not as a result of UK intransigence but, rather, because of disarray within the EU 27!

8.2. EQUIVALENCE: A BASIS FOR ACCESS?

The Prime Minister had already rejected the option of UK membership of the Single Market in her January “no bits of membership” speech on the basis that, while it would have afforded the UK with continued maximum access to the EU market, the conditions of membership were politically unacceptable. They included continuing EU control over UK borders, no change in budgetary contributions and strict subordination to EU law. The UK Government was clearly of the view that there would be little point in the UK leaving the EU to become an independent country, if it did recover from the EU all the sovereign freedoms necessary to make its way in the world as an independent country. To do that, it had to be a country not just of determination, but of self-determination. This means, though, that the only option now is for the UK to negotiate access (and the transitional arrangements referred to above) based on continuing regulatory equivalence with the EU – either as part of a pre Brexit tailored agreement or in the context of post Brexit third country mutual recognition.

Whether the UK has regulatory equivalence with the EU is not in question. It has. As an EU member state, it has already implemented all its rules and (as envisaged in the Government White Paper on the Great Reform Bill issued on the 30th March) UK equivalence will continue post Brexit. The issue is how much business access can it facilitate and does it provide a sufficiently robust platform for that business.

Some argue that equivalence should provide the same “passporting” rights as if the UK was still in the EU. That simply won’t happen. “Having cake and eating it” isn’t a negotiating option, otherwise half the member states would be up in arms and the other half would be serving their own Article 50 notices! At the other end of the scale are those who believe their business lines do not need any bestowed rights of EU access. Others are relying on the rather legally uncertain notions of characteristic performance or reverse solicitation. It is essential therefore that any negotiation outcome provides firms and market operators with legal clarity and business certainty as regards the scope and exercise of any post Brexit rights of market access.

The second problem is that, absent any special arrangements, access based on equivalence is regarded as less reliable than “passporting” access. For this reason and as an aside, I believe the Commission’s plans to make the process of measuring and monitoring equivalence more robust is to be welcomed. Indeed, if that is taken forward during the next two years, the UK will have a seat at the table! Various options for strengthening equivalence could include providing early notification of proposed rules changes; retaining the use of regulatory colleges, particularly for systemically important institutions; enhancing information-sharing gateways; enlarging cooperation protocols; facilitating joint supervision; harmonising the implementation of international standards; and collaborating more closely on regulatory policy. All this points to the need for a new collaborative European regulatory body.

Of course, any agreement to pool regulation in this way (a) must recognise the primacy and lead role of the licencing authority; (b) must not lead to the UK becoming a “rule taker”; and (c) must not impair the ability of the UK authorities to establish a simpler regime for purely domestic firms or recognise the regimes of third countries.

8.3. EUROCLEARING

A good example of how shared regulation could provide a workable interjurisdictional compromise is in relation to the controversial proposal of the European Central Bank (ECB) to restrict euroclearing to the eurozone.

The ECB is (understandably) concerned over the level of potential systemic risk posed by large volumes of euro-denominated business being cleared in London outside the Eurozone and now, post Brexit, beyond the reach of the EU authorities. At the same time, its proposal to restrict euroclearing to the eurozone also carries significant economic, legal and risk-related consequences (see the FSNF Forum’s paper “Euroclearing and Brexit: The Practitioners’ View”). For example:

- this kind of currency nationalism will undermine the euro’s role and reputation as an internationally traded and global reserve currency and could generate a “tit for tat” response from other jurisdictions;
- siloing euroclearing in the Eurozone will distort the economics of market participation by increasing the margin costs of raising capital, trading, investing and managing portfolio and commercial risks because of the potential loss of cross currency offsets;
- contract law issues could arise over any attempt to transfer existing eurocleared transactions into the Eurozone;
- the risk of encouraging the offshore use of other closely correlated currencies/instruments cannot be discounted, particularly if the basis risk is more than offset by the availability of cross currency offsets.

Of course, all EU CCPs, including those licenced in the UK, are regulated to the same high standard and that will continue post Brexit. But that will not be enough to satisfy the ECB when it comes to euroclearing. Shared regulation could, however, provide the kind of positive regulatory enhancement sufficient to satisfy the ECB’s systemic risk concerns and so avoid the market disruption of relocation. It is, of course, a decision for the UK authorities as to how much “consent to jurisdiction” they are prepared to concede in the wider market interest.

It is noteworthy that Mario Draghi commented in a recent letter to an MEP that the ECB has “broadly appropriate guarantees for the oversight” of EU-based clearing houses” so he would no doubt be content for post-Brexit euroclearing to continue in the UK (and in the US) if a comparable level level of oversight were to continue to apply to UK clearing houses also post-Brexit.

For these reasons, the Forum paper recommended *inter alia* the continuation of regulatory colleges, enhanced supervision and a more shared approach to oversight similar to the US conditions in place for recognising non-US CCPs.

8.4. “TRIANGULATION”

In the Forum’s report on equivalence, Norton Rose Fulbright used the term “triangulation” to describe the post-Brexit regulatory options available to the UK, namely:

- negotiating for fair EU access based on proven and strengthened equivalence with its rules;
- developing a simplified more proportionate framework of rules for purely domestic firms, particularly SMEs (as suggested in Andrew Bailey’s recent speech in Berlin);

- maximising the UK's freedom to negotiate tailored bilateral trade in goods and services agreements with other third countries (possibly adopting regulatory "adaquacy" as a more pragmatic measure of recognition?).

The first leg has already been covered in this article.

As to the second leg, it has to be accepted that, contrary to the views of some, Brexit will not be an opportunity to initiate a bonfire of rules for domestic firms. Many of the post-2007 crisis rules were put in place to comply with the G20 objectives for tougher, safer and more harmonised regulatory standards. Others are there to implement the conduct and prudential standards set by such international bodies as IOSCO and the Basle Committee. Others yet are reflective of FCA's own regulatory priorities. On the other hand, there are needlessly burdensome and costly requirements that could usefully be scaled back for such firms without undermining investor protection. The Government has to justify its position that Brexit will place the UK and its businesses in a better position than if it was a member of the EU. Enhancing their efficiency, reducing regulatory cost and facilitating their competitiveness makes for a very good start – and will also strengthen the UK as a location of choice for entrepreneurial start-ups.

As for the the third leg of "triangulation", a number of countries have already made their intentions clear – some because of their historical ties with the UK; others because of the simplicity of dealing with a single state rather than a federation of 27 mixed economies. Then there are those third countries which already have a trade deal with the EU. They will want to plug the market gap left in the EU by Brexit by signing a second deal with the UK. For them, the ability of the UK to demonstrate continued equivalence with the EU should help to shortcut the novation of those trade agreements to the UK on the basis of "same out as in".

As for the US, the prospect of a bilateral trade deal with the UK has, under the new US Administration, now gone from "*back of the queue*" to "*front of line*". While the scope, conditions and restrictions of such a deal and its value to the UK cannot yet be calculated, the failure of the EU-US TTIP means such a deal could be a game-changer not just for the UK's role in Europe, but also for the trade positioning of the EU itself – something that will not be lost on the EU's negotiating team. That said, the prospect of resuming the TTIP dialogue is already being urged in some quarters, so, if that were to happen, the UK could go to second in line! Of course, it is worth noting that the US were strongly resistant to the inclusion of financial services in the TTIP negotiations.

However, it is still in the favour of the UK that, while it is a much smaller market than the EU, it offers the negotiating simplicity of dealing with 1 state not 27. It also has a strong reputation as a politically stable, open market economy with a

healthy pro business bias. On the other hand, negotiating trade deals remains in the exclusive competency of the European Commission until the point of Brexit – and negotiating trade deals, as the European Commission has found, takes time. While the UK Government must observe the strictures placed upon it as a member state, it cannot afford the luxury of sitting on its hands for the next two years. Put another way, the UK may not yet be under starter's orders, but it and the private sector in all its different forms can and must undertake a considerable amount of pre race preparatory work in that two years.

In conclusion, while Brexit has not led to the economic nightmare predicted by some, it is early days and the full economic cost of Brexit and its impact on the standard of living have not yet fully materialised. Despite the high cost of exit – and it will be high – the case for the UK becoming an independent sovereign state in Europe rather than a tier two subject state of a centralist and eurozone driven EU is looking stronger. In the long run, that may turn out to be in the best interests of Europe as well. That said, the overriding objective now is to secure a positive post-Brexit future for both the UK and Europe – but also one which offers the best prospect of offsetting that cost over time.

9. BREXIT AND CLEARING

*Kathleen Tyson*¹

The European Central Bank has had a policy for some years of discouraging substantial euro-denominated payments, clearing or settlements outside the eurozone. Its rationale is that as lender of last resort it should have direct supervision of euro-denominated clearing that might pose a risk to financial stability or give rise to liquidity demands on the central bank during a crisis.

As an EU member state the United Kingdom was empowered to oppose policies discriminating against euro payments, clearing and settlements through UK institutions. The British government succeeded in the European Court in July 2015 to overturn an ECB decision requiring eurozone clearing and settlement of euro-denominated securities as over-reaching ECB authority. Once the UK is outside the EU, the British government will lack standing to oppose EU or ECB policies that harm London, unless it can take the issue to the World Trade Organisation.

Long before the 2015 decision, the Bank of England secured liquidity swap arrangements with the ECB to manage any potential euro liquidity demands that might arise in London. However, the Bank of England will lose standing to require non-discriminatory access to ECB euro swap and liquidity facilities once Britain is outside the EU.

Brexit makes it harder to defend clearing of euro financial instruments in London. So why does it matter where euro transactions clear, margin or settle? It matters for many reasons. Jobs usually top the list, but the key issues are legality, supervision, efficiency and financial claims to assets on liquidation.

Transactions occur under the laws of states as a matter of elective contract and financial assets are deemed legally owned, transferred and pledged where a depository is located. Over the past 25 years laws on securities and financial transaction trading, clearing and settlement have been harmonised by EU directives. Once the United Kingdom is outside the EU, then all transactions booked in the UK will be governed by UK law and all assets held with a UK depository will be owned, pledged and transferred under UK law. There will once again be potential for conflicts of laws between the UK and EU, as there were between the UK and EU member states before harmonisation. Legal uncertainty and conflicts of law are always bad for markets and discourage financial transactions.

¹ Granularity Ltd.

Another area for potential conflict is supervision. EU supervisors under harmonisation have roughly the same clearinghouse authorisation and supervision requirements in all states as the framework has been harmonised. Once the UK is outside of the EU, then UK supervisors might alter the authorisation and supervision regimes for UK clearinghouses in ways the ECB and European supervisors might dislike. To encourage harmonisation with EU requirements, the EU offers an equivalence regime for third-party state supervisors. The European Commission can determine that a supervisor's regime for authorising and supervising clearinghouses is equivalent to EU rules. If this determination is granted then EU-based members receive a huge benefit: they can reduce their regulatory capital on exposures to the clearinghouse from 100 per cent to just 2 per cent. There is a perceived risk a politicised European Commission might withhold an equivalence determination for UK supervisors regardless of the quality of UK authorisation and supervision. Without the equivalence determination the capital cost of clearing in London for EU-banks would become prohibitive.

The third big threat to clearing in London is a loss of systemic efficiency from fragmenting clearing and settlements among multiple institutions in multiple locations. Each clearinghouse needs to be over-collateralised at all times by initial margin in cash or high-quality liquid assets (HQLAs) for net exposure on each member. Exposures are revalued on an ongoing basis and initial margin is reassessed at least daily. Optimal efficiency for clearing is achieved if the clearinghouse can offset related securities, commodities and derivatives exposures through netting to reduce the total cumulative exposure per member. By concentrating global clearing in London, banks have been able to clear and margin more efficiently than if they had to independently clear and margin non-euro exposures in London and euro-denominated exposures with an EU-located clearinghouse. If members are forced to post some initial margin for exposures to a London clearinghouse and other initial margin for euro-denominated exposures to an EU-based clearinghouse, they will necessarily have to post more initial margin altogether to ensure both are always over-collateralised. As there is a serious and worsening shortage of HQLAs for use as collateral or margin, and borrowing conditions are sometimes unstable, this is an added complexity and cost that no EU bank wants to incur.

The final issue arising from Brexit and clearing is what happens to surplus assets after a clearinghouse liquidates a member's positions in a default. As noted above, clearinghouses must hold initial margin exceeding member exposures as cash and HQLAs. The surplus is designed to cover any potential for loss when the clearinghouse liquidates a defaulting member's positions. Once that liquidation is complete, the clearinghouse must return any surplus cash and HQLAs left over to the defaulting member or the insolvency practitioner overseeing the defaulting member's estate. If the assets held by the clearinghouse are deemed to be located

in the UK, then the UK insolvency estate gets the surplus assets which will then be used for the satisfaction of UK creditors. If the clearinghouse and assets are in the eurozone, then any surplus will go to the eurozone insolvency estate for the benefit of eurozone creditors. As liquidation of Lehman Brothers International demonstrated, there can be significant losses for UK creditors if assets are moved elsewhere.

No one knows what the Brexit deal will look like, or even whether there will be a Brexit deal in two years' time. What should be appreciated, however, is that euro-denominated clearing as an element of that deal will have major implications for the appeal of London markets and infrastructure. Supervision of clearinghouses and market participants, as well as resolution management, could become more complex, expensive and potentially inefficient. A lot more than a few hundred jobs is at stake.

10. BREXIT, DEGLOBALISATION AND INTERNATIONAL ASSET MANAGERS

*Menno Middeldorp*¹

10.1. INTRODUCTION

APG Asset Management invests almost half a trillion euros for Dutch pension fund clients. While one in five Dutch households has a pension that is managed by APG, it has no clients in other countries. Consequently, unlike many other asset managers, Brexit does not affect APG's ability to access clients. However, because APG is a sizeable international investor and active participant in international financial markets, Brexit does impact it in at least three other ways that also apply to asset managers generally. First, APG invests in the UK, so the impact of Brexit will affect current investments and decisions about future ones. Second, APG makes significant use of financial markets and services, often with counterparties based in the UK. Third, Brexit could contribute to a wider trend of deglobalisation that, in its most extreme forms, would have a profound impact on investors generally.

10.2. INVESTING IN THE UK

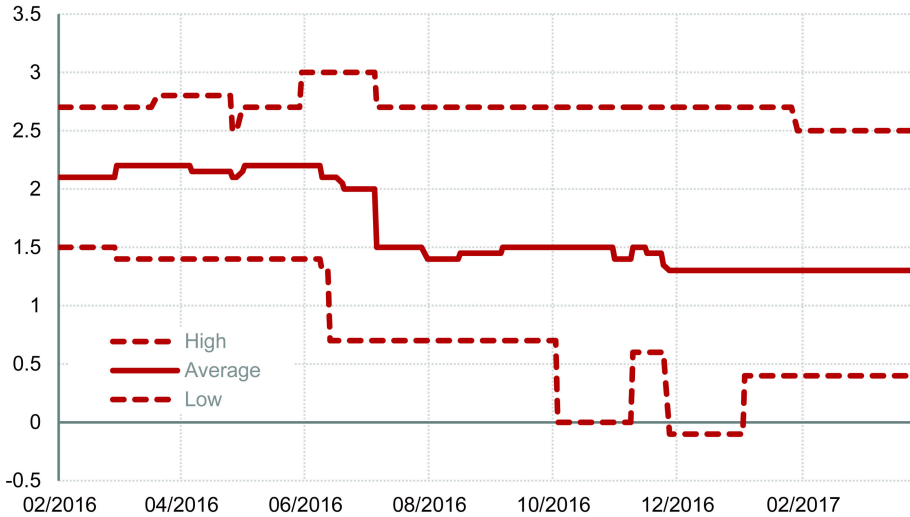
Despite the better-than-expected performance of the UK economy since the EU referendum, most economists still believe that the approach of Brexit will lower growth in the foreseeable future. According to Bloomberg, since the vote the average forecast for GDP growth in 2018 has dropped 0.9%-point to 1.3%. However, great uncertainty about the economic impact of Brexit remains, which is reflected in a near doubling of the range between the lowest and highest forecast to 2.1% (see Figure 1). Although the connection between the real economy and asset returns is not straightforward, it would seem that the risk-return trade-off for UK assets has not improved. That probably contributed to the 5% depreciation of the pound against the euro since the Brexit vote, which has obviously impacted all sterling denominated investments.

Nevertheless, changing economic and risk-return assessments are a normal part of investing for all geographies. Furthermore, underneath the headline asset prices and benchmarks there are a diversity of investment opportunities that need

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to be assessed on their individual merits. Macro factors like Brexit are only one of many inputs.

Figure 1: Surveys of UK GDP growth forecasts for 2018



Source: Bloomberg

10.3. EUROPEAN FINANCIAL MARKETS AND SERVICES

Asset managers like APG finance projects and buy and sell securities and other assets. Consequently they make extensive use of financial markets and services. Access to a wide variety of service providers and counterparties fosters competitiveness and improves choice. Furthermore, the liquidity of large integrated European financial markets helps to reduce transaction costs, which is particularly important for large asset managers.

The UK, specifically London, plays a central role in European finance. Therefore, the future landscape of financial services and markets will significantly depend on the shape of the post-Brexit agreements between the UK and EU. There is a risk that regulatory divisions will lead to a fragmentation of markets. Especially for commoditised markets that depend on concentration and scale to foster liquidity, that could increase costs. Even if some markets remain concentrated in London, there is a risk that regulatory costs means that accessing the City will become more expensive.

10.4. BREXIT AS PART OF DEGLOBALISATION

The fact that the UK voted for Brexit is part of a broader political backlash against the EU and globalisation. Even though many pro-Brexit politicians in the UK favour free trade, in other countries Brexit has been lauded by politicians proposing protectionist policies. It is therefore useful to think beyond the immediate impact of Brexit and consider what the implications for asset managers might be if the risk scenario of a substantial reversal of globalisation comes to pass. The public discussion in advanced economies regarding both Brexit specifically and deglobalisation in general has often focussed on trade and migration. However, from an asset manager's perspective, free movement of capital is at least as important.

10.4.1. Lower returns but also more diversification opportunities

Globalisation has led to “more efficient allocation of capital, productivity increases, and lower prices for consumers” (LAGARDE, 2016). Reversing it implies the opposite and thus suggests lower real asset returns. Clearly, this is just a generalisation of the specific point made about Brexit above, but now applied to a global portfolio.

Similarly, as with Brexit, there is great uncertainty about how globalisation will unfold. More generally, a more fragmented world, potentially with multiple economic and geopolitical powers, could also mean more volatile markets. However, the impact on different countries could vary depending on how reliant they are on global trade and capital flows, which countries impose restrictions and which industries are affected.

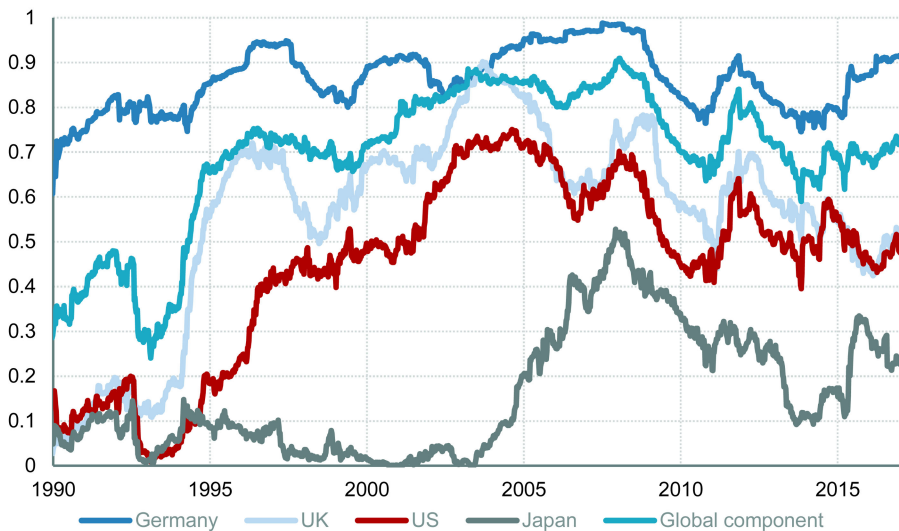
As trade barriers and capital controls are imposed, economies and financial markets of different countries will decouple. A growing part of asset returns will be driven by country specific factors. So, getting the economics of individual countries right will become more important and demand more country based economic and political analysis. As more country specific factors become more important, correlations across countries' asset prices fall, which brings more opportunities to diversify risk across geographies. So, while a deglobalised world might be riskier, it could actually become easier to diversify these risks. The net impact on the performance of a global portfolio is actually not that obvious.

10.4.2. Liability matching and global investing

Diversification is nice, but from the perspective of a liability-driven investor, asset prices that correlate with regulatory discount rates are even more desirable. Dutch pension funds are required to calculate the current value of their liabilities using an interest rate curve that is close to a risk-free one. Liability driven investors in the UK and other countries have similar considerations.

With globalized capital markets there is a, often dominant, global factor in domestic and international interest rates (see Figure 2 for an illustration with Dutch interest rates). That makes a global portfolio, particularly of bonds, more likely to match domestic liabilities while still providing some diversification of credit, liquidity and other risks. A more fragmented world makes it harder to hedge domestic discount rates with a global portfolio.

Figure 2: Global drivers of Dutch domestic yields



R^2 of 2-yr rolling regression of weekly changes in Dutch 10-yr government yield on German, UK, Japanese, US yields and the first principal component of all these rates to capture the global factor.
Source: Macrobond

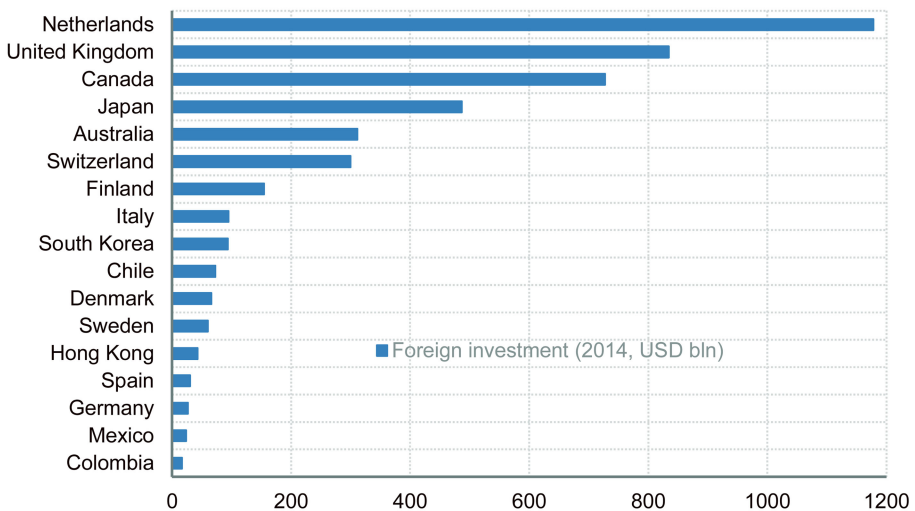
Apart from the difficulties of liability matching, deglobalisation forms a more fundamental constraint on international investors, particularly in countries with high savings rates. Saving by definition means deferring consumption and letting others use your current production capacity in exchange for claims on their future production. We trust that they will recognize that claim and deliver the goods and services later, for example when we need them in retirement. In the notable case of Dutch pension fund savings, this inevitably leads to building international

claims in exchange for net exports of goods and services. This is a big reason why the Netherlands has run current account surpluses between 5% and 10% of GDP over the last ten years and has built net international assets of 77% of GDP. Capital controls by their very nature constrain investment flows, so their widespread adoption would also constrain international investors. However, international savings rely on both free trade and capital flows. If consumers in one country are inhibited from importing goods and services due to high tariffs then they won't need to borrow from other countries. Conversely, if they can't borrow the money, they won't be able to buy more goods services on credit. So, if deglobalisation takes hold in either trade or capital controls, then it would be more difficult for net savers to build foreign assets or get a good return on them (e.g. Krugman, 2016).

10.4.3. Will we get our money back?

While both trade restrictions and capital controls constrain the flow of foreign investment, capital controls form a more direct risk to the value and availability of existing foreign holdings of international investors. Dutch and UK pension funds had respectively about 1.2 and 0.8 trillion dollars of foreign assets in 2014 (see Figure 3). With capital controls, pulling funds out is going to be more difficult or take longer. As a result, the resale value of those holdings is likely to decline due to an increased liquidity premium.

Figure 3: Pension funds have a lot of foreign assets



Source: PWC

Capital controls undermine one of the assumptions underlying globalisation that is so fundamental that investors (especially in advanced economies) often don't think about it, namely, the sanctity of foreign property rights. When investing internationally, especially in illiquid assets, investors assume that these property rights will be respected for decades to come. One of the more extreme deglobalisation scenarios involves countries not just constraining capital flows but simply not recognizing past foreign claims. While this is a tail risk, it becomes more likely if we see trade barriers or capital controls starting to be erected. If countries decide they no longer want to run a trade deficit nor borrow to finance it, then what is the point of maintaining good credit? Why continue to pay interest on past borrowing or recognize these claims? Politically other more emotive arguments may be used, like regaining control of local industries from foreigners or retaliating against earlier trade restrictions.

Here too, outcomes would be different per country. Diversification is one response to the risk of capital controls and asset expropriations. However, a more focussed one would be a revival of country-risk management. Local political and economic circumstances can give some indication of how serious the risk of capital controls and expropriation are: populist nationalist governments increase the risks; dependency on foreign inputs or large foreign holdings reduce it (although, even countries that don't have a strong incentive to impose tariffs or nationalise foreign-owned companies, may do so in retaliation to the actions of others). If risks are deemed high, then country risk limits may need to be imposed that cut across asset classes. Globalisation has made such country risk analysis and management less common and mostly confined to emerging markets. Instead asset managers have focused on global asset classes and sectors. It is not yet clear to what extent globalisation will be meaningfully reversed. However, if it does, then country-risk analysis and management should become a more important part of the investment process.

10.5. CONCLUSION

Even for asset managers outside of the UK, Brexit has important implications. It affects, probably negatively, the risk-return characteristics of UK investments. Taking London outside of the EU could also lead to a more fragmented market for financial services and assets, which would increase costs of asset managers. While neither of these are desirable outcomes, they do not deeply affect most asset managers based outside of the UK. However, if Brexit contributes to a much more dramatic reversal of globalisation then international investors will be profoundly impacted. Interestingly, it may be easier to diversify risks in a fragmented world. However, that benefit can only be realised if capital controls are not imposed and

property rights continue to be respected. Neither of these things can be taken for granted in a world of escalating protectionism, which means that asset managers will need to more actively monitor political risks in the countries they invest in.

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