EPFSF Briefing on "Brexit" 20 February 2018

Introduction

This briefing paper provides a high-level overview of the current status of the Brexit negotiations and discusses a number of key issues which arise in relation to financial services.

Status of the political negotiations

On 15 December 2017, the European Council decided that the progress achieved during the first phase of negotiations was sufficient to move to the second phase related to transition and the framework for the future relationship.

The European Council agreed to start negotiating a transition period for inclusion in the Withdrawal Agreement, emphasising that the transitional arrangements should be clearly defined and limited in time. The European Parliament has also recognised that transitional arrangements are necessary. On 29 January 2017, the General Affairs Council (GAC) adopted negotiating directives on the transition period which mandated the European Commission to start discussions with the United Kingdom on this matter.

Many market participants have called for a swift conclusion to these negotiations, with clarity on the details of such a transition by the end of March being desirable to avoid further market uncertainty.

The future economic relationship between the EU and the UK is expected to be the subject of further guidelines to be approved at the next meeting of the European Council on 22-23 March, leaving just a few months for agreement on a framework for the future relationship alongside the Withdrawal Agreement.

While negotiations on the future relationship have not yet formally commenced, a number of initial positions and statements have been put forward. Prime Minister Theresa May has so far ruled out the UK remaining a member of the single market and has expressed a desire to negotiate a close economic relationship through a free trade agreement covering goods and services. The EU negotiation team, led by Michel Barnier, has made statements indicating that he views the Canadian free trade agreement (CETA) as the most appropriate starting point for the future relationship with the UK in light of the UK government's conditions. The European Parliament has raised the possibility of an association agreement as the basis for the future relationship. The choice of model will have significant implications for the future relationship and the progress of negotiations over the next few months will therefore have important implications for the future of financial services in Europe.

Impact on financial services

Brexit raises profound questions for the future of Europe's capital markets. The UK is the EU's largest financial centre with the City of London providing access to global markets for businesses across Europe. Many financial services firms have used the UK as a hub to service European markets, relying on single market passports to do so. This has led to a very high degree of interconnectivity between the UK and EU27 markets, with for example 46% of the EU's equity capital raised through UK capital markets, 49% of global OTC interest rate derivatives trading executed in the UK and over one-third of EU assets under management being managed in the UK.

Without a new trading relationship involving the UK remaining in the single market (which appears to be politically unlikely given the statements of the UK government), existing single market passports for financial services will end. Financial services firms are undertaking extensive planning to seek to maintain service to clients in different scenarios. Faced with no clarity on the future relationship between the EU and the UK, market participants are having to develop contingency plans, and take important decisions amid considerable uncertainty.

Industry participants and businesses have highlighted that the current negotiations on a transitional period are a key priority to:

- provide time for an orderly adaptation to the new framework for the future relationship;
- avoid "cliff edge" risks; and
- enable businesses to avoid or minimise disruption to their financing and risk management activities.

Supervisory cooperation agreements are a basic starting point for the rules that underpin the flow of cross-border business in financial services between the EU and third countries. In parallel to discussions on a transitional arrangement, EEA and UK regulators need to prepare co-operation arrangements to ensure these are in place in the event that negotiations on a transition do not yield an agreement that would avoid a "cliff edge". Irrespective of the political negotiations, close regulatory cooperation will be important to maintain financial stability.

While financial services firms are carrying out their plans to adapt to the UK leaving the single market, a number of issues are likely to require legislative or regulatory intervention to ensure an orderly withdrawal, provide clarity and maintain financial stability. Areas of uncertainty include the ability, post-Brexit, for:

- clients and policyholders to continue to rely on services under existing cross-border contracts;
- firms to transfer personal data between the EU27 and UK; and
- EU27-based firms to access UK financial market infrastructure (and vice versa).

Brexit and the future relationship that is ultimately agreed will also raise important questions for the evolution of the EU's capital markets, including:

- the framework for regulatory cooperation and supervision;
- the degree of ongoing alignment between EU and UK regulation; and
- important EU legislative initiatives in the financial sector, such as the Capital Markets Union project and the ESAs Review.

Conclusion

With just over a year until the UK is due to withdraw from the EU, very significant uncertainty remains. While market participants are adapting to put in place their plans to mitigate potential impacts, the outlook and implications for market participants remain unclear.

This event provides an important opportunity to discuss some of these issues at a critical time for Europe's financial industry.

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