Brexit and financial services: How will the markets cope?

Rapporteur: Apostolos Thomadakis

The UK's withdrawal from the EU is likely to have significant market, political, and policy consequences for the UK financial system, for the single market and the euro area, and for the international financial system. What will be the ultimate settlement between the UK and the EU? How will the EU financial system develop post-Brexit? How will the international financial system respond?

Transitional arrangements

With just over a year to go before Britain leaves the EU, there has been little progress and much uncertainty on what will happen after March 2019 causing concern among market participants and regulators. There is an urgent need for the UK government to clarify what outcome it wants from phase two of Brexit negotiations and on transitional arrangements, as well as on how to achieve it. At the moment, an FTA/CETA style agreement – which includes access to financial services – is the preferred and most realistic option for satisfying all the UK's red lines. On the other hand, an equivalence regime seems more problematic: non-negotiated, can be withdrawn, a time-consuming and tedious procedure and with a limited access to financial services (e.g. lending and deposit trading).

Financial regulation

Given that after Brexit the UK will become a third country, a real challenge that needs to be tackled is how different directives/regulations (e.g. EMIR, MiFIR, MiFID I, MiFID II, MAR, Solvency II) will be applied and implemented. The third-country concept is defined differently in different directives/regulations, and has been implemented differently in different countries.

Apostolos Thomadakis is Researcher at the European Capital Markets Institute (ECMI).

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For asset managers and investment funds, an area of concern is the distribution of financial products, in particular those that are managed in the UK and distributed in the Union. In this case the AIFMD will apply, which means that these products will not be available for distribution to retail investors within the Union. Finally, there is much uncertainty on what will happen with OTC derivatives contracts post-Brexit. While existing cross-border contracts will still be valid and legal, activities such as novation and compression are expected to be disrupted.

Financial centres

London is a unique, global and open financial centre. While market participants should be prepared for the worst case scenario (i.e. a 'hard Brexit'), negotiators are unlikely to want to punish European consumers by restricting their access to deep and liquid pools of capital. Key will be an appetite for global cooperation and a risk-sharing attitude. It should not be a competition between the UK and the EU: it is not about strengthening the EU and weakening the UK, but maintaining a level playing field and financial stability. As the cliff edge approaches, compromises will no doubt be made by both sides. However, it should not be forgotten that mutual recognition requires cooperation at a regulatory level.

Derivatives markets

Finally, regarding derivatives, there should be continuity of contracts. Parties should be able to continue to respect their contractual obligations – including payments, settlements and collateral transfers – as before, irrespective of the form of the UK's withdrawal from the EU. It should not be ignored that a potential relocation would create fragmentation, leading inevitably to financial instability. Even if international financial markets are well-interconnected and fast-moving, and will probably adjust quickly to reach a new equilibrium level, the question remains of how much risk we are willing to take.

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