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UK financial services should shift focus away from equivalence

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After nine rounds of negotiations that took more than six months (March-October 2020) and covered eleven areas, the EU-UK Trade and Cooperation Agreement (TCA) concluded on 24 December 2020. It is fair to say that the City has ended up with a 'no deal' in terms of financial services. Despite their strategic importance for the UK economy, financial services were not dealt with to any extent in the negotiations, and the agreement itself lacks anything substantive on them.

Equivalence is not a panacea and neither is it part of the agreement. Its determination is a political judgement, and it only solves a few small areas of the Brexit puzzle. Instead of waiting for a bus that will never come (or arrive very late), the UK should be pragmatic and move forward. A clear focus would be for London to develop as a non-EU financial centre, prioritise the EU business that can still be done through the City and capitalise on its deep financial services culture, critical mass and economies of scale that made it a global financial centre.

The TCA does not include any provisions that make up for the loss of passport rights, nor any provisions on equivalence or regulatory cooperation in financial services. In fact, the only specific financial services provisions in the TCA concern: i) the general commitment to implement international standards in the prudential, anti-money laundering, tax avoidance and anti-terrorism areas; ii) any new services that could be supplied under existing regulations; and iii) guaranteed access for UK firms to any self-regulatory bodies required for the conduct of their business and to public clearing and payment systems. These provisions are subject to a prudential carve out meaning that each party may take any measures deemed necessary to protect its consumers and investors, or the integrity of its financial system.

Although the UK is entitled to ask for equivalence treatment, this is only available where it is explicitly envisaged in the EU legislation. Equivalence allows non-EU financial institutions to offer a limited number of services in the EU, as long as the EU recognises their home country regulatory frameworks as 'equivalent' to EU standards. However, equivalence clauses are

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designed for the needs of each specific act, so their meaning may vary substantially from one legal text to another.

Currently, the UK has only two equivalence decisions, one for central securities depositories (CSDs), and another one for central counterparties (CCPs). These two decisions – out of the 39 potential equivalence agreements envisaged under EU financial services law – are a long way from the 'permanent and comprehensive equivalence' the UK was asking for a year ago. In comparison, Australia and Canada have 19 and 20 equivalence decision agreements respectively, while the US has 23.

Equivalence does not have a horizontal impact across different activities in financial markets. On the one hand, in equity trading – an activity that is entirely dependent on equivalence for stock exchanges – around 41% of the total value of trading on UK platforms is in EU-27 stocks and 59% in UK stocks.[1] On the other hand, approximately 13% of the value of derivatives contracts through UK CCPs are with an EU clearing member, and thus subject to equivalence.[2] In addition, only 7% of EU derivatives trading is affected by the Derivatives Trading Obligation (DTO).[3] In other words, although equivalence is important in some sectors, it is less so in others.

Since 1 January 2021, the UK and the EU financial services industries have been operating under a 'no-deal scenario', where the bulk of financial services provisions will be based on unilateral equivalence decisions with regard to specific activities and types of financial services. To protect itself and avoid potential 'cliff-edge' effects, the Temporary Permissions Regime (TTR) adopted by the UK government allows relevant EEA financial firms and funds that had previously operated through an EU passport in the UK to continue their operations temporarily.[4]

Furthermore, and regarding equivalence decisions to access its market, the UK has adopted an outcomes-based approach, something that was proposed during the 2020 trade negotiations but rejected by the EU. This more flexible interpretation of equivalence implies that a third-country regulatory framework can be considered equivalent to UK standards even if specific regulations differ, as far as they achieve a similar outcome. Thus, it is not about having identical rules, but rather whether these rules achieve common outcomes.

Alongside the TCA, the two parties have adopted a Joint Declaration on Financial Services Regulatory Cooperation, which allows for transparency and dialogue on equivalence decisions. Although the EU and the UK commit to a future dialogue on financial services, there is no clarity as to what shape this dialogue will take, nor on whether or how it will impact the EU's current equivalence framework. The Joint Declaration is an agreement to agree at a later stage to some

[1] New Financial analysis based on Fidessa data.

[2] As of August 2020 there were around €67 trillion of derivative contracts between UK CCPs and EU clearing members (Financial Stability Report, December 2020, Bank of England), while UK CCP derivatives contracts with a UK or a third-country clearing member were about €436 trillion (EU Derivatives Markets, ESMA Annual Statistical Report, November 2020).

[3] Approximately €50 trillion of the €681 trillion total notional amount outstanding in European derivative markets is subject to DTO ("UK grip on European derivatives at risk in fight over post-Brexit rules", November 2020, *Financial Times*).

[4] For up to three years, while they are waiting for UK authorisation.

of the detail on financial services. A framework for this cooperation – a Memorandum of Understanding (MoU) – was agreed on 26 March. However, this broad and non-binding commitment to regulatory cooperation is noticeably different from the guaranteed single market access that UK financial services firms had until 31 December 2020. The MoU is about creating a voluntary framework and process of dialogue, cooperation, and transparency, and not about agreeing common regulations that might be a foundation for subsequent equivalence rulings.

Equivalence only solves a few small areas of the Brexit puzzle. Most firms have relocated and having done so have now got that access to EU markets and EU clients. If the UK wants strategic autonomy, to be able to set the rules and have control over supervision and regulation, then – as Andrew Bailey, the Governor of the Bank of England has repeatedly said – perhaps equivalence is not the right tool. The Commission's recent decision to grant equivalence to US CCPs, and allow them to operate throughout the bloc, is an indication that the EU will likely increase pressure on UK and EU firms to relocate and develop a local capacity for clearing inside the EU, instead of relying on clearing in London. The EU may feel encouraged to squeeze harder and tighter, and perhaps look at repatriating in other sectors beyond equity trading, derivatives, and clearing.

Early 2021 data show that equity trading has been moved from the City of London to Amsterdam and to a lesser extent to other financial centres in the EU.[5] In other areas such as derivatives and foreign exchange, London's daily trading volumes still vastly outweigh its European neighbours.[6] In fact, one segment that has been unaffected by Brexit is currency trading. As opposed to shares and bonds, which usually trade in the market where they are issued, currency trading takes place globally. According to the latest BIS data, the UK has 43% of the global forex market,[7] 48% of the euro FX trading, and 44% of the global USD turnover. Fintech is another sector where the UK has retained its role as the top-ranking investment destination globally and in Europe. In 2020, €3.7 billion venture capital and growth private equity was invested across a total of 408 deals in the UK.[8] In comparison, the US attracted €19.7 billion, and Europe €4.7 billion.

The pre-eminence in finance that London enjoys is a vital component as the UK emerges from Brexit. London should maintain and enhance the standards and regulatory oversight that will maintain firms' confidence in London as a place to do business. No longer having to coordinate and agree with 27 EU countries should enable the UK to be more flexible in this regard. It will

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[5] CBOE Europe estimates that London's daily average trading in European shares declined to €8.6 billion in January (from €14.6 billion in December).

[6] With regards to derivatives, and although we are still at the beginning of the year, trading in euro-denominated derivatives has shifted from London to New York, Amsterdam, and Paris. According to IHS Markit, trading on UK marketplaces declined from 40% in July 2020 to 10% in January 2021. At the same time, the market share of European venues increased from less than 10% to 25% over the same period, while those in the US grew by almost 10 percentage points.

[7] The US follows with 16% (in a declining trend), while the Asian centres of Japan, Hong Kong, and Singapore have predominantly been static.

[8] See data by Innovate Finance.

allow it to corner emerging areas such as fintech and tech investment, and green finance,[9] for example by developing and regulating new financial products that will enable investors to positively engage with climate-change finance and cryptocurrencies.

Although Brexit may mean financial services business continues to be lost, the UK needs a thoughtful and future-focused approach that will enable it to bounce back. The questions that the UK should now be prioritising are how London can be developed as a non-EU financial centre, how much EU business can still be done through London (which is quite a lot, as after all, it is not entirely dependent on equivalence), and how it can further maintain and enhance its several competitive advantages (e.g. expertise and cluster of specialists, infrastructure, financial culture, network of supporting services, and time zone).

[9] Recently, in an effort to attract more fast growing, tech-focused companies to the market, the UK has launched a review into its listing rules. The review, among other measures, will consider the rules around free floats, dual class share structures and track record requirements, the requirement to produce a prospectus, and rules for secondary listings where companies are already listed in countries with high corporate governance standards.

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