4 Uncertainties surrounding Brexit

Article 50 and the future EU-UK relationship

With the recent triggering of Article 50 of the TEU, the process that will leave the United Kingdom outside the European Union has formally started. But uncertainties on the future relationship and its consequences for financial firms have not been tempered. It is not clear whether the UK will be able to strike a deal within the next two years. Furthermore, since the current equivalence regime is not reliable as a long term solution, the financial sector should prepare to deal with a hard Brexit scenario.

Brexit was never thought to be an easy path, but despite the formal start of the process we have little clarity on what the final outcome might look like. The tough stance on both sides of the English Channel increases the likelihood of the UK leaving without a new relationship agreement (or at least one that does not contemplate access to the single market for financial services). The 2 years deadline is not going to help either. As a consequence of Brexit, the UK would become a third-country for the purpose of financial regulation. Considering a "*hard Brexit*" (currently the baseline scenario following May's "*Brexit means Brexit*" and her Lancaster House speech), the lack of agreement means that UK-based firms will lose their passport for financial services. This represents a serious threat for those institutions based on the UK, particularly wholesale institutions which will not be able to keep on providing financial services for EU clients.

This situation is particularly problematic for the UK, whose current account depends on financial services exports. But even if the consequences of Brexit are expected to be more severe for the UK, there will be associated costs for the EU as well. Such is the case for market infrastructures. EU financial firms can use non-EU CCPs only if they have been recognised by ESMA, and if the country in which these CCPs are located is granted equivalence. This means that trading through UK-based CCPs might not be acceptable by EU authorities. This would lead to a fragmentation of the liquidity pool, which in turn could lead to an increase in costs. Nevertheless, these costs, while non-negligible, should not be disruptive for the EU since there are alternatives to the City (arguably less efficient than current arrangements). A limited transition period that grants additional time to adjust to the new situation, alongside grandfathering rights for current contracts, would help to reduce uncertainties, limiting the damage.

Is equivalence the solution?

The third-country equivalence regime might temper the negative outcomes in the short-run as it could provide for market access for non-EU firms. But it is insufficient as a long term solution since it is only a piecemeal approach: there are pieces of legislation that do not include a third-country regime, or that only allow the equivalence for limited purposes. Furthermore, equivalence can be withdrawn at any moment if the scheme is no longer deemed to be equivalent. Finally, for this alternative to work we need two assumptions: i) the third country adjusts its regulation following the EU (something the UK might not be so enthusiastic about), and ii) the EU is willing to rely on the third-country's supervision regime (something it might not be so eager to do considering the significance of the EU operations in the UK).

Some voices have asked for a revision of this regime, seeking for "*broad global standards of equivalence*". The idea is to grant equivalence based on compliance with globally agreed regulatory standards, instead of a "*line-by-line*" revision of the regulatory setting. While this idea has merits on its own and should have been considered even without Brexit, any revision of the framework should not be limited only to deal with the threats posed by Brexit. A comprehensive revision of the equivalence framework should be in the benefit of EU financial stability, and not to provide a backdoor to grant access to the single market for financial services.

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