

W. Georg Ringe
University of Hamburg, Institute of Law & Economics
University of Oxford, Faculty of Law



The Irrelevance of Brexit for the European financial market

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Introduction

Starting point: Start of phase 2 negotiations

- end of EU membership, March 2019
- different scenarios for future relationship (Norway model, Swiss model, New York, Singapore, etc.)
- hard Brexit versus soft Brexit
- in any case, City access to EU financial market under threat

Introduction

A rather optimistic view:

- Brexit will be irrelevant in practice, at least for financial services
- Very strong economic and political case for staying in the single market for financial services
- Legal framework more accommodating than usually assumed
- Broader point: economics (and politics) will trump law

(1) The risk of Brexit

The doom scenario

No more passporting post Brexit?

Passporting – principle of home state control in EU financial markets regulation

- Once authorised, no further scrutiny elsewhere (allows branch or CB service provision)
- Reduces costs of CB business within the EU, attractive for 3rd country players
- Enshrined in all relevant laws, eg MiFID II, CRD IV, UCITS, AIFMD, PSD, IMD/IDD

The doom scenario

Relocation of clearing to EU27

- Clearing of euro-denominated securities – massive market, worth about \$2tn per day
- Long envy of continental Europe
- Unsuccessful attempt to relocate to Eurozone in 2011
- Brexit is the perfect opportunity to repeat efforts

The doom scenario

‘Norway model’ as the alternative?

- EEA membership largely seen as unattractive in the UK
- Single market access, but subject to rules without seat at the table
- Norway critical of UK membership

The doom scenario

A tailor-made agreement?

- Wide divergence in standpoints
- UK seeks to restrict free movement of persons
- EU27 see this as an integral part of single market access

Conclusion:

- no deal?
- End of passporting

(2) A more realistic scenario

A more realistic scenario

Economic case for single market access for financial services – for the UK

- Financial services = UK's biggest industry, worth as much as 10 per cent of GDP
- nearly 5,500 UK firms use passports to access the EU market (FCA 2016)
- Clearing of Euro securities under threat
- Leaving Single Market could cost 35,000 jobs in finance (Oliver Wyman); up to 285,000 financial sector jobs at risk (Treasury)
- When the banks leave, the professional services firms who work with them would follow over time
- Third country banks (US, Japan) most likely to move

A more realistic scenario

Economic case for single market access for financial services – **for the EU27**

- About 8,000 EU firms use passports to access the UK market (FCA 2016)
- ‘passporting is a two-way street’
- Common interest – City weakness would hit German and French exports to the UK (Fuest 2016) – close relationship of mutual economic dependency between UK and Eurozone
- Agglomeration effect of finance
- Threat of arbitrage and competition with an independent City of London (eg bonus caps)

A more realistic scenario

Politics

- Narrow majority, 52/48%; majority of MPs are pro-remain
- 'Parliamentary rebellion' 2016/17
 - *R (Gina Miller) v Secretary of State* [2017] UKSC 5, and other cases
- December 2017 amendment to Withdrawal Bill
- Regional problems: Scotland and Northern Ireland
- Public opinion is turning

A more realistic scenario

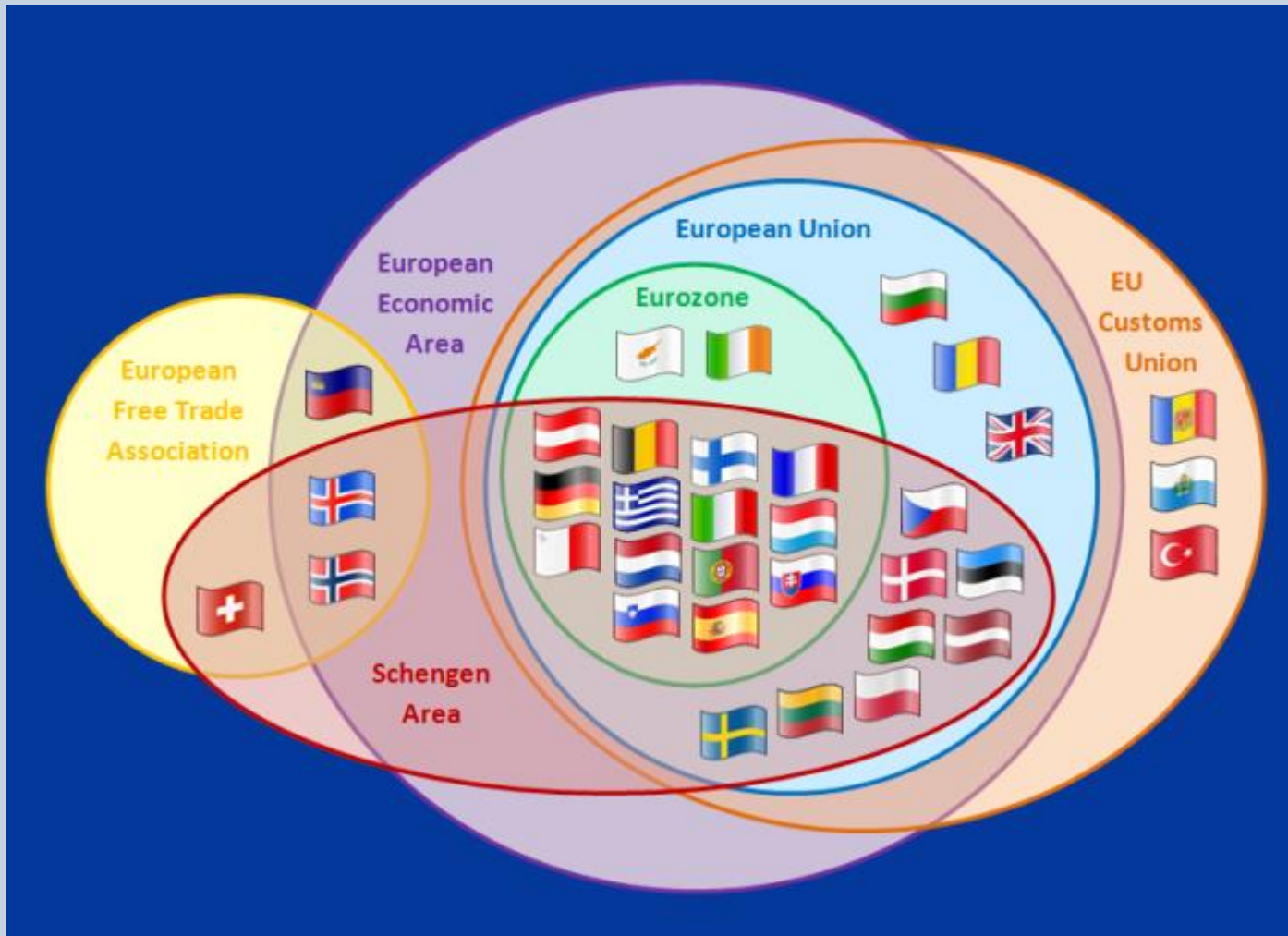
Currently hardening positions

- pre-bargaining rhetoric
- Theresa May's dilemma
 - domestically, she needs to speak tough to honour referendum outcome -> tough talk on immigration, sovereignty and ECJ jurisdiction
 - in Europe: this rhetoric will prevent her from getting a good deal
- creates counter-reactions and tough rhetoric from the EU's side!
- Phase 2 negotiations will show common ground

A more realistic scenario

But – what about the risk of setting a precedent / inviting copycats?

- Size of the UK and its financial market
- historical examples:
the UK rebate – reduces the UK's contribution to EU budget since 1985 (Thatcher)
- Multi-layer EU already a reality: Eurozone, Banking Union, Schengen etc



A more realistic scenario

Legal rules are malleable

- in crisis times, they become unimportant
- “Given a choice between financial stability and the rule book, ditch the rule book” (The Economist)
- ‘Brexit’ will formally be implemented, but legal creativity will find a solution for financial services

Politics & economics trump law

Historical Examples

- European integration full of examples for creativity
- Crisis-era legislation
 - ESM, Greece rescue vs. ‘no bail-out’ clause (*Pringle case*)
 - Creation of Banking Union – legal basis unclear
 - ECB: “Whatever it takes”, OMT and QE (*Gauweiler case*)
 - Italian banking crisis 2016 and bail-in
- Opt-outs, special arrangements, vetoes
- Multi-layer EU

Politics & economics trump law

Should we worry?

- Pistor: genius of law is its flexibility in crisis situations
- German government – establishment of a rules-based Europe

What does it mean for Brexit?

- Legal rules a malleable: in crisis times, they become unimportant
- ‘Brexit’ will formally be implemented, but politics will find a solution for financial services

(3) How could a solution look like?

Solutions

(1) Most likely outcome

- 'Special deal' with the UK
 - UK is formally out of the EU
 - Single market access remains, at least for financial services
- UK to give in on immigration?
 - Actually to the benefit of the UK!
 - Wide carve-outs likely
- Bespoke agreement with EU ~ Continental partnership (Bruegel)

Solutions

(2) Alternative?

Third country passport – relying on ‘**equivalence**’ (eg Art 46 MiFIR)

- (P) typically restricted to wholesale financial services, not retail
- Shouldn't matter, UK financial industry mostly focused on wholesale
- Patchy, eg doesn't apply to UCITS
- Still risk of political exploitation, agreement preferable

Solutions

(3) Private solutions?

- If political actors do not act, business will have to arrange this themselves
- Easier for large groups that tend to have subsidiary in EU already
- Problematic for small firms – and for UK economy as a whole

Summary

“Brexit means Brexit”

- Brexit will be implemented – formally
- Strong incentive to reach agreement in substance
- Legal creativity will accommodate a solution

Professor Wolf-Georg Ringe
University of Hamburg
Institute of Law & Economics
Email: georg.ringe@uni-hamburg.de

See the full paper at <http://ssrn.com/abstract=2902715>