Preparing for a future
UK-EU trade relationship

A Finance Watch briefing note
Preparing for a future UK-EU trade relationship

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European Commission's official Brexit timeline

29 March 2017
29 April 2017
May 2017
Actual negotiating period: ≈ 18 months
At the latest by autumn 2018
At the latest by February 2019
March 2019

* Strong QMV = 72% of the 27 Member States, i.e. 20 Member States representing 65% of the EU 27 population.


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Summary

EU free trade agreements have repeatedly brought the integrity of the financial services regulatory framework into question and do not put protection of citizens first. Putting in place a framework for regulatory cooperation, based on a minimum set of agreed fundamental protections that citizens already have, could provide a good starting point for a future trade relationship between the EU and the UK in the area of financial services. This framework should ensure that the same level of protection for citizens is carefully enforced, supervised and developed through close cooperation and sufficient mechanisms for arbitration.

- **Proper preparations** must be taken by both governments and companies to ensure that citizens are not negatively impacted by Brexit. These preparations should mean that governments and companies are ready as possible for a ‘no-deal’ Brexit given the uncertainty around the approval of the withdrawal agreement and a future trade deal.

- EU States and the UK need to find a way to **constructively collaborate** post-Brexit. If States prioritise competing for financial services ‘business’ it could have a negative impact on the regulatory framework and so on citizens.

- Grandfathering is not a solution to ensure continuity of services provision, because it will not guarantee citizens’ rights or enforcement of rules without further cooperation agreements being put in place. Existing EU trade agreements and methods to grant market access to non-EU countries pose concerns over guaranteeing the **continuity and integrity of the current financial regulatory framework**.

- The EU and the UK should agree on a **withdrawal period of at least 5 years**, to allow the negotiations on future cooperation to be properly concluded. This would also help to reduce the risk of a Brexit without an agreed future trade relationship, which has the potential to cause a large negative economic impact.

- Priority should be given to ensuring a set of mutually agreed **fundamental protections** that exist in the current shared EU financial regulatory framework. A new structure for cooperation between the UK and EU should be put in place to enable practical cooperation that safeguards key mutually agreed fundamental protections and that respects the principles of the EU internal market. This list of protections should aim to cover the following areas:
  - Prudential rules in line with the current levels of protection under the EU banking package, Solvency II, MiFID II, EMIR, CCCTB/ CCTB and FiCoD.
  - Conduct of business rules in line with the current levels of protection under the EU market abuse directive, prospectus directive, consumer credit directive, mortgage credit directive, distance marketing directive, MiFID II, IDD and the GDPR.
Key terms used

UK referendum ➔ refers to the legally non-binding referendum on membership of the United Kingdom in the European Union. The UK government at the time had promised to enforce the result of the referendum. A simple majority of 51.9% of voters were in favour of leaving the EU.

UK exit from the EU/Brexit ➔ the formal process of the UK triggering Article 50 of the Treaty on the European Union and withdrawal as a member. Article 50 outlines a two-year period where the withdrawal of an EU member state can be negotiated. If the terms of the withdrawal agreement cannot be approved then the member state will anyway cease to be a member of the EU, unless an extension to the period of negotiation has been unanimously agreed by all parties.

Withdrawal agreement/trade deal/FTA ➔ the withdrawal agreement refers to the negotiation terms, within the Article 50 notification period, for the UK to leave the EU. The trade deal refers to an agreement on future trading relationship between the EU and the UK. This agreement is being negotiated in parallel with the finalisation of the withdrawal agreement, as part of a second phase of negotiations between the EU and the UK. The future trade relationship under negotiation is often referred to an FTA (free trade agreement). FTA is an EU term for the trade relationships it has negotiated with third countries. These agreements are also sometimes referred to as economic partnerships.

Third countries/equivalence ➔ refers to the EU term for countries that are not members of the Union, but with whom the EU has trade arrangements or agreements. One of the ways that access to the single market can be obtained is through a decision of the European Commission recognising that a jurisdiction, or third country, has an equivalent regulatory regime. This means that the levels of protection provided by the third countries’ laws are considered to be of at least the same level as those provided under EU law. The possibility for the Commission to take these equivalence decisions has to be specifically allowed under a specific EU law. This means that current laws without this provision would need to be amended through the full legislative process to include it where it does not already exist.

No-deal scenario ➔ refers to the situation where the UK and the EU are unable to approve the terms of the UK withdrawal from the EU, or agree a future trade relationship. In this case trade between the EU and the UK will be governed by WTO (world trade organisation) rules. This will mean that a series of tariffs on goods and services traded between the EU and the UK will apply. It means that companies will also no longer be able to use ‘passports’ to provide services across the UK/EU borders.

Passporting ➔ refers to the possibility for any company authorised to provide services in the EU to market these services to other countries that are part of the single market or European Economic Area (EEA). Currently UK companies can provide services within any other EU or EEA country and vice-versa.

Re-papering ➔ refers to the process of adapting portfolios of existing contracts in preparation for a ‘no-deal’ scenario. This can be done by amending or transferring contracts, to ensure that companies can continue to provide services.

1 Anjuli Davies, Huw Jones: “Banks face contract repapering rush to retain clients after Brexit”, in: Reuters, 30 Nov 2017; online available at: https://www.reuters.com/article/us-britain-eu-banks/banks-face-contract-repapering-rush-to-retain-clients-after-brexit-idUSKBN1DU1W0
**Article 50** refers to Article 50 of the Treaty on European Union. This article explains the process for a member state to leave the EU. This includes a two-year period for negotiating the withdrawal of a member state from the EU, once notification that the state intends to leave is given. It also includes the possibility for EU member states to unanimously vote to extend this two-year period.

**Most favoured nation clauses** Under World Trade Organisation rules a principle has been established under the General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services (GATS). The principle is that if a country offers a preferential rate to one WTO member country it must offer it to all the others. Regional Trade Agreements (RTAs) are allowed between WTO member countries. The EU is an example of a RTA, as are all the FTAs agreed between the EU and third countries. The EU itself has also included most-favoured nation clauses in its FTAs, such as under the agreement with Canada. Under the EU clauses in CETA, Canada and the EU should be given at least the same level of access as other third countries that agreements are made with.

**Statutory Instruments (SIs)** These are a legislative tool in the UK, which can be granted to a government through a law voted in Parliament. It gives government departments the power to make changes to a law without having to go through the full parliamentary process and scrutiny.

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4 World Trade Organisation, “The GATT years: from Havana to Marrakesh”; online available at: [https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact4_e.htm](https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact4_e.htm)

5 World Trade Organisation, “The General Agreement on Trade in Services (GATS): objectives, coverage and disciplines”; online available at: [https://www.wto.org/english/tratop_e/serv_e/gatsqa_e.htm](https://www.wto.org/english/tratop_e/serv_e/gatsqa_e.htm)

6 World Trade Organisation, “Regional trade agreements (RTAs)”; online available at: [https://www.wto.org/english/tratop_e/region_e/region_e.htm](https://www.wto.org/english/tratop_e/region_e/region_e.htm)

7 European Union, “Inventory of agreements to which the European Union (EU) is a contracting party containing a Most Favoured Nation (MFN) clause”; online available at: [http://ec.europa.eu/world/agreements/ClauseTreatiesPDFGeneratorAction.do?clauseSelID=188](http://ec.europa.eu/world/agreements/ClauseTreatiesPDFGeneratorAction.do?clauseSelID=188)

Preparation for a future UK-EU trade relationship

Introduction

There has been considerable political turmoil around the result of the UK referendum and subsequent decision to leave the EU. The discussions around the UK withdrawal agreement and diverse political views amongst UK politicians have even raised the question of whether or not Brexit will really happen. The need to prepare for a UK exit from the EU is, however, very real.

Regardless of the final outcome of discussions around the withdrawal agreement, or if successful a future relationship between the EU and the UK negotiated during a transition period, preparations will have to be made for ‘no-deal’ scenario. The uncertainty over whether the withdrawal agreement will be approved or not mean that the first likely deadline for preparations will be ahead of March 2019. If the withdrawal agreement is confirmed ahead of this date then the same preparations will serve ahead of the current transition period under discussion. The latest white paper from the UK government states that the UK will no longer be able to operate under the EU ‘passporting’ regime. This underlines the importance of properly preparing even if a deal is reached.

After a UK withdrawal from the EU having a consistent, properly enforced regulatory framework in place is essential for a number of reasons. It can ensure that companies conduct business by competing to provide services that are deemed not to be harmful, but rather useful for society. The case of the UK withdrawal from the EU brings into focus the possible negative role of competing states.

However, by agreeing common regulatory frameworks governments can promote common levels of enforcement and protection for both businesses and citizens across broader jurisdictions. Such a framework should be negotiated outside of trade negotiations but should have the form of a sectoral agreement.

Enforcement is a key element of ensuring that the framework is sustainable and that the level of protection is adequate.

The impact of the UK withdrawing from the EU without an approved withdrawal or a future trade agreement has been extensively assessed, with many predictions and analyses warning of the negative economic impact it could have. The Governor of the Bank of England has been a prominent voice warning that a ‘no-deal’ Brexit could have serious consequences, similar to those of the 2008 financial crisis for the UK economy. This demonstrates what is as stake and the importance of having in place the right future EU-UK relationship.


Preparing for a future UK-EU trade relationship

A regulatory race to the top for services provision

The UK exit from the EU brings into question the future of the EU financial legislative framework that has been jointly constructed. This framework should serve as a basis to continue to better enforce and improve financial services regulation in both the UK and the EU. An effort does also need to be made to stop financial services companies from exploiting regulatory loopholes arising from the UK exit from the EU, which risk undermining the current framework.

In the short term there are already concerning signs from the UK proposal for its ‘EU withdrawal act’\textsuperscript{12}. The proposed use of Statutory Instruments (SIs) to address issues with EU laws seems to be too broad a mandate. Firstly it raises questions of undermining democratic process and scrutiny in the key area of financial services law. It also potentially leaves the UK with a large amount of flexibility to amend the regulatory framework as it is adapted into UK-only law. This flexibility is a concern given the dialogue around the UK exit from the EU on promoting the UK as a centre for business, particularly in the area of financial services, by deregulating the sector.

This was seen through an immediate move to meet with the financial services companies operating in the City of London to gather their input on possible opportunities arising from the UK exit from the EU\textsuperscript{13} and also due to the UK’s industrial strategy\textsuperscript{14}. These meetings have continued, with a change in the dialogue from the UK government\textsuperscript{15} to acknowledge that taxpayer and consumer interests should be at the heart of a future trade relationship. However, no limitations or clarifications on the use of SIs have yet been given to ensure there is no possibility of creating or causing regulatory arbitrage. The July 2018 ‘Chequers’ paper has further added to concerns that the UK government intends to reduce the level of regulation and protection in the area of financial services\textsuperscript{16}.

In the case of the EU member states there is an equally important need to avoid a deregulatory race to the bottom. The European Supervisory Authorities (ESAs) have already issued warnings over national supervisors aiming to incentivise companies to register legal entities in their jurisdictions\textsuperscript{17}. There are indications that national supervisors have been prepared to less stringently enforce rules to attract companies to their member state. Several practices such as outsourcing and delegation have been addressed by the ESAs to be avoided for this reason.

A specific example is where a 'brass plate' company is set up, without being properly staffed or a true functioning part of an organisation, but is still used to provide services in a certain area. Until now many financial companies have been registered in the UK, both because it is a financial hub and to gain access to the EU market. The issue of 'brass plate' companies can arise when they wish to keep their activity and business based in the UK, but use an essentially empty company in one of the member states to maintain access to the EU market.

Another possibility is that a company relocates its European headquarters to an EU member state, with a promise of favourable tax treatment or less stringent application of regulation. Member states could be tempted to allow this by the promise of possible gains in tax returns and jobs creation. However, the result of allowing these practices to take place would be putting the regulatory framework and protection it affords at risk.

One key aim to ensure the integrity of the current levels of regulatory protection in a post-Brexit environment would be to define the terms for future cooperation, whilst respecting the integrity of the EU Internal Market. This could involve on a practical level creating a platform for continued supervisory cooperation, including the ESAs. The ESAs currently include observers in their meetings, but this framework may not be sufficient to ensure regulatory arbitrage is properly monitored and addressed. A specific body could be set up to initially deal with immediate challenges arising from the UK withdrawal from the EU would be useful. This body could be based on extending the Joint Committee of the ESAs working structure and including representatives of third country supervisors. It should also aim to include stakeholders to ensure the widest possible view on potential issues related to regulatory arbitrage. This could be through a panel of independent experts and should include representatives of civil society.

It could also involve taking a joint commitment to maintain a set of fundamental protections. A framework would then be needed to jointly develop and improve on these core areas, within the predefined and agreed scope that sets a minimal level of protection. An independent arbitration body, based on the model under the EU-Ukraine association agreement, could be used to assess the enforcement of the fundamental protections. It could also address complaints linked to enforcement, claims of bypassing of the protections and issues arising from Brexit.

The fundamental protections should be based on the current jointly agreed financial services rules in place in both the EU and the UK. These rules would serve as a guaranteed minimum level of protection, which should then be discussed and further developed as part of ongoing joint cooperation. It should include the protection afforded under the following regulations:

- Prudential rules in line with the current EU banking package, Solvency II, MiFID II, EMIR, CCCTB/ CCTB and FiCoD.
- Conduct of business rules in line with the EU market abuse directive, prospectus directive, consumer credit directive, mortgage credit directive, distance marketing directive, MiFID II, IDD and the GDPR.

A key issue here is the time it would take to agree and establish new frameworks for cooperation, or adapt existing ones. Sufficient time will, in fact, be needed for any future relationship to be agreed. In the case that the withdrawal agreement is not approved by March 2019, an alternative solution could be for the EU to extend the withdrawal period under Article 50(3). If the period were extended to five years, starting from 2019, it could give the necessary space to agree a more detailed and secure framework for future cooperation. If the withdrawal agreement is approved then the same five years could be applied to a transition period. This would give authorities on both sides more time to ensure that regulatory arbitrage is avoided.

18 European Supervisory Authorities, “About the Joint Committee of the ESAs”, online available at: https://esas-joint-committee.europa.eu/about-us
Planning for the future and not grandfathering for the past

One of the immediate issues for financial services companies following the UK exit from the EU is deciding what should happen to existing contracts and liabilities. The favoured solution of these companies would be an arrangement that allows them to continue to apply the same current rights and conditions to contracts already in place before Brexit.

This practice, called grandfathering, provides a good solution for the immediate issue on the table of continuity of contracts for companies in the short term, but does not deal with the practical consequences for citizens moving forward. An example is that grandfathering in the case of Brexit does not seem to take into account the practical issues over arbitration, to ensure access to redress. This is largely a concern as the UK would no longer fall under the jurisdiction of the Court of Justice of the EU.21

There is also a potential issue over supply chains, given that some agreements are based on FTAs between the EU and third countries. In this case a further ‘great-grandfathering’ step could be needed to ensure that the UK also recognises the appropriate access agreement that the service was provided under.22 A linked issue is that the UK has clearly targeted obtaining trade deals after its exit from the EU,23 which would likely include attempting to reinstate links with countries that it previously had through EU FTAs. This would potentially create trilateral negotiations with even greater challenges and complexity than the current EU processes for agreeing FTAs.

Most importantly grandfathering is not a legitimate solution for companies to continue services provision in the face of Brexit, because it is entirely dependent on the outcome of the negotiations on a future trade relationship and the approval of the withdrawal agreement. As previously mentioned, the results of these negotiations will likely not be known and confirmed in time for companies to rely on them. This means that alternative solutions must be sought out and put in place without delay and in time for the UK exit from the EU in March 2019. The dice roll of waiting and hoping to lobby for a favourable outcome under either the approved withdrawal agreement or the future trade agreement is irresponsible and not a risk that companies should take with their obligations to their customers.

Having already recognised the risks of waiting on a possible grandfathering regime, many companies have already looked at ‘re-papering’ contracts. This can be done in a number of ways, also potentially linked to the way in which companies plan to operate their future cross-border business. Contracts can be amended or moved to a new entity through this process to ensure continued service provision, but also to avoid triggering a right to terminate a contract or other provisions as a result of Brexit. Here there is a key risk as part of this re-papering exercise changes being made are used as a pretext to lower the rights that consumers have under contracts. This issue needs to be closely monitored by both the UK and EU member state supervisory authorities. These authorities could benefit from a structure to exchange views and information on where the issue materialises.

Tailor-made free trade with the EU

The UK exit from the EU has brought into focus the different trading arrangements that are already used or being agreed with third countries and the EU. EU free trade agreements (FTAs) and equivalence decisions delineate areas for tariff-free trade between the EU and non-EU members, or third countries. These FTAs and decisions might not be tailor-made in the sense that the UK government has spoken about, but do offer specific agreements to different countries. These existing agreements have then formed a basis for the different options that the EU is prepared to offer depending on the level of cooperation with a third country.

One of the issues with EU FTAs is the possibility they can provide to subvert regulatory frameworks and processes, under the guise of reducing barriers to trade. This causes the same potential concerns as the proposed use of SIs by the UK.

Even if a FTA is agreed between the UK and the EU, so far these agreements have not sufficiently covered financial services. The current mechanism that exists to provide some limited access to the EU single market is third country equivalence regimes. Only 15 of the 40 post-crisis pieces of financial legislation include the possibility for third country access. Decisions to grant access under third country provisions are taken by the European Commission according to these provisions. This poses issues as there is not yet a fixed regulatory framework to structure how the decisions are taken.

The European Parliament has already called for such a framework to be introduced, which would increase its role in the process. This has possible positive and negative consequences. On the one hand it opens up the process for proper checks and balances. On the other hand it creates a space for debate that numerous competing interests will seek to influence and could risk creating regulatory arbitrage.

There is also the issue of most favoured nation clauses. Under agreements such as the CETA, the EU should give the same conditions to Canada as any other third country it agrees an FTA with. It means that negotiating a deeper trade agreement with the UK risks meaning that EU citizens may also have to accept the consequences of offering the same market access to Canada and other countries that fall under EU most favoured nation clauses.

The issue of investment protection would need to be considered as part of the future relationship. The EU and the UK could sign an investment protection treaty or include an investment protection chapter in a future FTA. If one of these options is chosen, then the risks related to a potential ISDS (or ICS) between the UK and the EU and its member states would need to be jointly addressed.


Preparing for a future UK-EU trade relationship

Fundamental Principles for a future cooperation framework

A future trade relationship between the EU and the UK could be based on a new framework for cooperation, based around agreed fundamental principles, whilst respecting the integrity of the EU Internal Market. The first important questions would be does this then significantly differ from EU membership, or would this turn into a new kind of de facto flexible EU membership? The answer has to be no and the key would be to work within the constraints of the red lines set out by both sides.

The process of negotiation could end up essentially providing an unstructured framework for cooperation in any case, if agreements are found on this basis. The added value would really come from the additional structure aiming to agree a clear list of fundamental principles to enable practical cooperation that targets the safeguarding of key agreed protections could provide, as well as ensuring consistent coverage of these protections through cooperation on supervision. As previously mentioned giving additional time and space to achieve this would also be important.

What the cooperation framework would also allow is for both the UK and the EU to assess the merits of regulatory enforcement and alignment, as issues or developments in the current body of legislation occur. There would not be an obligation for either side to accept new rules or to adapt the current protections, but the structure would be in place to allow an organised dialogue around these developments.

It is also important to note that the UK may have adopted and implemented a similar regulatory framework, even if it was not an EU member state, as it reflects the G20 reform agenda. This would also likely continue to be true after the UK’s withdrawal from the EU. The UK would be expected to continue to contribute to and align with the overall work of international bodies and standard setters, such as the Basel Committee and the Financial Stability Board. The additional level of structured cooperation with the EU could therefore be complementary, whilst allowing both sides the possibility to take decisions on an equal footing.

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27 Niamh Moloney, “Financial services, the EU, and Brexit: an uncertain future for the city?” German Law Journal, 17 (2016), pp. 75-82; online available at: [http://eprints.lse.ac.uk/67292/1/Moloney_Financial_Services_the_EU_and_Brexit.pdf](http://eprints.lse.ac.uk/67292/1/Moloney_Financial_Services_the_EU_and_Brexit.pdf)

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About Finance Watch

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