Why the EU needs the City too

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The UK might appear to have the most to lose from Brexit if City firms find it harder to sell financial services into the EU. But London has actually consolidated its position as the world's leading financial centre since the vote to leave, helped by strong signals that the UK at least will keep its markets open. The EU should follow this lead.

The reality is that maintaining relatively free trade in financial services is in the best interest of both sides. EU businesses, consumers and governments would all face higher borrowing and transactions costs if local regulations deny easy access to the services that UK firms provide.

There is a danger of falling into a simplistic discussion of 'passporting' versus 'equivalence' or 'mutual recognition', when what matters are the general principles. But whatever the precise terms used, the UK and EU should continue to cooperate closely to provide the confidence that each other's regulations are just as good as their own.

Introduction

Everyone is aware of the importance of the City to the UK. Financial and related professional services, broadly defined, account for as much as 10% of the UK economy, provide 2.3 million jobs and contribute large amounts in tax. TheCityUK (2018) summarises the key facts. However, many people elsewhere in Europe appear to regard the success of the City as a competitive threat, and therefore view Brexit as an opportunity to correct the balance by taking business away from London. In my opinion, this is understandable, but misguided. The initially sceptical responses to UK proposals for a new system of 'mutual recognition' in financial services are symptomatic of this short-sighted approach.

A primer on 'passporting', 'equivalence' and 'mutual recognition'

It is important not to become bogged down in the terminology, but some explanation of three concepts is essential. First, when the UK leaves the EU it will lose the automatic 'passporting' rights that allow banks and other providers of financial services who are authorised in one member state to do business in any other. In the absence of alternative arrangements, they will be forced to rely on a patchwork of country-by-country rules.

> Brexit means that UK financial firms will lose the automatic passporting rights that allow them to do business anywhere in the EU. The EU's current system of 'equivalence' would only be a poor substitute.

Second, the EU does allow some non-EU firms to provide a limited number of financial services in the EU if their home-country regulatory regime is accepted as being 'equivalent' to the EU's own. But it is widely agreed that the EU's current system of 'equivalence' would be a poor substitute for passporting, because it only covers a small range of financial activities and because access can be withdrawn at short notice.

Third, UK experts and trade organisations have therefore proposed several alternatives based on the concept of 'mutual recognition', where the UK and EU would agree to recognise the adequacy of each other's regulations as a substitute for their own.

> Fortunately, there are several better alternatives based on the principle of 'mutual recognition'. Here, the UK and EU would agree to recognise the adequacy of each other's regulatory approaches.

For example, Barney Reynolds (2016 & 2017) has developed an 'enhanced equivalence' model, which fills in the gaps in the current system and makes further improvements. UK Finance (2017) set out a framework for cross-border market access based on mutual recognition of regulatory approaches, underpinned by a high degree of regulatory and supervisory cooperation. Singham and others (2017) proposed a system of 'dual regulation coordination'. And McBride and Singham (2018) discuss how the UK could develop an international regime based on shared principles, either bilaterally with other financial centres or multilaterally through the WTO.

So far, the EU has been lukewarm, at best, towards all these ideas. Indeed, Michel Barnier has appeared to rule out any special deal for UK financial services, whether based on 'mutual recognition' or called something else. This is consistent with the general reluctance to offer the same benefits to third countries as those available to states who are willing to sign up to all the rights and obligations of EU membership. Nonetheless, there are several good reasons to believe that this opposition can be overcome.

The case for 'mutual recognition' in financial services

For a start, there is nothing new about the principle of mutual recognition. Correia de Brito (2016) provides a comprehensive survey. Indeed, the EU pioneered mutual recognition as a more practical (quicker) alternative to the harmonisation of national standards when the common market was being developed. To quote the European Commission (2018) itself, 'Mutual Recognition Agreements (MRAs) promote trade in goods between the European Union and third countries and facilitate market access'. It is worth adding that mutual recognition allows for healthy competition between different regulatory regimes, and for greater flexibility to reflect local conditions.

> Mutual recognition is nothing new. Indeed, the EU itself pioneered the concept in developing the common market in goods.

What's more, as Verdier (2011) explains, the principle of mutual recognition is already well established in international finance, both in theory and in practice. Contagion from the financial sector may pose greater risks to the wider economy. But McBride and Singham (2018) provide many examples of existing cooperation among countries such as the US, Australia and Singapore. And the UK and the EU will, of course, be in a position of complete regulatory alignment to begin with.

Perhaps most importantly, some form of mutual recognition agreement in financial services is clearly in the best interest of both the UK and the EU. This is because the rest of the EU benefits enormously from easy access to the services that the City provides. As Paul Krugman (1993) put it, "an introductory economics course should drive home to students the point that international trade is not about competition, it is about mutually beneficial exchange. Even more fundamentally, we should be able to teach students that imports, not exports, are the purpose of trade. That is, what a country gains from trade is the ability to import things it wants." This applies to financial services, just as much as it does to goods.

> A mutual recognition agreement in financial services is clearly in the best interest of both the UK and the EU.

The EU needs easy access to the services that the City provides

The City is Europe's dominant financial centre for many reasons, and these advantages are deeply embedded, or, in the words of Lyons (2018), 'Brexit-proof'. Perhaps the single most important of these advantages is the benefit of size: the UK is a world leader in currency, equity and derivative trading, bond issuance, cross-border lending, insurance, law and consultancy.

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Even those who identify opportunities from Brexit for the rest of the EU, such as Bruegel (2017a and 2017b), therefore still emphasise the risks. As a special report for Reuters (2017) put it, 'if Europe cuts off London's deep financial markets when Britain leaves the EU, costs will likely rise for Europe's banks and companies". To cite just one set of figures from the Reuters report, Britain has the largest foreign exchange market and the second largest derivatives market in the world, accounting for just under 40% of global trade in those markets. Paris, London's nearest EU rival, handles under 5%.

This in turn helps to explain why attempts to attract business to the rest of the EU have, so far, largely been unsuccessful. Since the vote to the leave the EU, London has actually consolidated its position as the world's no.1 financial centre in the Global Financial Centres Index (2018). In contrast, Frankfurt was 20th, Paris 24th, Dublin 31st and Amsterdam only 50th (behind both Edinburgh and Glasgow). What's more, estimates of City job losses have been scaled down, from as many as 100,000 according to a report by PWC (2016), to less than 10,000.

> This helps to explain why attempts to attract financial services business to the rest of the EU have mostly been unsuccessful, despite earlier fears of a 'Brexodus' of City jobs.

A further important part of this story is that the UK itself has signalled that it will keep its own markets open. For example, EU wholesale banks and insurers will be able to apply for authorisation to operate as a branch in the UK after Brexit, rather than as a subsidiary (which would impose higher capital requirements). However, this is conditional on there continuing to be a high degree of supervisory cooperation – of the type envisaged under mutual recognition.

Conclusion

A new financial services agreement based on the well-established principle of 'mutual recognition' is the most promising solution to the challenges presented by the UK's departure from the EU. If the EU and the UK fail to maintain the open access that already exist, both sides will lose out. In particular, EU businesses, consumers and governments would pay a heavy price for increased market fragmentation and reduced liquidity – in the form of higher borrowing and transaction costs – perhaps at a time when the euro-zone financial system is again under strain. Avoiding this outcome would truly be a win-win.

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