DEVELOPING TRADE IN SERVICES

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Executive Summary

Services are simultaneously the most important sector of the UK economy and the sector facing the biggest challenge as a result of Brexit. The prospective departure from the European Single Market reduces the UK to the status of '3rd country' in respect of services. Accessing the internal market will depend on both subjective and objective conditions that differ from sector to sector, requiring detailed and highly specific arrangements for such industries as aviation and financial services.

In practice, the EU can be expected to use these circumstances to discourage the UK from significantly diverging from European regulatory norms, as a matter of policy. In view of the weakness of, and uncertainty surrounding, international moves to oversee, let alone to further liberalise, trade in services, Brexit will thus leave the UK's services sector – and especially financial services – uniquely isolated and exposed. The government will hence need to consider carefully the costs of decisions to diverge from EU regulatory standards, and should be giving great priority to establishing clear objectives for close cooperation between the UK and the EU policy makers and regulators.

Introduction

The economic consequences of the UK's exiting the EU will be determined in major part by the specifics of the arrangements ultimately agreed to. At issue will be not only its departure from the Single Market (SM) and Customs Union (CU), but also which elements of the Withdrawal Agreement (WA) will survive – for ultimately it is these that will shape the EU's post-Brexit propensity to cooperate with the UK.

The UK government's narrative about the SM and CU has more often than not presented the two concepts as largely inseparable. As far as goods are concerned, there is indeed considerable overlap, although even here it is not complete. Turkey is virtually part of the CU, but not of the SM. The other three EFTA members of the EEA – Iceland, Liechtenstein, and Norway, together with Switzerland – never joined the CU; and Switzerland is part of neither but has a specific agreement on goods standards.

In theory, at least, the UK has significant room for manoeuvre in respect of manufactured goods and agricultural produce by virtue of its willingness to engage in 'unilateral trade liberalisation'. But the case of services is fundamentally different.

'Services' is an integral part of the EU's so-called 'Four Freedoms' – the free movement of goods, capital, services, and labour – which are underpinned by (full) regulatory harmonisation. Hence any country that is not a member of the SM – any '3rd country', whether European or otherwise – is ultimately confronted by a difficult trade-off between harmonisation and discrimination.

The single most sensitive services-related issue is the level of regulation at its departure from the EU and thereafter. At that moment, UK's services regulations are completely aligned with those of the SM. But Brussels will watch extremely closely any move by the UK to diverge from the EU template. The EU can be expected actively to discourage the UK from regulatory divergence, as a matter of policy.

The EU approach

By defining freedom of movement as a principal red line in its strategy, the UK Government thereby

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excluded institutionalised participation in the SM. Given that services production in the UK is far greater in value than goods production, as well as being its most regulated sector, exiting the SM would represent a fundamental structural change.

To minimise the immediate consequences of this, a key element of the Withdrawal Agreement (WA) negotiated by the May government was the conversion of directly-applicable law into UK law, and preservation of domestic law related to the implementation of EU directives.

In the event of a no-deal exit, however, this agreement would – with the possible exception of a limited transition period – presumably be lost.

Given the growing erosion of the global institutional framework (more below), losing its SM affiliation would place the UK in the vulnerable position of having only '3rd country' status. This said, such a position would not differ greatly irrespective of the type of relation with the EU.

Because of its regulatory specificities, the SM's external dimension is characterised by the following features:

- Protecting the (often as yet only partially achieved) internal regulatory harmonisation, the extent depending on the sector;
- Ensuring that the '3rd country' jurisdiction offers a satisfactory level of market access (reciprocity);
- Assuring a measure of comparative regulation including the 3rd party's readiness to guarantee its authority in terms of implementation and oversight; and
- Promoting the EU's specific regulatory system at global level.

The complexity of arrangements, and the likely difficulties in reaching acceptable '3rd country' agreements can be appreciated simply by considering a number of the quantitatively more important areas.

Air transport

Air transport services are of considerable economic importance in themselves and a central plank of a number of policy pillars of the SM, including state aid and competition. They are also an interesting exemplar of the EU's outreach. They represent a contractual undertaking with the US, the 'Open Sky' agreement, which is a compromise in terms of market access for market structures that differ considerably on the two sides of the Atlantic. Furthermore, the two 'Open Sky' partners have agreed basically to go for mutual recognition of their respective regulatory systems, in particular in the area of safety.

While the EU has concluded a series of agreements with various overseas jurisdictions, Brussels has been adamant about its intention to create a European regulatory space, the European Common Aviation Area (ECAA). This includes the hard core of countries that have taken over the EU legislative 'acquis' in the area, as well as partners that have accepted European regulation as their benchmark. In some cases, the cooperation also extends to Eurocontrol, the organisation mandated to achieve safe and seamless air traffic management across Europe.

Thus, whereas in the US case the EU has settled for mutual recognition (regulatory cooperation), at the regional level, depending on the geographic location and the economic overlap of the partner, EU standards (regulatory convergence) are the norm.

This complex and challenging backdrop explains why in the case of the UK the EU devised, for the very short term, a unilateral, reciprocal, and time-limited contingency regime so as to preserve basic trade connectivity while excluding an extension of the SM level of market access. Hence, in the best of cases, the UK would either have to accept the principle of the 'acquis' (with everything that goes with it), or it would have to settle for a massive reduction of access to key 'air freedoms'.

The case of financial services (FS)

From the outset of the Brexit debate it was evident that, because of a number of near-unique characteristics, FS would be one of the hardest nuts to crack. In particular:

- There is a high level of post-2008 crisis financial regulation that reflects European socio-economic preferences, which seek to safeguard systemic stability, put in place an effective prudential framework, and protect consumers;
- However, while the 'package' is considered to be broadly achieved, the regulatory landscape remains incomplete; most conspicuously, where Capital Markets Union (CMU) is concerned. From a structural point of view markets remain disturbingly fragmented.
- The pivotal role of the UK's capital market has contributed to the centralisation of key market functions in London, to the advantage of the whole area. With the UK exiting the SM, the EU is set to impose harsher conditions on cross-border activities,

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while adapting its regulatory regime to allow some of those functions to be carried out within the EU.

In moving to '3rd country' status, the UK's interaction with the EU in the area of FS stands to undergo a paradigmatic change. Because the EU's FS market access rules are fundamentally binary, there is virtually no room for 'bespoke' forms of cooperation. Of the entirety of the FS body of legislation enacted over the last ten years, only about half contain a '3rd country' provision. It is for those – and for those only – that the equivalence determination procedure applies, which means in practice approximately 40 areas.

Equivalence determination is carried out under the authority of the European Commission, in close cooperation with the competent supervisory authority, particularly as regards the technical assessment of the 3rd party's set-up and the contacts with the supervisors of the latter. In some cases, the interaction between the EU and the 3rd party regulator can take the form of a quasi-negotiation. But it is the Commission that selects the jurisdiction(s) that take part in the process, and ultimately decides, in the shape of implementing acts, on the determination as well as on possible conditions, time limitations, reviews and revocations. Thus, the equivalence procedure is both unilateral and discretionary in nature, to which the Commission adds the criteria of proportionality and risk sensitiveness.

In a recent communication,[1] the Commission has updated and fine-tuned its approach on equivalence in view of its forthcoming dealings with the UK. Basically, the adapted scheme stands to impact Brexit at two levels:

- On the political plane, precisely because FS represent such a central plank in the bilateral scheme of things, the EU can be expected to interpret its conditions broadly, which explains why the above text speaks of taking into account EU policy priorities at large. In other words, Brussels is definitively freeing its hands in order to set even unrelated conditions to 3rd parties.

- At the material level, the Commission stands to handle its assessments so as to ensure that London's propensity to move its FS regulation away from the EU standard is kept in check. This means that the UK Government would have to choose between a rock (its ability to utilise the advantage of having control over its level of regulation in the sector at large – including taxation) and a hard place (maximising its market access opportunities, i.e. its equivalence profile).

The evolving global context

After having grown into a quasi-global regulatory reference system in the wake of the financial crisis, driven principally by the Central Banks, the G20/Financial Stability Board (FSB)'s disciplining role has steadily eroded. This is the result not only of a growing fragmentation and introversion at the top table, but also of a loss of functionality of (existing) multilateral bodies, that themselves are more and more inhibited by the political and economic realities at national and regional level.

Hence, the fading leadership of the traditional powers and the forceful advent of newcomers – with a different trade policy DNA – is progressively undermining the longstanding commitments underpinning multilateralism. (This trend has recently been defined as the new G minus 2 or G-2). Lacking a broader consensus, the potential for sectoral bodies, such as the Bank for International Settlements (BIS) and International Organization of Securities Commissions (IOSCO), to operate 'under the radar' is limited. The deeper implications of these changes obliges industry not only to navigate diverging – and more often than not conflicting – regulatory systems, but also to cope with a growing number of conflicting and extraterritorial measures (sanctions). Jurisdictions that are not part of a larger aggregation, would seem likely to move closer to, rather than further away from, the larger, integrated areas.

If the UK leaves the SM then, even in the event of a bilateral trade agreement with Brussels, trade in services will become a major issue, although this is unlikely to result in significantly improved market access. For without a contractual coverage of activities, FS would, for all practical purposes, be based on WTO/General Agreement on Trade in Services (GATS) rules and commitments. And the liberalisation mechanism that underpins WTO/GATT has in the past proved largely inadequate for services: while the GATS and the Understanding on Commitments in Financial Services proved useful in terms of disciplines, they never developed into a functioning driver of liberalisation.

Given that services constitute the largest part of high-income economies, the bodies that regulate them face massive challenges at the interface of jurisdictions. In a situation in which mutual recognition is losing traction because of the lack of agreed comparability criteria, the intricacies and depth of domestic regulation, reciprocity and conditionality are returning to the forefront of the debate, thereby giving rise to increasing unilateralism.

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At the moment of leaving the EU and (re)joining WTO on its own, the UK would have to file its FS schedule, which presupposes a clear vision of its global offensive/defensive priorities. Combined with an uncertain future of the WTO dispute settlement system, all this would require a both inventive and robust vision.

Conclusions

First, overall international strategic and economic cooperation is under acute duress. Introversion, regionalisation, and fragmentation are modifying the *modus operandi* – and in certain cases the very vocation – of global institutions. Such a backdrop seems a suboptimal moment for a player, such as the UK, to leave the EU, an institution that may not be perfect, but which at least tries to combine an internal functionality and a relatively liberal outreach. Hence, a form of separation should be devised that will set the conditions for constructive cooperation with the EU, both in regional and in global fora.

Second, notwithstanding the great importance of services, both at national and cross-border level, there was a limited degree of institutional rule-setting even before the present deterioration of international cooperation. While the G20/FSB did play a key role in the aftermath of the financial crisis, that momentum was lost due to the difficulties of various institutions in implementing broader commitments agreed at the top. GATS, since its inception, tried to extend the GATT/WTO system to services, but never went beyond the setting of principles and rules. In other words, GATS never developed a dynamic mechanism of liberalisation. Consequently, an independent UK would have to be aware that its membership of GATS represented a weak regulatory replacement for the defence of its interests, all the more so given that the WTO's dispute settlement system faces an uncertain future.

Third, the EU's policy on market access for FS is fundamentally binary. Given that the UK has excluded free movement, it thereby has to accept '3rd country' status. This will remain basically the case whatever the UK's chosen trade policy option. In the FS field, after having tried to get Brussels to consider the principle of mutual regulatory recognition for months, the UK Government came to the hard reality that the equivalence process was the only regime on offer. Although the latter was initially a strictly unilateral and largely discretionary affair, the EU has recently broadened the determination criteria. This could mean that in the UK's case Brussels could easily make its readiness to consider assessing equivalence in a given area dependent on London's more general position vis-à-vis Brussels (i.e. on elements of the Withdrawal Agreement).

Fourth, and on the material level, Brussels will henceforth monitor, and in painstaking detail, the UK's post-departure regulatory trajectory. By recently adding the notions of proportionality and risk sensitivity, the EU is clearly signalling how it intends to measure regulatory divergence in practice. That said, the case of the UK is special, because its Financial Services body of regulation was identical up to its departure. Given the UK's 'genetic' regulatory baggage, it would make sense for London and Brussels to create a regulatory platform that would oversee their bilateral interaction, at least at the beginning. Consequently, the UK Government would have to evaluate carefully, at every step, the advantages and costs of regulatory divergence.

Finally, it would seem to be of the uttermost importance for the UK Government to plan the next stage of the Brexit process by agreeing on a hierarchy of objectives. Services in general, and financial services in particular, do not seem to have been accorded sufficient attention, given their systemic, economic, fiscal, and societal relevance. Furthermore, the rapidly changing global mechanisms of cooperation dominated by a limited number of grand players, combined with largely new 'horizontal' themes, should encourage the UK not to lose sight of its geo-strategic location.

Policy proposals

- *Establish an overall hierarchy of objectives that allows services in general, and financial services in particular, to have satisfactory and non-discriminatory access in what is an increasingly challenging global environment.*
- *Recognise the vital role of regulatory comparability as a necessary condition for accessing the Single Market when addressing the trade-off between control over the UK's own regulation and maximising its opportunities in the EU market.*
- *Undertake whatever is needed to achieve a sufficient level of bilateral interaction with EU regulatory bodies in the financial services field.*

NOTE

1 Communication of the Commission to The European Parliament, The Council, The European Central Bank, The European Economic and Social Committee, and the Committee of the Regions. Equivalence in the area of financial services. Brussels, 29.7.2019:COM (2019) 349 final.

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