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BREXIT & FINANCIAL SERVICES

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HOW BREXIT WILL AFFECT THE FINANCIAL SERVICES SECTOR

The UK's vote on June 23rd to leave the European Union sent shockwaves through financial markets and the reverberations will continue for some time to come. Over the last few days we witnessed Mark Carney, President of the Bank of England, pledging GBP 250 billion to stabilise markets, the ECB committing to inject liquidity in financial markets if necessary and the 27th June saw a suspension of trading in shares of RBS and Barclays.

However, beyond the short term response of markets, a Brexit triggers important questions about London's position as Europe's financial centre and the UK-based financial industry's long-term ability to access the European single market. A loss of the EU 'passport' would have a profound impact on the sales and distribution strategies of financial firms located in London.

The strong British influence in the EU is also felt at the regulatory level. The UK plays an important role in the three European Supervisory Authorities (ESAs) in the financial services sector in terms of their technical input, physical resources and market expertise. Decreasing UK influence in the ESAs as a result of Brexit will be seen in the final content of legislation as well as on the way European supervisors agree to apply the rules.

In addition, the ESAs are funded through the EU budget and contributions from Member States, in accordance with their size. The UK leaving the EU will likely lead therefore to a decrease in the budget of the ESAs.

Regardless of the timeline for the UK's exit, a withdrawal process that has not yet commenced, the much sought-after regulatory certainty will hinge on two important questions: how can the UK ensure the EU 'passport' for its financial services firms to access the EU singlet market? What domestic legislative changes will the UK have to undertake to ensure access to the EU single market?

In this briefing, prepared with the assistance of external advisers, we provide an overview of how various financial services subsectors might be affected, the daunting domestic legislative challenge the UK will face and the wider impact of Brexit of the EU agenda on financial services. It represents best efforts at predicting the situation in the first week of July 2016.

ACCESS TO THE EU SINGLE MARKET – IT IS ALL ABOUT REGULATORY EQUIVALENCE

From an EU perspective, the decision to leave the EU will place the UK in the category of a third country. Financial firms based in these countries can only access the EU Single Market if the legislative framework of their country is deemed ‘equivalent’. The procedure for assessing and obtaining this equivalence decision may vary from legislation to legislation. Moreover, some EU laws do not contain equivalence mechanisms.

WHOLESALE CAPITAL MARKETS

The Brexit decision casts a cloud of uncertainty over the trading, clearing and settlement operations of UK financial markets. The first immediate question is whether the UK will implement MiFID II and MiFIR, scheduled to enter into force in January 2018, or will develop a different framework.

This question becomes more critical for UK capital markets once MiFID II becomes applicable across the whole EU in January 2018. To sustain existing capital markets, it will be critical for the UK to obtain equivalence for its trading platforms. In the context of MiFIR’s trading obligation for shares and derivatives, the absence of adequate equivalence could mean EU-based brokers and investors are not able to trade on UK trading venues, with a detrimental impact on volumes and liquidity as a result.

The UK will also need to secure equivalence for clearing houses, such as LCH, CME and the LME, under EMIR[1]. This equivalence will give them the coveted status of Qualified CCPs[2] without which it would imply a manifold increase of capital requirements for clearing members. In this context the protracted negotiations between the EU and US to get mutual equivalence over the better part of 4 years are a sobering reminder of the complexity of these equivalence discussions. It is not automatic.

1 European Market Infrastructure Regulation
2 Central Counterparties

Finally, many questions emerge around central securities depositories whose regulatory framework is nearly exclusively determined by the CSD[3] regulation and which would need to be replaced.

ASSET AND INVESTMENT MANAGEMENT

The buy side will also be significantly affected by Brexit. The equivalence challenges under the two main asset management legislations – UCITS and AIFMD – are quite different.

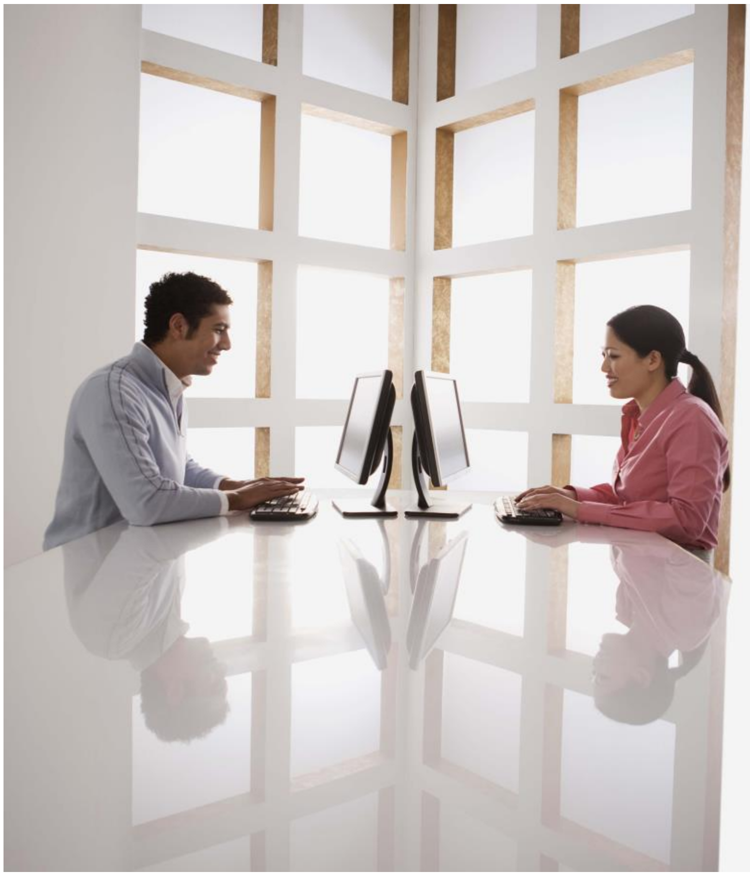
The UCITS directive requires a fund and its management company to be located in the EU and does not contain provisions for third country equivalence. Currently many funds and their management companies are located in Luxemburg or Ireland with the investment and portfolio management being conducted out of London. The ability to maintain the model of providing portfolio management services out of London will depend on the UK’s ability to get equivalence under MiFID II & MiFIR, which will enter into force in January 2018, probably before the departure of the UK from the EU. Otherwise buy side firms may be forced to relocate their operations inside the EU.

The AIFMD contains equivalence provisions for third countries. A crucial part of the AIFMD – the granting of an EU passport to third country firms – has not yet entered into force. The European Commission is scheduled to take a decision on that towards the end of 2016. The prospects of the UK becoming a third country may significantly impact the Commission’s decision.

> A lack of passport would mean fund managers would need to seek separate approvals in each EU Member State before distributing their funds there.

Therefore, important question marks exist regarding the ability of the UK-based asset and investment management industry to effectively access the EU single market.

3 Central Securities Depositories



BANKING

The impact on banks located in the UK is going to be very significant. UK headquartered banks as well as large subsidiaries of American, Swiss and Japanese banks currently use the UK as a hub to access the EU single market thanks to their passport under CRD IV[4]. The decision to leave the EU will ultimately result in the loss of that passport. This probably implies that banks will have to set up operations within the EU to keep the benefits of their passports or will face the unappealing prospect of having to ask for separate authorisations in each EU Member State.

Additionally, equivalence of the UK under CRR[5] will be critical for banks located in the EU. Indeed, a lack of equivalence would mean that these banks may have to apply less advantageous rules to calculate their capital requirements for exposures to the UK, thereby having a major potential impact on the flow of foreign capital into the UK.

Finally, the EU Single Rulebook currently embodied in the CRR regulation and the vast amount of Level 2 legislation and Level 3 Guidelines would have to be replaced with UK domestic legislation. This is especially the case as many of these rules emanate from international commitments at the G20, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) of which the UK is an integral member.

4 The 4th Capital Requirements Directive

5 Capital Requirements Regulation

INSURANCE

The insurance sector will not be spared by a Brexit. Insurers and re-insurers established in the UK will lose their passport under the Solvency II Directive, limiting their ability to provide insurance and re-insurance services across the entire EU single market.

ACCOUNTING & AUDIT

The new EU regulatory framework on statutory audit only just became applicable across the EU in June 2016. It lays down the rules on rotation of auditors and auditor independence among many other things. An exit will require the UK to pass its own legislation to determine how listed companies are audited or continue with its application of the EU Audit Regulation and Directive.

Similarly, International Financial Reporting Standards (IFRS) apply for the consolidated financial statements of listed companies in the EU because of an EU Regulation: each adopted IFRS is directly applicable in the UK. This regime would also have to be replaced by a UK equivalent to ensure consistency in financial reporting for international investors. Any changes will also affect UK tax legislation.

CHALLENGES FOR WESTMINSTER?

EU financial services legislation comes in the form of directives and regulations. Directives, such as MiFID II, the AIFMD and CRD IV, must be transposed into national laws which are likely to remain in place after the UK's withdrawal of the EU.

On the other hand, regulations such as EMIR, MiFIR and CRR apply directly in Member States and are not transposed into national laws. Their application in the UK is therefore contingent on EU law being applicable to the UK which will no longer be the case post-withdrawal.

To fill this vacuum, the UK will have to regulate the content of these regulations by passing laws in the UK parliament. However, any deviation from EU regulations is likely to complicate and decrease the likelihood of a swift and much sought after 'equivalence' necessary to access the EU single market. Moreover, many of the regulations that will need to be replaced emanate from agreements reached in international fora such as the G20, the FSB and the BCBS to which the UK is a party. The ability of the UK to deviate without breaching its international obligations will be limited.

A NEW EUROPEAN OUTLOOK ON FINANCIAL SERVICES?

The result of the UK referendum has already had an immediate and tangible effect on EU financial services policy with the resignation of the UK's Lord Hill from his position as European Commissioner for Financial Services. His portfolio will be taken over by Valdis Dombrovskis, European Commission Vice-President for the Euro and Social Dialogue. We expect that this may result in the EU's financial services policy shifting its point of gravity to the Eurozone. As a result, the Banking Union and related banking prudential regulations are likely to crowd out policy initiatives such as the Capital Markets Union (CMU) from the EU's agenda.

The decision by the UK to leave the EU may alter further the balance of power in the Council of Ministers between the Eurozone and the eight remaining Member States not participating in the Eurozone. It is clear that the political weight of the non-Eurozone Member States will be reduced, which may result in EU financial services policy being gradually geared towards the needs of the Eurozone, particularly in the area of banking regulation.

The UK's decision to leave the EU will also have a bearing on the location of the European Banking Authority (EBA) currently located in London. The EBA will eventually have to be relocated inside the EU. With the EBA in charge of developing the Single Rulebook and the latter's increasing importance for the Banking Union in the context of the Single Supervisory Mechanism (SSM), we would expect the EBA to be relocated in a Eurozone Member State.

Finally, the Brexit decision may also reinvigorate the debate on whether particular financial services activities, such as the clearing of Euro denominated derivatives contracts, should relocate within the Eurozone. The ECB's attempt to force the clearing of Euro denominated derivatives contracts to relocate within the Eurozone was struck down by the European Court of Justice in March 2015. However, the period of high volatility on markets and an important depreciation of the pound versus the Euro after the vote may reinforce the ECB's financial stability arguments.

WHAT NEXT?

Now is the time to identify opportunities and risks from this fluid situation. It is also the time to engage at EU and member state level. Governments will need help to understand and try to mitigate the impact of this process on key sectors.

The regulatory and public policy team at the BDO Global Office, in conjunction with external consultants, prepared this short paper to help you begin to understand the impact in the short, medium and long term.

The political situation is of course very fluid at the time of writing and doubtless there will be further developments and clarity as the months go on.

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