Paper Three

Financial Services

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The Impact of Brexit on Financial Services

Summary

The UKs pre-eminence as a global financial centre is of immense value to our own economy, as well as to that of the EU and the rest of the world. This role is in danger of becoming greatly diminished in the absence of the financial services "passport" system currently enjoyed. Other mechanisms used by countries outside the EEA such as the equivalence regime and the emergent third country passport, will not fill the gaps created by the loss of the passport. The WTO terms, also, are not sufficiently developed in relation to financial services to suffice.

- We therefore urge the Government to create a bespoke agreement with the EU, replicating the status quo as far as possible and covering the gaps created by the loss of the passport regime.
- We urge the Government to establish this as a transitional arrangement, as well as one more permanent following Brexit. Given the need for legal certainty, phased implementation of a new relationship or, failing the conclusion of negotiations on the new relationship, a transitional period should be a key aspect of HM Government's approach.
- We also urge the Government to provide legal certainty to businesses and firms, giving specific consideration to the status of contracts covering financial services and products in the Article 50 negotiations.

The Impact of Brexit and Financial Services

Overview

1. The contribution of the financial services industry to the UK economy is well-known, constituting 7% of GDP and directly employing 1.1 million people, two-thirds of them outside the leading global financial centre of London[1]. The consequential benefits to professional and other service sectors and the significant contribution to fiscal revenue are equally well-documented. Suffice to say that the UK's pre-eminence as a global financial and related professional services centre benefits not just the UK, but also the EU and the rest of the world. London is a magnet for capital globally and the principal centre for corporate finance raising for manufacturing and other industries across Europe and beyond. From a legislative, regulatory and supervisory point of view, the UK's experience and expertise has shaped and influenced both international standard-setting measures and the development of EU legislation in this field. An essential aim of HM Government should be to maintain the UK's role, pre-eminence and influence. This is clearly in the interests of the UK but it would also benefit the EU and the rest of the world.

The Current Position

2. The financial services "passport" is a key benefit of the UK's membership of the EU. It is available, in respect of certain specified financial services activities and/or products, to all financial institutions authorised and regulated in one of the 31 European Economic Area ("EEA") Member States. A passport, once obtained, may permit such a firm to:

a) provide certain cross-border services from its home Member State into any of the other 30 EEA States;

b) provide certain products cross-border from its home Member State into any of the other 30 EEA States; or

c) set up a branch to provide certain services in any of the other 30 EEA States.

3. The passport is undeniably beneficial: it avoids the costs and requirements of setting up a subsidiary authorised and regulated in each Member State into which it is desired to do business. The Financial Conduct Authority provided figures to the House of Lords EU Committee[2] which reveal the large number of passports used both by UK firms to access other EEA markets and by other EEA firms to access the UK market. What cannot be as easily established, however, is the extent to which passports are actually *required*. It is good practice for a firm to apply for a passport if it intends to provide certain services and products cross-border within the EEA but it does not follow that there is a legal requirement for the passport.

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[1] For example: TheCityUK *Key facts about the UK as an international financial centre 2016* (March 2016); the House of Lords EU Committee *Brexit: financial services* (9th Report of Session 2016 – 17, HL Paper 81); and TheCityUK report commissioned from Oliver Wyman, *The Impact of the UK's Exit From the EU on the UK-based Financial Services Sector* (4 October 2016)

[2] See *Brexit: financial services* ibid. at para 17

A significant number of services and products, especially in wholesale markets, can be provided cross-border without triggering the need for authorisation and regulation and hence the need for a passport, although the exact detail of what can be offered differs between Member States. Operational models involving, for example, outsourcing and delegation can also facilitate the cross-border supply of services and products. Further, given the failure to complete the single market in retail financial services, it is not clear the extent to which the passport is utilised in retail, as opposed to wholesale, business.

The position if nothing is done

4. There are other mechanisms that allow firms from countries outside the EEA to provide services/activities and products across the EEA. These mechanisms are the equivalence regime and the emergent third country passport. We agree with the House of Lords EU Committee that these existing mechanisms do not suffice to fill the gaps created by the loss of passporting. This is because:

a) The third country passport is a new concept which has not yet been activated and currently has extremely limited availability.

b) Utilisation of a third country passport may, based on existing precedents such as AIFMD[3], involve the firm in question complying with the relevant EU law requirements, potentially on a global basis.

c) The equivalence regime is patchy and does not have the same coverage as the passport regime[4]. For example, retail financial services is not covered.

d) The recognition of equivalence of legislation in a particular area is uncertain, time-consuming and potentially influenced by politics, so there can be no guarantee if and when equivalence would be granted.

e) Whilst the UK's current legislative regime is equivalent to that of the EU, there can be no guarantee that this will remain the case in the future.

5. The WTO rules on financial services are notoriously under-developed and untested. Whilst the recognition of four modes of supply under the General Agreement on Trade in Services ("GATS") provides a basis for arrangements in some parts of the sector, the regime is still subject to a 'prudential' carve-out permitting States to impose restrictions on cross-border supply.

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[3] Alternative Investment Fund Managers Directive.

[4] According to the European Commission, equivalence means that "in certain cases the EU may recognise that a foreign legal, regulatory and/or supervisory regime is equivalent to the corresponding EU framework". It allows the EU authorities to rely on the compliance of foreign entities with the equivalent foreign framework, stating that "equivalence decisions may apply to the entire (regulatory) framework of a third country or to some of its authorities only". Equivalence decisions are taken unilaterally by the Commission, but can be revoked at any time. See: http://ec.europa.eu/finance/generalpolicy/global/equivalence/index_en.htm

Recommendations

6. In the absence of EEA membership[5], even on a transitional basis, we recommend that a bespoke arrangement is necessary to safeguard the interests of both the UK and the EU. A bespoke arrangement could involve a patchwork of alternatives to the existing passporting regime. It could, for example, build on and develop the existing equivalence and/or third country passport regimes. In order to conduct effectively the negotiations, it is essential that an empirical analysis of the existing passporting regime should be undertaken so that the services/activities that can *only* be carried on and the products that can *only* be provided cross-border under the aegis of a passport can be identified. This analysis should identify those services/activities that can be carried on, and products that can be provided, in specific Member States without triggering the need for authorisation and regulation (and hence a need for the passport), including through delegation and outsourcing structures. It should also identify those services/activities that could be carried on, and products that could be provided, should the UK be granted full equivalence in all possible areas and if it obtained the available third country passports. The different criteria for equivalence and third country passports should also be set out so as to ascertain the likelihood and attractiveness of these options. This analysis will inevitably identify gaps caused by the loss of the passporting regime that cannot, using existing mechanisms, be filled. It is these gaps that a bespoke arrangement should seek to fill.

7. As noted in the Bar Council's paper on *Jurisdiction and enforcement of judgments*, commercial parties require continuity and legal certainty, particularly in relation to contracts extant at the time of Brexit. Parties to financial services contracts would face the same uncertainty detailed in the aforementioned Bar Council paper but could also face additional uncertainties due to EU prudential requirements, for example, where a contract concerns U.K. holdings which may not attract the same capital treatment post-Brexit. It is recommended, therefore, that specific consideration is given to the status of contracts covering financial services and products in the Article 50 negotiations.

8. The desire to reach an agreement on the UK's future partnership with the EU by the conclusion of the Article 50 negotiations is recognised. If this were achieved, then the phased implementation to which the Prime Minister referred in her speech of 17 January 2017 would be possible. It is also possible, however, that it will take longer to negotiate a wholly bespoke relationship and, in such circumstances, we would recommend a transitional period replicating the status quo as much as possible and covering the gap between WTO terms and the establishment of a new arrangement. Given the need for legal certainty, phased implementation of a new relationship or, failing the conclusion of negotiations on the new relationship, a transitional period should be a key aspect of HM Government's approach. Inevitably many, particularly larger, firms cannot wait until the conclusion of the Article 50 negotiations and are in the process of developing their contingency plans on the basis that the UK does not remain a member of the single market and will no longer benefit from the existing passporting regime. This includes but is not limited to the shifting of functions and therefore jobs to other EEA financial centres. In many instances, this will require the restructuring of

[5] EEA membership comes closest to continuing the status quo and would enable the UK to retain the passport regime but appears to have been ruled out by the Prime Minister in her speech of 17 January 2017.Were it useful to consider EEA membership, an annex to this paper could be provided.

operational models to ensure firms retain a presence in the EEA. An early announcement of HM Government's position on financial services should be made to reassure financial institutions and their customers.

Brexit Working Group
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