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Brexit and Financial Services

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MYTHS AND REALITIES

MYTH 1

There is a single market in financial services, and the only way to have access to it is to be a member of the European Economic Area.

Reality

Although significant progress has been made towards the goal of a single market in financial services in the past ten years (through the development of the EU Financial Services Action Plan), in fact there remain considerable practical and legal barriers to most forms of cross-border financial services activity. For example, member states may apply stricter requirements to UCITS (Undertakings for collective Investment in Transferable Securities) established in a given member state provided these requirements apply to all UCITS funds in that member state.

Access to the single European market is therefore a relatively meaningless term with respect to financial services. What the UK financial services sector needs is full access to the key markets and infrastructure in Europe, and to be able to conduct their work in a manner that enables them to provide the full range of their services. In this respect any UK discussion with the EU (bilaterally, on the basis of mutual recognition and equivalence) could lead to progress on a single financial market, at least as it pertains to the UK, above and beyond what is currently in play.

MYTH 2

The passport is the only way that financial services can be provided to UK institutions to access European markets.

Reality

Financial services providers need market access and market contestability in European markets. The passport is a regulatory regime that allows these services to be exported between member states (the “Services Passport”), and allows branches to be set up in other member states (the “Branch Passport”). However, there are other ways for UK services to be allowed into European markets (see also myth 3 below). Under a Financial Services Trade Agreement, UK institutions can provide services into the EU. In order for this to be accomplished, the UK would have to negotiate a free trade agreement with a services chapter that covered these areas. Services agreements generally cover four modes of the provision of services. Mode 1 is consumption abroad. Mode 2 is cross-border supply of services. Mode 3 is commercial presence (i.e. the branch or subsidiary office). Mode 4 is movement of natural persons (i.e. the movement of people between different parts of the same firm located in different countries). In order to deliver services access, the UK would have to negotiate comprehensive disciplines in these modes of supply. The EU is also motivated to negotiate similar schedules for access given that its financial services industry will want access to the UK market.

One problem with the passporting regime is that it could be withdrawn or modified by the EU (in the normal legislative process), with no trade sanction available to a country that loses benefits under it. The benefit of a trade agreement based regime is that it provides that the EU cannot regulate in a specific manner which is distortive to trade or discriminates against the UK. If it does so, the advantage of a trade regime is that there is a trade sanction that can be imposed, and the fact that this is possible certainly disciplines the behaviour of the parties to the agreement.

MYTH 3

Without EEA (European Economic Area) membership, financial services jobs would leave London.

Reality

In many, but not all, cases a third country passport will be available to UK institutions, irrespective of a wider trade agreement. Revisions to the EU's Markets in Financial Instruments Directive and Regulation ("MiFID II"), which take effect from January 2018, may provide a mechanism for many UK firms to continue providing services into the EU on a cross-border basis much as before, even without the UK continuing to be a member of the single market.

On leaving the EU, the UK will become what is known as a "third country" under MiFID, with financial institutions domiciled in the UK becoming "third country firms". Under MiFID II, third country firms that are registered with the European Securities and Markets Authority (ESMA) will be able to provide investment services to non-retail clients on a cross-border basis throughout the EU, provided that the EU Commission has determined that the legal and supervisory arrangements of that third country have "equivalent effect" to the requirements set out in MiFID II. At the point of the UK's departure from the EU (assuming that it is after January 2018), the law in the UK will not just be equivalent to that in the EU, it will, in fact, be exactly the same. MiFID II is the framework legislation for key aspects of the UK Financial Services industry—in particular, it regulates the activities of operating markets (the LSE and others), dealing in investments (stock-broking) and providing investment management services.

A similar third-country equivalence regime is provided for:

» Under the European Market Infrastructure Regulation ("EMIR") in respect of central counterparties and trade repositories and equivalence recognition has been issues in respect of a number of countries including Switzerland, the USA, Japan and Hong Kong;

» In the Capital Requirements Regulation ("CRR"), which includes a number of provisions enabling the recognition of equivalence with the EU prudential supervision and regulatory requirements enabling the preferential treatment of certain exposures in respect of capital requirements;

» In the Alternative Investment Fund Managers Directive ("AIFMD") which regulates the private equity and hedge fund industries, under which a recognition process is ongoing in respect of 12 countries, including the USA, and where ESMA has advised that there are "no significant obstacles" to recognition of Canada, Guernsey, Japan, Jersey and Switzerland;

» Under Solvency II, in respect of insurance and reinsurance, under which equivalence decisions have been adopted in respect of the USA, Switzerland, Bermuda, Mexico, Brazil, Japan and Canada;

» Under the CRA Regulation, in respect of credit ratings agencies used by EU financial institutions.

There are gaps in respect of key financial services. At present there is no third country passport or equivalence regime in respect of:

» Deposit taking and the business of credit institutions under the Capital Requirements Directive ("CRD");

» Retail investment funds in the Undertakings in Collective Investments in Transferrable Securities Directive ("UCITS");

» Selling insurance under the Insurance Mediation Directive;

- Payments services and electronic money under the Payment Services Directive and the Electronic Money Directives (although it is possible for non-EU countries to participate in the Single Euro Payments Area);
- Non-bank mortgage lending under the Mortgage Credit Directive.

The two lists illustrate that while there are gaps in the coverage of equivalence regimes, MiFID II, EMIR and Solvency II and others provide a roadmap as to how this may be achieved. There are also practical work-arounds that firms operating in areas that do not benefit from third country equivalence recognition could adopt, for example MiFID II enables the provision of retail investment services by the establishment of a branch in a member state.

Where there is no clear pathway to a third country passport, the issue would have to be covered in a trade agreement services negotiation. However, the fact that a third country passport is already available in many areas makes it more likely that a satisfactory result will be reached in a trade negotiation with the EU.

MYTH 4

5,500 UK businesses rely on passporting.

Reality

FCA (Financial Conduct Authority) figures show that 5,476 UK firms use passporting, however, it is common for firms to register a passport at the point of application for licences for its business, even if it has no intention to use the passport and provide services in other member states, as there is no cost and no requirement to substantively use the passport. So the fact that 5,476 firms have one or more passports does not mean that they all need or use their passports. A more granular analysis of the actual business needs of the firms who holds passports is required.

MYTH 5

The EU would retaliate and deny either services access or passporting in a negotiation with the UK.

Reality

There are currently more EU passport holders permitted to use their passports to access the UK market, than UK passport holders with access to the EU market. There is at least as much interest among EU institutions to have access to the City of London as there is interest among UK entities to have access to the EU. It is therefore very likely that commercial interests will drive a resolution of this issue.

MYTH 6

If the UK leaves, we will not be able to retain enough workers in the City of London because of the change in immigration rules.

Reality

It is likely that citizens of EU member states outside of the UK currently working in the UK will retain rights to live and work here. It is important to note, however that for non-EU citizens, the UK's immigration policy is quite restrictive. It would be possible for the UK to have a more open immigration policy in respect of countries like the US, Australia, New Zealand and Canada, after it leaves the EU and is not bound by the free movement principles of the European Treaty.