Equivalence or else?

ASSESSING THE IMPACT OF BREXIT ON FINANCIAL SERVICES

More than half of the world's largest financial services firms have European headquarters in the UK, and London in turn gives Europe global reach and influence in this sector of the economy. So the uncertainty created by Brexit is particularly acute in financial services, and is affecting institutions throughout the EU. But as formal negotiations over the terms of Britain's exit get underway, financial services businesses can begin to build the case for outcomes that will bolster their contribution to the economy, in the UK and across the European continent.

The importance of financial services to the UK, in terms of national income, tax revenue and the current account of the balance of payments, must make them a key area of focus for the team of ministers who will lead Britain's negotiations once Article 50 is triggered. And the UK will have no time to lose. For all the importance of tactics during the talks, other European Governments have varying degrees of patience, and uncertainty depresses confidence in London. Meanwhile other financial centres in Europe are assessing their competitive position, and seeking to exploit the opportunity to strengthen their standing.

> London provides a crucial economic support service to the businesses and companies of many European countries.
>
> *Philip Hammond, UK Chancellor of the Exchequer*
>
> *14 July 2016*

Financial institutions EU-wide have felt some of the shock waves from the Brexit vote. The precise effect on individual firms will, of course, depend on the nature of their customers, their type of service and international relationships. But all will need to work through the economics of possible outcomes, to help them:

- **Adapt to the change in commercial opportunities.** Current strategies may no longer fit with the potential post-Brexit world. Firms will need to search out the opportunities presented by different forms of Brexit, as well as build resilience against the risks they present.
- **Influence UK and EU policy-makers.** Some Brexit outcomes will obviously suit businesses better than others, but there are trade-offs in each. Firms need to identify their preferred outcomes, and build coalitions of mutual interest to influence negotiations between the UK and the EU.

Picking through the puzzles

The overarching uncertainty is around the nature of the settlement that the UK and EU will seek to arrive at, as set out in Frontier's first bulletin on Brexit. The new British Prime Minister's repeated assurance that "Brexit means Brexit" still leaves a number of possible options open. At one extreme would be a "soft" Brexit (or the EEA/Norway model) which would replicate much of the present arrangements, though without a place for the UK at the EU institutional tables. Such a model, however, looks increasingly unlikely, given that it would require the UK to contribute to the EU budget and accept free movement of people – both of which look politically unattractive to the Government following a "Leave" vote.

At the other extreme is "hard" Brexit (falling back on rules set by the Word Trade Organisation). This would allow the UK to write its own financial regulation but significantly reduce its access to EU financial services markets. Financial service firms need to decide where on this broad spectrum between these two extremes their best interests lie, and calibrate this view with an understanding of the politically possible.

As with all policy debates, the devil will be in the detail. So here we explore the main issues for financial services firms.

Access to markets

One of London's key strengths today is its single market access to customers and investors throughout the EU. Current arrangements give UK financial institutions a "passport" to all EU markets, for example under the Markets in Financial Instruments Directive (MiFID) and Capital Requirements Directive (CRD). MiFID II is in the process of implementation, which adds extra confusion with respect to Brexit timing. The UK is also, currently, the landing-place for many non-EEA institutions that want to access EU markets. Passporting also allows EU institutions easy access to global markets through London.

The extent of access to the EU post-Brexit will depend on the outcome of negotiations.

- In a "soft" Brexit scenario, the UK would, as a member of the EEA, still have access much as it does today.
- After a "harder" Brexit, the UK would become a "third country" (like the US). But it could still be allowed access to clients in the EU if its regulatory regime is recognised as "equivalent" to the EU regime.

In theory, the UK should easily meet this equivalence requirement, and it should be in all parties' interests to give this recognition. However, this will depend on whether other EU members would be prepared to give an exiting member such status, and if the application process is not completed by the time of Brexit, uncertainty would be magnified into disruption.

Without equivalence, firms currently based in the UK who want EU access would need to set up subsidiaries in an EU member state, and transfer EU business and staff to that location.

> "We have very clearly in our minds the need to ensure access to the EU single market for our financial services industry.
>
> *Philip Hammond, 14 July 2016*

There is also the question of the market for talent. London has a deep pool of financial services expertise (and supporting professionals in, for example, law, accountancy and IT) from across the EU. Restrictions on free movement, or fears of its consequences, could begin to drain that pool. Early settlement of the position of EU nationals working in the UK, and of arrangements for EU nationals in future, is essential to avoid a reduction in London's international capability.

The future of Europe

The biggest geopolitical question relating to Brexit is, of course, its impact on the EU, and in particular on the EU's commitment to creating and maintaining the "four freedoms" of movement in goods, people, services and capital. Anti-EU sentiment, and/or fears of immigration, have grown not just in the UK but in other member countries too. These are issues Brussels will have to address at the same time as negotiating with the UK. A positive outcome would be an evolution that made it easier for both sides to agree some kind of associate status for the UK, but it is much too early to tell whether Brexit will lead to instability and sub-optimal decisions, or to flexibility and adjustment.

So far as financial services are concerned, a key political question is whether Brexit causes one or other of Europe's financial centres to gain sufficient business relocations or core functionality (e.g., in clearing) to act as a magnet to talent and new business and begin to rival London. In the aftermath of the Brexit vote, phones were clearly hot in Dublin, Amsterdam and Frankfurt, while Paris was making a public case for a primary role. However, the very fact of competition between these cities may at least delay the moment at which it is clear there is a "winner", giving London – which is at present so very far ahead of any of them in any "league table" – time to steady nerves and try to mitigate the effect of Brexit on its role in the forthcoming negotiations.

One other financial centre affected, of course, is Edinburgh. Since Scotland voted strongly to "Remain", many Scottish voters favour the notion that they could stay in the EU by leaving the UK. Early post-Brexit polls suggested a strong lead for Scottish independence, seeming to fulfil fears that a "Leave" vote elsewhere in the UK risked its break-up. The Scottish First Minister, Nicola Sturgeon, has said that "…a second [Scottish Independence] referendum must be on the table…".[1] However, there will be strong opposition in the UK and EU. The leader of the Conservative Party in Scotland, Ruth Davidson, has said pushing for a referendum is "like saying the only response to shooting yourself in the foot is to then amputate your leg".[2]

Regulatory and legal clarity

The UK Government and its regulatory agencies face a huge task in replacing EU laws with national alternatives – or even duplicates. Some Directives (for example, the framework for the Takeover Code) are already clearly embedded in UK legislation (in this case, the 2006 Companies Act) that will obviously remain in force until anyone chooses to change it, which looks unlikely.

The easiest short-term option to remove any legal doubts about other EU legislation, it has been argued, might be to import current rules wholesale for the time being, passing general legislation deeming them to continue to apply in the UK unless or until Parliament enacts something different. But such an approach would be fraught with difficulty.

Without clarity on this issue there will be much uncertainty not only as to compliance requirements but also as to the status of many contractual arrangements, and the assessment of legal implications is a key element in risk mitigation for all firms in the sector. However, putting such a sweeping law through Parliament – without amendment – would not be an easy task, particularly when the Government's majority is small and its Brexiteers are on the look-out for any signs of backsliding.

The question comes into sharpest focus with respect to EU Directives in financial services in the process of implementation, notably MiFID II and the 'PSD2' directive on open banking (see box). The UK has worked hard to achieve satisfactory outcomes to the development of much of the upcoming financial regulation in the EU, and British financial institutions have already made substantial investments in IT and compliance systems in anticipation of its implementation.

Moreover, common standards, legal platforms and regulatory frameworks are of considerable advantage to firms operating across Europe. So there are great advantages in continuing to implement; but at the same, firms (and even regulators) may not want to pass up the opportunity to smooth rough regulatory edges. There is a clear need for the Government to give guidance as soon as possible.

Opening the bank

The revised Directive on Payment Services (PSD2) has promised significant changes to how customers bank and make payments. Customers will, for example, be able to ask their banks to share their data with third parties, such as price comparison websites or retailers, in order to make payments. This is expected to give a boost to innovation and reduce barriers to entry for new "fintech" firms. It also provides the legal framework for the Single European Payments Area (SEPA).

The directive was adopted by the European Parliament and Council late in 2015, giving members until January 2018 to implement it. While strictly speaking the UK remains legally obliged to apply EU law so long as it is a member of the EU, it is not entirely clear what would happen to legislation coming into effect after Article 50 has been triggered.

[1] BBC News, "*Brexit: Nicola Sturgeon says second Scottish independence vote 'highly likely'*", 24 June 2016.

[2] The Press and Journal, "*Scotland must be "integral" to all UK Government does, says Davidson*", 13 July 2016.

Survival of the most adaptable

Now is not the time for crystal balls. As the referendum result itself showed, they can be spectacularly misleading – betting exchanges were giving a “Remain” vote 95% probability when polls closed. Firms need to be placing multiple bets, so that they can adapt quickly to developments. The strategic work that firms need to carry out now can be grouped under four headings:

- **Scenario analysis.** For each risk, firms should consider what the impact would be of different outcomes on the economics of different aspects of their businesses.
- **Competitor assessment.** Firms should also map the effects on their key competitors, in order to identify their own relative strengths and weaknesses.
- **Contingency planning.** Firms should identify the key choices to be made as events unfold, in order to preserve value or open up new opportunities.
- **Spread bets.** Firms should decide what actions they can take now to minimise risk. There is no status quo and all options should be on the table.

How businesses adapt to each Brexit uncertainty will depend on the type of institution and its exposure – see the box below for some examples.

Three responses to Brexit uncertainties

- A **UK retail bank** has been trying to win customers with a current account product that pays a high interest rate. It has done so in the expectation that interest rates would rise, which would provide it with the revenue over the lifetime of the customer to cover its costs. In a scenario of an extended low interest rate environment, this product would be loss-making. The bank may want to develop an alternative product in response to the change in the macroeconomic policy environment.
- A **fintech start-up** in London is developing a payment product in anticipation of PSD2 (see box above) and is authorised in the UK. There is a risk that it will find its access to European markets restricted, while in the UK it faces different regulatory requirements down the line. The company may want to consider obtaining a licence to operate in another member state to minimise potential disruption. This may mean setting up a new base in the EU, which will help it to develop local expertise and marketing, and allow it to refocus its UK business on non-EU markets.
- An **EU insurer** uses its passporting rights to offer products to UK customers through a third party distributor. Depending on the size of its UK business, it may want to establish a joint venture with the third party in the UK to obtain the relevant regulatory authorisation and maintain its distribution channel. It should also review its competitive strengths in its EU markets relative to UK-based firms.

Cards on the table

The Brexit settlement will be the result of a complex multi-party, multi-issue negotiation, highly-charged politically, between the UK and an EU itself subject to change. This greatly complicates the task of seeking to gain the ear of policy-makers. But the key elements of the influencing task remain the same as for any policy debate. As an affected business, you need to:

- **Know what you want.** Don’t list problems: identify solutions. Calibrate your understanding of what you want with what you think is achievable. Don’t stick to generalisations (e.g., EEA versus an equivalence regime); fill in the details (what matters most to us within the particulars of each piece of regulation, and how this could be achieved). Build an evidence base for the advantages of your preferred outcome, in terms of the policy-makers’ own objectives.
- **Identify trade-offs.** You need to understand the value EU and UK policy-makers may attach to different elements of a complex set of issues, outside as well as within your sector (e.g., do they “value” manufacturing more than financial services), and therefore where they may think worthwhile trade-offs can be made. And you need to help them understand why your preferred trade-off is the right one (e.g., because it may provide more jobs/tax revenue).

- **Develop coalitions.** There are UK and EU financial service providers that will have different positions on different issues, and there will be differences of view amongst policy-makers too. Drawing the map of stakeholders and understanding their relative influence will help you to align different parties and present a coherent view.
- **Make credible commitments.** Providing evidence to policy-makers of the likely effect of their decisions may involve statements about your own future behaviour (e.g., whether you will continue to maintain headquarters or a substantial presence in their jurisdiction). Promises or threats both have to be highly credible.
- **Know everyone's reservation price.** If your desired outcome cannot be achieved, what will happen and how can that situation then be improved? What opportunities can you encourage policy-makers to pursue outside of a European settlement?

Conclusion

Progress in resolving the uncertainty following Brexit is unlikely to be rapid, and there will be plenty of false dawns and dark nights along the way. Economic logic will not always triumph, in a complex negotiation highly-charged with political energy. But if the negotiating teams don't fully understand the underlying economics, they will have even less chance of achieving the best possible outcome. And for all the determination of the British Prime Minister to take her time before pulling the Article 50 trigger, the scope to influence the terms of Britain's exit may narrow quickly once formal negotiations get underway. Now, therefore, is the time for firms with a stake in the debate to do all they can to shape it, before it is too late.

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