LEAVE ALLIANCE

Brexit Monograph 14

Financial Services and Brexit

4 October 2016
(corrected2)

Introduction
Financial services are an important part of the UK economy. They contribute nearly five percent of UK growth and earn £25 billion annually through international trade. Over a third of the UK's surplus in financial services comes from trade with EU countries. The industry contributes £31 billion in multiple forms of taxation, with more than a third of this dependent on EU access.

A high proportion of financial market activity in the EU is located in the UK. London and the UK have a leading share of trading in interest-rate OTC derivatives (74 percent of EU total), foreign exchange turnover (74 percent), management of hedge fund assets (85 percent) and private equity funds (42 percent). The EU is the biggest single market for UK exports of financial services, generating a trade surplus of £16.6 billion – 37 percent of the UK's total trade surplus in financial services in 2012. The UK's financial services trade surplus with the EU has more than doubled over the past decade.[1,2]

The UK banking sector is much more open to foreign presence than its EU counterparts. Foreign banks (via branches or subsidiaries) represent 37 percent of total bank assets in the UK, and about 14 percent in the euro area. The UK is a major host for EU bank sub-entities – often hosting wholesale operations - with approximately €1 trillion of assets.

Around ten percent of all branches or subsidiaries of euro area banks operating outside the area are in the UK. Conversely, about 15 percent of all branches and subsidiaries of non-euro area banks in the banking union are branches or subsidiaries of UK banks. Based on data at the end of 2014, these account for at least €750 billion of total assets. Five subsidiaries are supervised by the ECB.[3]

[1] http://www.thetimes.co.uk/article/hard-brexit-could-cost-10bn-in-lost-taxes-hl2mkf5s0
[2] https://www.bba.org.uk/about-us/bba-europe/
[3] https://www.bankingsupervision.europa.eu/press/speeches/date/2016/html/se160309.en.html

Because of the trading relationship with EU Member States, and the degree of regulatory integration, it is likely that Brexit will have a significant effect on the industry as a whole. In this Monograph, therefore, we take a first look at the sector and its regulatory base, and make a first assessment as to how it will be affected by Brexit. Because of the complexity of the subject, we will be returning to this several times.

The legislative base

The regulatory process applying to the financial sector is rarely visible to the popular media and almost entirely unknown to the general public. Only very occasionally does a hint of the real power emerge, as in January 2014 when the Basel Committee ruled on leverage ratios for banking loans, the issue at the heart of the 2008 banking crisis.[4] The picture, however, is extremely mixed.

The general terms, the regulatory package is not primarily of EU origin. Intellectually, it stems from a commitment made by the G20 nations in the Washington summit of November 2008, in the wake of the global financial crisis. Then they pledged "to enhance our cooperation and work together to restore global growth and achieve needed reforms in the world's financial systems".[5] This was followed by the London declaration of April 2009 when they agreed to "take action to build a stronger, more globally consistent, supervisory and regulatory framework for the future financial sector, which will support sustainable global growth and serve the needs of business and citizens".[6]

As to the regulatory situation, it is likely the UK would have implemented the vast bulk of its current regulation had it acted unilaterally, not least because it was closely engaged in the development of the international standards from which much EU legislation derives.[7]

Europe-wide, the regulatory package is underwritten by the "four freedoms" of the Single Market, and in particular the free movement of capital. In or out of the EU, though, free movement of capital is assured by the OECD's Code of Liberalisation of Capital Movements.[8] The detailed regulatory code combines many elements, including those which form part of what the EU calls the Banking Union, applicable primarily to the euro area.[9] At its core, the package embraces the Capital Requirements Directive (2013/36/EU), which applies to deposit taking and lending by "credit institutions" and the Markets in Financial

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[4] *Sunday Telegraph*, 18 January 2014, The 'too big to fail' problem just got worse, http://www.telegraph.co.uk/finance/comment/liamhalligan/10581764/The-too-big-to-fail-problem-just-got-worse.html, accessed 18 January 2014.

[5] https://g20.org/wp-content/uploads/2014/12/Washington_Declaration_0.pdf, accessed 26 April 2015.

[6] https://www.imf.org/external/np/sec/pr/2009/pdf/g20_040209.pdf, accessed 26 April 2015.

[7] House of Lords European Union Committee, 5th Report of Session 2014–15

[8] http://www.oecd.org/daf/inv/investment-policy/CapitalMovements_WebEnglish.pdf

[9] http://ec.europa.eu/information_society/newsroom/cf/fisma/item-detail.cfm?item_id=20758&newsletter_id=166&lang=en

Instruments Directive (MiFID) (2004/39/EC). This covers investment services and activities such as trading in securities and derivatives, executing client orders, investment advice and portfolio management.

Other instruments include: the Payment Services Directive (2007/64/EC, amended by 2015/2366); the Second Electronic Money Directive (2009/110/EC), covering e-money; the Alternative Investment Fund Managers Directive (2011/61/EU) (AIFMD), which applies to the management and marketing of alternative investment funds (AIFs); the UCITS IV Directive (2009/65/EC), covering the establishment and operation of retail (UCITS) funds regulated at EU level; the Mortgage Credit Directive (2014/17/EU), which covers mortgage lending; the Solvency II Directive (2009/138/EC), which regulates the insurance and reinsurance market; and the Insurance Mediation Directive (2002/92/EC), which covers insurance mediation.

Elements have been "downloaded" from the US Dodd-Frank Act and the Basel III accord, and many other external sources.[10] Of the more complex instruments, only the Alternative Investment Fund Managers Directive (AIFMD) is largely of EU origin.[11] That is seen as a building block of "Fortress Europe" – a more protective European market sheltered from competition. A recent survey had 68 percent of respondents believing that AIFMD will lead to fewer non-EU managers operating in the EU. Some 72 percent viewed the Directive as a business threat.[12]

The Global Legal Entity Identifier (LEI)

Since the 2008 financial crisis, the "spine" of the regulatory and enforcement system is the so-called Legal Entity Identifier (LEI) system. This requires every trader to have a unique identity code, each fed into a global database which enables regulators, private sector firms, and industry associations instantly to identify anyone engaged in specified financial activities.

Its origin is a sub-system based on the ISO 17442 standard. The code comprises a twenty-digit alphanumeric code and associated set of six reference data items uniquely to identify a legally distinct entity that engages in financial market activities.[13] Despite the simplicity of the concept, the ramifications make it

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[10] Regulatory Reform and Collateral Management: The Impact on Major Participants in the OTC Derivatives Markets, J P Morgan, Winter 2012. https://www.jpmorgan.com/cm/BlobServer/Regulatory_Reform_and_Collateral_Managmentpdf.pdf?blobkey=id&blobwhere=1320534213352&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs, accessed 9 December 2013.

[11] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:01:EN:PDF, accessed 9 December 2013.

[12] http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-aifmd-survey-responding-new-reality.pdf, accessed 9 December 2013.

[13] https://www.treasury.gov/initiatives/wsr/ofr/Documents/LEI_FAQs_August2012_FINAL.pdf, accessed 22 March 2016

extremely complex to achieve in practice.[14] Private industry made several attempts over the past 20 years to establish a system and failed. Now it is going ahead under the aegis of G20 and the Financial Stability Board (FSB) – two of the primary players in financial regulation.

At their direction, there was established in January 2013 a Regulatory Oversight Committee (ROC), called the LEIROC. This is a group of over 70 public authorities from more than 40 countries. It will coordinate and oversee the worldwide LEI framework.[15]

This led in 2014 to the setting up of the Global Legal Entity Identifier Foundation (GLEIF) to act as the operational arm of the system. It operates out of offices in Basel, Switzerland, home of the Bank for International Settlements. GLEIF also accredits and monitors the Local Operating Units (LOUs). These are the partner organisations which actually issue the LEIs to legal entities engaging in financial transactions.[16] In the UK, one of the prominent LOUs is the Stock Exchange. It contributed to the development of the ISO, and is the UK's National Numbering Agency for the provision and maintenance of financial reference data.[17]

When it comes to the UK withdrawing from the EU, the crucial thing is that the EU is a downstream organisation in this part of the system. It was not even on the ground floor. US interests as early as 2009 were pushing for the system but the idea was not endorsed by EU Internal Market Commissioner Michel Barnier until February 2011.[18] "We must also work together in a common identification of market players", he then said: "This is an area where the US is already committed, but that requires global standards".

This makes the point that the EU is not the originator of much of the regulatory framework. Most often, it is the law taker rather then the law maker. In this respect, the UK, outside the EU would continue to shape and then adopt international regulation.

Accounting standards
Common accounting standards are an important element in the Single Market and indeed, an important part of the internationalisation of financial services. At EU level, such standards are used to underwrite core EU legislation such as Council Directives 78/660/EEC, 83/349/EEC on consolidated accounts, Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and Directive 91/674/EEC on the annual

[14] https://www.gleif.org/en/newsroom/blog/taking-the-next-step-legal-entity-identifier-regulatory-oversight-committee-proposes-process-for-collecting-data-on-direct-and-ultimate-parents-of-legal-entities, accessed 22 March 2-16
[15] http://www.leiroc.org/, accessed 22 March 2016.
[16] https://www.gleif.org/, accessed 22 March 2016
[17] href="http://www.lseg.com/LEI, accessed 22March 2016
[18] http://www.sifma.org/uploadedfiles/issues/technology_and_operations/legal_entity_identifier/lei-global-calls.pdf?n=65408, accessed 22 March 2016

accounts and consolidated accounts of insurance undertakings – as amended by Directive 2013/34/EU.[19]

An independent UK, however, would not be disadvantaged by the proliferation of these standards as they are not generated by EU institutions. Rather, via Regulation (EC) No 1606/2002 (the "IAS Regulation"), the International Financial Reporting Standards (IFRS) is used.

Crucially, IFRS are issued by the International Accounting Standards Board (IASB) and related interpretations by the International Financial Reporting Interpretations Committee (IFRIC), two bodies of the International Accounting Standards Committee Foundation (IASCF).[20]

The sponsoring organisation for the standards board is the IFRS Foundation, "an independent, not-for-profit private sector organisation working in the public interest". The governance and oversight of the activities undertaken by the IFRS Foundation and its standard-setting body rests with its Trustees, who are also responsible for safeguarding the independence of the IASB and ensuring the financing of the organisation.[21]

IFRS are used alongside the standards of the US Public Company Accounting Oversight Board (PCAOB), the two standards effectively providing the global base for company reporting. As of August 2008, more than 113 countries around the world, including all of Europe, currently require or permit IFRS reporting and 85 require IFRS reporting for all domestic, listed companies. Currently, profiles are completed for 122 jurisdictions, including all of the G20 jurisdictions plus 102 others.[22]

Interestingly, the growth economies such as China, Korea and Brazil are very supportive of the IASB work, seeing IFRS as "an opportunity to secure a seat at the top table of global financial reporting". For example, China provides the secretariat for the IASB's emerging economies group.[23] Thus, a globally-orientated UK would be better able to work with these actors, without having to work through the filter of EU institutions.

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[19] European Commission: EU Single Market, Directive on statutory audit, http://ec.europa.eu/internal_market/auditing/directives/index_en.htm, accessed 10 February 2014.

[20] Regulation (EC) No 1606/2002 of 19 July 2002 on the application of international accounting standards, http://www.esma.europa.eu/system/files/Reg_1606_02.pdf; European Commission: EU Single Market, International Standards on Auditing (ISAs), http://ec.europa.eu/internal_market/auditing/isa/index_en.htm, 10 February 2014.

[21] About the IFRS Foundation and the IASB, http://www.ifrs.org/The-organisation/Pages/IFRS-Foundation-and-the-IASB.aspx, accessed 10 February 2014.

[22] IFRS around the world, http://www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx, accessed 10 February 2014.

[23] Hans Hoogervorst, LSE, November 2012, http://www.ifrs.org/Alerts/Conference/Documents/HH-LSE-November-2012.pdf, accessed 11 February 2014.

Passporting
Notwithstanding the current raft of legislation, EU measures aimed at integrating the financial services sector have been in place since 1 January 1993, with the introduction of the Single Banking Licence. This was created by the Second Banking Coordination Directive (89/646/EEC), from which credit institutions authorised in any Member State became free to establish branches and to provide cross-frontier services throughout the Community on the basis of the fundamental principle of home country supervision.[24]

This is the concept as "passporting". From then on, no Member State was able to impose local "endowment capital" requirements on branches of credit institutions from other Member States or to apply an "economic needs" test on their establishment.

Provided they were authorised by their home Member State, credit institutions could offer a wide range of investment-related services as well as traditional banking and payment services. Through the Directive, therefore, the European Union was set to create the world's largest banking market free of regulatory barriers. In addition, the "freedoms" described were to extend to Efta states other than Switzerland as soon as the EEA Agreement entered into force.[25] By this means, the banking market was to extend to the entire EEA area.

Since 1993, the scope of the free market in financial services has been substantially extended, and the passporting system has also been considerably extended. In the event of an Article 50 settlement which does not embrace continued participation in the Single Market (such as with the UK remaining a contracting party to the EEA Agreement), these arrangements will largely cease to have effect in the UK, despite claims to the contrary.[26]

The implications of a loss of passporting rights are undoubtedly significant. Data provided by the Financial Conduct Authority indicate that 5,476 UK-registered firms hold some 336,421 passports to trade elsewhere in EEA. Just over 8,000 companies authorised elsewhere in the EEA use 23,532 passports to trade in the UK.[27,28]

If access to EU markets for UK financial service businesses is limited as a result of losing passporting rights, it can affect the sector in two possible ways. Firstly, there will be a direct loss of business as UK firms are no longer able to trade directly. Secondly, and perhaps as significantly, London as a location for foreign (non-EU) financial business European headquarters will become less attractive, as those operations will no longer be able to trade directly in EU (or EEA) Member States.

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[24] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31989L0646&from=en
[25] http://europa.eu/rapid/press-release_IP-92-1058_en.htm?locale=en
[26] http://www.telegraph.co.uk/business/2016/07/22/uk-financial-firms-to-keep-eu-passporting-says-boris-johnson/
[27] https://www.theguardian.com/politics/2016/sep/20/passporting-rights-brexit-uk-firms-fca-eu
[28] http://www.bbc.co.uk/news/business-37416280

The extent of any direct financial losses, however, is difficult to quantify – and especially as there are mitigation strategies which can be adopted. For instance, foreign (non-EU) businesses providing investment services and activities under MiFID can apply for "third country" passporting rights. That would enable UK firms to trade in the non-retail market without having to establish offices in the territories of EU Member States.[29]

The equivalence provisions are a harmonising measure. Hitherto, access arrangements have been left to Member States. But although they simplify the current system, they are not straightforward. First, an equivalence decision must be taken by the Commission, in respect of a specific third country. Then, the European Securities and Markets Authority (ESMA) must establish cooperation arrangements with the competent authorities of that third-country. Only then can businesses from that third-country submit applications to ESMA. These businesses must first be authorised by their home country regulators to supply the services which are to be provided in the EU and must be subject to supervision and enforcement by that regulator.

Once registered with ESMA, they can only provide services to professional clients and "eligible counterparties" (essentially, banks, investment firms, insurers, asset managers and other institutional investors, including large corporations).[30]

As to establishing cooperation arrangements, the rules have yet to be defined and are still subject to detailed technical discussion.[31] What is apparent is that, while most regimes are operating to the same general rule book, there are inconsistencies and misalignments in the application of requirements, some of which may be sufficient to preclude automatic acceptance of UK arrangements.[32] It is thus far too early to assess whether the UK could, post-Brexit, immediately enjoy third country passporting rights.

Overall, the signs are not encouraging. When the US and the EU together in 2012 agreed on the Regulation of OTC (over-the-counter) Derivatives Markets, there was significant commonality of approach between the EU and the US but there were also some important differences.[33] Thus, it took until March of this year (2016) for the European Commission to adopt an equivalence decision in respect of the US, and to July before it was formalised.[34,35] Furthermore, continued recognition of equivalence requires regulatory convergence to be

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[29] http://europa.eu/rapid/press-release_MEMO-10-659_en.htm?locale=en
[30] http://europa.eu/rapid/press-release_MEMO-14-305_en.htm
[31] https://www.esma.europa.eu/sites/default/files/library/2016-1389_dp_trading_obligation_for_derivatives_mifir.pdf
[32] *Ibid*, see pp 37-39.
[33] https://corpgov.law.harvard.edu/2012/09/23/regulation-of-otc-derivatives-markets-eu-vs-us-initiatives/
[34] http://europa.eu/rapid/press-release_IP-16-807_en.htm
[35] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016D1073&from=EN

maintained. If there is any significant divergence, authorisation to trade can be withdrawn.[36]

As regards the Brexit negotiations, the European Commission may not consider the equivalence issue until the settlement is concluded, delaying assessment until the final regulatory structure in the UK is settled. This may mean a gap of several years before UK businesses are able to benefit from MiFID provisions.

Single Euro Payments Area (SEPA)
Alongside the introduction of the euro as the single currency of the euro area, the Union was been working towards an integrated transfer system known as the Single Euro Payments Area (SEPA), under the aegis of the Payment Services Directive (PSD). By providing standardised and harmonised regulation of payments – including card payments, direct debits and credit transfers – SEPA is designed to allow efficient transfers of payments across borders at reduced costs.

The core legislation is Directive (EU) 2015/2366 of 25 November 2015 on payment services in the internal market (PSD 2), repealing Directive 2007/64/EC (PSD1).[37] This followed a review of the original directive and consultation on the Commission Green Paper of 11 January 2012, entitled, "Towards an integrated European market for card, internet and mobile payments".

The review had shown significant areas of the payments market, in particular card, internet and mobile payments, remained fragmented along national borders. Many innovative payment products or services did not fall, entirely or in large part, within the scope of the original Directive and, for certain payment-related activities, the Directive had proved in some cases to be too ambiguous, too general or simply outdated, taking into account market developments.

The new Directive provides for a full harmonisation approach, but as many as 23 optional provisions left a certain margin of discretion to the Member States.[38] It entered into force on 12 January 2016 and Member States have until 13 January 2018 to transpose it into national laws.[39] For the UK, the question is whether it should pursue the full range of integration or hold back, awaiting the outcome of Brexit.

As for the SEPA, this is regarded as "the first important milestone" on the journey towards an integrated European market for card, internet and mobile payments.[40] The specific legal base is Regulation (EU) No 260/2012

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[36] See Article 43: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN
[37] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015L2366&from=EN
[38] http://ec.europa.eu/finance/payments/docs/framework/transposition/list-of-options_en.pdf
[39] https://www.visaeurope.com/about-us/policy-and-regulation/
[40] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52011DC0941&from=EN

establishing technical and business requirements for credit transfers and direct debits in euro (the SEPA Regulation). From the end of October 2016, existing national euro credit transfer and direct debit schemes will be replaced by SEPA Credit Transfer (SCT) and SEPA Direct Debit (SDD).[41]

This system permits consumers, businesses and governments to make cashless payments throughout the euro area from a single payment account anywhere in the euro area using a single set of payment instruments.[42]

Participation is a significant issue for the UK. The credit-card industry - dominated by Barclaycard - issues 73 percent of all cards across the EU. If the UK no longer accepts the Interchange Fees Regulation (IFR), UK-issued cards may be less acceptable in the EU27 since they may incur higher costs for retailers, unless measures are taken to ensure price parity.[43,44]

As regards SEPA, there are currently 35 members of the European Payment Council, including all EU and Efta states. Non-members include the microstates of Monaco, San Marino and Andorra, and the UK dependencies - the Isle of Man, the Channel Islands and Gibraltar – are also members.[45] In that there are non-EU/EEA members in the system, there would appear to be no bar to a post-Brexit UK remaining SEPA. It would, however, have to satisfy the European Commission of the equivalence of its regulatory framework.[46]

An industry view is, therefore, that it is unlikely that the UK will be forced to abandon SEPA when it leaves the EU. In any event, UK financial service providers, payment processors and other businesses recognise the need for payment standardisation between the neighbouring nations of Europe. And even outside of SEPA, there is scope for UK to continue using processes and technology that will maintain interoperability with other payment processors across Europe.[47]

However, much will depend on the Article 50 settlement agreed with the EU. If it decides on EEA participation, then the UK will continue alongside the EU in developing the integrated payment market. But, with Prime Minister Theresa May pledging her "Great Repeal Bill" and the repatriation of all EU law, the way may be open for sector-specific bilateral agreement.[48]

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[41] http://www.europeanpaymentscouncil.eu/index.cfm/about-sepa/sepa-vision-and-goals/
[42] https://www.ecb.europa.eu/press/pr/date/2006/html/pr060504_1.en.html
[43] https://www.ft.com/content/ceea2c78-81b5-11e6-bc52-0c7211ef3198
[44] Regulation (EU) 2015/751, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0751&from=EN
[45] http://www.europeanpaymentscouncil.eu/index.cfm/knowledge-bank/epc-documents/epc-list-of-sepa-scheme-countries/epc409-09-epc-list-of-sepa-scheme-countries-v2-4-april-2016/
[46] http://www.europeanpaymentscouncil.eu/index.cfm/about-epc/epc-members/
[47] https://www.landz.co.uk/blog/where-does-sepa-stand-post-brexit/
[48] Conservative Party Conference, 2 October 2016, http://press.conservatives.com/post/151239411635/prime-minister-britain-after-brexit-a-vision-of

Conclusions
This brief snapshot of the financial services sector gives only a general overview of the nature and implications of Brexit. There seems little dispute in the public arena that the main challenge is the potential loss of passporting rights, which will only be partially compensated for by the limited equivalence measures.

Apart from global instability in the financial system, and the structural deficiencies in the European single currency, the European sector also has to confront what might be the greater challenge of managing relative decline. Whilst in 2005 the UK, Germany, France, Spain and Italy accounted for 27 percent of global banking assets, PriceWaterhouseCoopers projects that in 2050 the share will have decreased to 12.5 percent. PWC also projects that Brazil, Russia, China and India will see the value of their global banking assets leap to 32.9 percent of the total in 2050 - from the 2005 figure of 7.9 percent.[49]

Thus, the introspective view brought about by Brexit may not adequately reflect the extent of the challenges facing the sector. Brexit, in fact, may be the lesser of the UK's concerns. It could even amount to a relief for the UK industry where, in rhetoric previously used, it is "shackled to a corpse" of the euro area. Release might bring short-term problems but there might be greater gains from decoupling, with the industry insulating itself from contagion, able to focus on global issues and the global market.

In the short-term, the issue of primary concern is uncertainty. But as to the particular technical issue, this can be resolved if the UK maintains it participation in the Single Market, most obviously as a contracting party of the EEA. Failing that, there may be room for sectoral agreements, based on the UK's willingness to repatriate the *acquis*.[50]

For the rest, the claimed loss of influence over the framing of the legislative system is overstated. So much of the regulation stems from international level, at which the UK is adequately represented, that it should suffer no such loss. If anything, without having to align with the EU's position, the UK's influence should be considerably enhanced at a global level.

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[49] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/332874/2902400_BoC_FreedomOfCapital_acc.pdf and http://www.pwc.com/gx/en/psrc/pdf/world_in_2050_jan2011.pdf

[50] Conservative Party Conference, *Op cit*.