‘The impact of Brexit on financial services: consequences for the UK and possible benefits for the Union’

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A. THE CONCEPTUAL FRAMEWORK

- The legal status of subsidiaries and branches of financial firms is different.
- The perimeter of financial firms and trading venues to be affected by the future EU-UK relationship in the field of financial services is wide.
- The UK government, the Bank of England (BoE) and other administrative financial authorities are fully embedded in the international institutional framework governing the financial system. This is important for the future EU-UK relationship in financial services, even if the UK were to become a ‘third-country’ under WTO rules.

The four modes of supplying services at international level

According to a widely used categorisation in trade negotiations, there are four modes of supplying services between countries:

•***Mode 1 ('cross-border supply')*** *refers to the supply of a service from the territory of one WTO Member to another;*

•***Mode 2 ('consumption abroad')*** *occurs when a service consumer of one WTO Member consumes a service while in the territory of another;*

•***Mode 3 ('commercial presence' or 'establishment')****, involves a service supplier of one WTO Member doing business in another WTO Member through commercial presence in the latter; and*

•***Mode 4 ('presence of natural persons')*** *occurs when a service supplier from one WTO Member sends individuals to another WTO Member to supply services to consumers in that territory.*

However, this ***terminology is not uniform****. In a number of EU Preferential Trade Agreements, the term 'cross-border supply' is used to cover both of Modes 1 and 2.*

The four modes of supplying services at international level (cont.)

*Importantly, the category of Mode 3 services trade covers forms of economic activity which are also commonly understood as **foreign investment**, leading to an **overlap between rules on trade in services and rule relating to the treatment of foreign investors'***.

Within the European Single Market – being more than an area with trade agreements – activities across Member States are based on the exercise of the four Treaty freedoms and covered by the relevant directives, regulations (the *aquis)*, etc. In the field of financial services **'commercial presence'** may take two forms:

•The first form is the establishment in the 'host' country of a **subsidiary** which is a **separate legal entity** owned or controlled by a parent company (established in the 'home' country). A subsidiary needs to get a license from the competent authorities of the host country in order to be able to operate, and is considered as a 'national' of that country.

•The second form is the opening of **branches**. Branches do **not have a legal personality**; they are defined as a *place* of business (other than the head office) which are a part of the financial firm and provide financial services for which the financial firm has been authorised.

Table 1
UK membership in international standard-setting bodies

Forum	Objective	UK membership
Financial Stability Board (FSB)	Overall coordination Resolution of financial firms	BoE, FCA and Treasury
Basel Committee on Banking Supervision (BCBS)	Banking regulation and supervision	PRA
International Organisation of Securities Commissions (IOSCO)	Capital markets' regulation and supervision	FCA
International Association of Insurance Supervisors (IAIS)	Insurance sector regulation and supervision	PRA and FCA
Joint Forum	Regulation and supervision of financial conglomerates	PRA and FCA
Committee on Payments and Market Infrastructures (CPMI)	Oversight of payments and market infrastructures	BoE
Financial Action Task Force on Money Laundering (FATF)	Combating money laundering and terrorist financing	Government
International Association of Deposit Insurers (IADI)	Operation of deposit guarantee systems	Financial Services Compensation Scheme
International Federation of Accountants (IFAC)	International auditing standards	Several Associations and Institutes

B. FUTURE EU-UK RELATIONSHIP CONCEPTS AND THEIR IMPACT ON FINANCIAL FIRMS

•The three potential concepts under examination lead in general to different conclusions with regard to the future EU-UK relationship in financial services:

•If the UK were to become a member of the European Economic Area (EEA), the current situation would not be significantly affected; under the other two options (WTO or bilateral trade agreements), the UK would be have a third-country status.

•If the UK were to have a third-country status, the ‘passporting rights’ of the of UK financial firms operating cross-border or via branches in the EU and of EU financial firms operating in the UK would cease to operate. In contrast, in such a case, the position of their subsidiaries would not be affected.

Application of the GATS

The position of UK financial firms in the EU: If the UK were not to become a member of the EEA or to conclude any bilateral agreement for its participation in specific areas of the EU single market, it will have no access to the latter. Given that the UK is already a member of the WTO, applicable in this case would be the provisions of the GATS. The UK would be subject to the general obligation of the MFN clause and would have to negotiate a new Schedule on specific commitments.

EU Directives which have already been transposed into UK law would continue to apply, unless this national legislation would be repealed or amended (a very unlikely development in the case of legal acts reflecting international financial standards). **EU Regulations** would cease to apply from the date of the UK's withdrawal from the EU. This is of particular importance to the extent that a significant part of EU financial law now consists of Regulations and the UK will have to legislate de novo on the subject-areas. New EU directives, regulations, delegated and implementing acts, etc., would not be binding upon the UK either.

The impact on subsidiaries

The procedure for establishing a subsidiary of a financial firm would be based on the licensing conditions laid down in EU law (as implemented in the national legal order). Accordingly, the UK's exit from the EU would not affect the legal status of subsidiaries. However, the financial group's *set-up of operations* - for instance if the London head office provides certain EU-wide services - could necessitate major changes. The application of a '*subsidiarisation strategy*' would allow the group to make use, via the establishment of a EU subsidiary, of the single passport to establish branches and provide services without (permanent) establishment in other Member States.

The impact on branches

The EU right of establishment of branches (and all other related aspects) would cease to apply. The operation of UK financial firms through branches would be governed by the EU's GATS Schedule on specific commitments in financial services, the provisions of EU financial law on third-country financial firms/branches, and national GATS Schedules and laws.

The position of EU financial firms in the UK: The position of EU financial firms in the UK would also be affected. The passporting provisions will not apply to EU financial firms having (or intending to establish) branches and providing (or intending to provide) services without permanent establishment in the UK. These aspects would be governed by the UK GATS Schedule on specific commitments in financial services and national UK law. On the other hand, the establishment of subsidiaries of EU financial firms in the UK would be governed by the provisions of the relevant UK law and those of the UK GATS Schedule on specific commitments in financial services. Depending on the set-up of operations, financial services firms in the EU will have to adapt their model of providing services.

Bilateral agreements

The conclusion of bilateral agreements would not provide for participation in the EU single market as a whole either. Depending on the content of the agreement, the treatment of UK financial firms in the EU could be more favourable than in the case of the application of the GATS. In this context it is reminded that according to EU financial law the EU may conclude agreements with third countries providing for the application of provisions which accord to branches of credit institutions or investment firms having their head office in a third country identical treatment throughout the territory of the EU. It is to be expected that these provisions would be taken into account when drafting an EU-UK bilateral agreement.

Mutatis mutandis, the same considerations would apply to EU financial firms in the UK, if an EU-UK bilateral agreement were to be concluded.

EEA Membership

The position of UK financial firms in the EU: Opting for this concept (also called the ‘Norwegian model’) would ensure that the basic EU freedoms and hence the principle of mutual recognition would be granted. The EU Regulations on *EU financial law* would continue to apply, while EU financial law Directives are either already incorporated into UK law (unless they were to be repealed or amended), while new ones would apply to the UK as long as they are of relevance for the EEA. However, with the right of these freedoms comes the obligation to contribute (partially) to the EU budget, be bound to EU (financial services) legislation and accept EFTA Court jurisdiction and the free movement of persons.

If the UK could establish a seamless transition from EU Membership to EEA Membership, under the EEA concept, the UK’s exit from the EU would not affect either the operation of UK financial firms’ branches in other Member States or the provision by these firms of services without (permanent) establishment in other Member States. The establishment of subsidiaries of UK financial firms in the UK would be governed by the provisions of the UK legal acts transposing the relevant sources of EU financial law into the UK legal order.

The position of EU financial firms in the UK: The position of EU financial firms in the UK would also not be affected. The passporting provisions will apply to EU financial firms having (or intending to establish) branches and providing (or intending to provide) services without (permanent) establishment in the UK.

C. REGULATORY ASPECTS FOR BANKS AND IMPACT ON PAYMENT SYSTEMS AND MARKET INFRASTRUCTURES IN THE WTO SCENARIO

- Under a ‘third-country status’ scenario for the UK, the framework governing the micro-prudential supervision of the EU branches of UK credit institutions and the UK branches of EU financial firms, their reorganisation, resolution and winding-up, as well as their participation in deposit guarantee schemes would be affected significantly.
- For the subsidiaries of these financial firms the implications would be less significant to the extent that the principle of mutual recognition does not apply to them.
- Under the same scenario, the impact on the large-value payment system ‘TARGET2’, the SEPA, and the financial infrastructures for clearing and reporting transactions would be less significant.

The impact on the regulatory framework governing credit institutions

Micro-prudential supervision of branches of foreign credit institutions

Under the CRD IV, EU credit institutions are being supervised on a solo basis by the competent authorities of their home Member State or by the European Central Bank (**ECB**) if they are considered to be significant and their head office is located in a Member State whose currency is the euro within the context of the (European) Banking Union.

This micro-prudential supervision also covers (with some exceptions) their branches which are established in other Member States, by application of the principle of mutual recognition.

If the UK became a third-country, this regime would be altered. The conduct of micro-prudential supervision of UK credit institutions would hence continue to be the responsibility of the UK PRA in accordance with the provisions of UK law (which currently, and unless amended, is based on the CRD IV). Nevertheless, the branches of these credit institutions in the EU would then have to be (authorised and) supervised by the competent authorities of the host Member State. The branches of EU credit institutions in the UK would become subject to micro-prudential supervision by the UK PRA in accordance with UK law.

The impact on the regulatory framework governing credit institutions

Resolution

The BRRD provides the EU regulatory framework governing the recovery and resolution of credit institutions (and investment firms).

The UK's exit from the EU in the form of a third-country status raises several issues. The first issue is whether this will lead to a substantial modification of the UK's legislation (BRRD implementation). The BRRD follows and introduces into the EU legal order the international FSB standard '*Key Attributes of Effective Resolution Regimes for Financial Institution*'.

This standard was approved in November 2011 by the heads of state at the G20 Cannes summit. The UK is a member of both, the G20 and the FSB, and was one of the states that significantly contributed to both, the elaboration of this framework and its approval at international political level. Furthermore, the UK was one of the first EU Member States that adopted a special regulatory framework for the resolution of credit institutions before any such efforts officially started at European level. Particularly with regard to one BRRD element, i.e. raising the minimum requirement for own funds and eligible liabilities (**MREL**), the Bank of England (BoE) announced on 8 November 2016 that the relevant rules will be implemented fully by 2022.

The impact on the regulatory framework governing credit institutions

Resolution (cont.)

In addition, the BRRD's provisions on third countries, which refer to the conclusion of agreements with third countries, the recognition and enforcement of third-country resolution proceedings, the right to refuse recognition or enforcement of third-country resolution proceedings, the cooperation with third-country authorities and the exchange of confidential information will be applicable. The BRRD also provides that the resolution of a branch of a third-country credit institution operating in a Member State may be carried out, under specific conditions, by the Member State's resolution authorities.

The impact on the regulatory framework governing credit institutions

Participation in deposit guarantee schemes

The rules and procedures relating to the establishment and the functioning of deposit guarantee schemes (**DGSs**) are laid down in **Directive 2014/49/EU** (**DGSD**) Membership of EU credit institutions in the DGS(s) operating in their home Member State constitutes a *sine qua non* condition for their right to be authorised and to accept deposits from the public. According to the principle of mutual recognition, deposits which EU credit institutions accept through their branches established in host Member States, are covered by the DGS operating in their home Member State.

The impact on the regulatory framework governing credit institutions

Participation in deposit guarantee schemes (cont.)

For the UK as third-country, this regime would be altered: UK credit institutions would continue to be members of the UK deposit guarantee scheme. The guarantee of deposits at UK banks' branches established in EU Member States would continue to be governed by **Article 15** DGSD which requires Member States to check whether the branches established in their territory by third-country credit institutions have protection '**equivalent**' to that prescribed in the DGSD, and at least that depositors benefit from the same coverage level and scope of protection as provided for in the DGSD. Accordingly, if (UK) protection would not be considered to be equivalent, these branches would be obliged to join a DGS(s) within the territory of the Member State. Member States must respect the above-mentioned provision of **Article 47(1) CRD IV** according to which Member States are not permitted to apply to branches of non-EU credit institutions provisions which result in more favourable treatment than that accorded to branches of EU credit institutions.

The branches of EU credit institutions in the UK would be required to participate in the UK deposit guarantee scheme in accordance with the provisions of UK law on the treatment of foreign branches.

Impact on payment systems and market infrastructures

The EU large-value payment system ‘TARGET2’

As regards large-value payment systems, in the case that the UK would become a third country, the operation of the banking system of the EU Member States might be affected with regard to the clearing and settlement of transactions taking place through the Trans-European Automated Real-time Gross settlement Express Transfer system (**TARGET2**).

The main component of this payment system is owned and operated by the Eurosystem. TARGET2 has expanded the benefits offered by national real-time gross settlement systems beyond national borders and, at the same time, enabled participants to be credited or debited on a continuous basis, in central bank money with immediate finality of the transaction. TARGET2 functions on the basis of a single shared IT platform interlinking, on the one hand and on a mandatory basis, the ECB and the central banks of the 19 Member States which have adopted the euro, and, on the other hand, on an optional basis, the central banks of one Member State, Denmark, which has opted out of the single currency (as the UK did, too) and four Member States which (still) have a derogation. The payment services that may be used by system members are credit transfers, direct debits and transfers namely the sending (or movement) of funds or securities, or of rights relating to funds or securities, from one party to another party.

Impact on payment systems and market infrastructures

The EU large-value payment system ‘TARGET2’ (cont.)

Given that, TARGET2 services are provided into Member States which (national central banks) are not participating in TARGET2 (including the UK) and, in view of the total daily average value of processed euro-denominated payments (amounting to trillions), the impact for credit institutions from Member States operating in the UK may be significant as far as the services provided by them are concerned if and to the extent that they participate as users in the above payments system.

Impact on payment systems and market infrastructures

The Single Euro Payments Area (SEPA)

With regard to retail payment systems, one of the key initiatives at European level is the establishment as of 1 August 2014 of the SEPA. Its geographical scope covers 34 countries (i.e., the EU Member States, Norway, Lichtenstein, Iceland, Switzerland, the Principality of Monaco and the Republic of San Marino).

The establishment of the SEPA enables the conduct of payment transactions in euro between payment accounts kept with payment service providers established in SEPA countries, in the same manner as payment transactions carried out at national level. Its characteristic is that the payment users (natural persons and legal entities) may use payment accounts to carry out payment transactions in all 34 SEPA's members.

Given that the geographical scope of the SEPA is (as mentioned above) broader than that of the EU single market and that SEPA is, to a large extent, a product of market self-regulation, **no significant impact** on the banking system of the (other) Member States should be expected from the UK's exit from the EU.

Impact on payment systems and market infrastructures

Financial infrastructures for clearing and reporting transactions

Financial infrastructures for clearing and reporting transactions (such as trade repositories and central counterparties) have been created to facilitate the implementation of decisions and obligations undertaken at international level. In the event that the UK would be subject to third-country status, the users of such infrastructures established in the UK would lose their regulated status and hence the EU passport, unless they would continue to operate as eligible trading or clearing organisations, having ensured the recognition of their operational status as equivalent to that of the EU.

It is reasonably expected that the provisions governing the operation of these financial infrastructures would continue to apply and are likely to become UK law. Nevertheless, it is possible that credit institutions, trading venues and clearing houses established in EU Member States **would not be allowed to conduct transactions with UK infrastructure organisations** until the latter were deemed to be equivalent, which would likely require (time consuming) further adjustments. In addition, in the case of limited access to the EU single market by UK credit institutions, UK trading venues and UK clearing organisations being users of European infrastructures, it is likely that the volume of data and information processed by EU Member States' supervisory authorities would be considerably reduced.

Table 2

The impact of alternative concepts for the future EU-UK relationship regarding UK financial firms

Concept	Single passport	Other impact
Application of the GATS	-	Lack of access to the EU single market Restricted movement of services The micro-prudential supervision, reorganisation and winding-up, as well as the resolution of branches of UK credit institutions in the Member States, and their participation in deposit guarantee schemes would be governed by the provisions of EU law applying to third-country credit institutions
Bilateral agreements	-	Limited access to the EU single market (under specific conditions and in specific sectors, including those on financial services, upon the agreement) Potentially similar results as in the case of application of the GATS with regard to the regulatory aspects applying to UK credit institutions
EEA membership	√	Access to the EU single market Application of EU legislation

D. THE IMPACT ON THE MONETARY AND FINANCIAL EU INSTITUTIONAL FRAMEWORK

•Irrespective of the future EU-UK relationship, the functioning of the European System of Central Banks (ESCB) and the European Central Bank (ECB) will not be substantially affected by the UK's exit from the EU. The only exceptions are the ECB's capital and the decision-making process in its General Council.

•The operation of the European System of Financial Supervision (ESFS) will, in principle, also not be affected, with some exceptions as well.

•Arrangements will also have to be made with regard to the UK's share in the European Investment Bank's (EIB) subscribed capital and its paid-up capital.

•There will be no impact on the two main pillars of the Banking Union (i.e., the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM)).

•It is likely that the European Banking Authority (EBA), currently located in London, will be moved to another Member State.

E. CONCLUSIONS

1. The first main conclusion is that the EU regulatory framework provides for a favourable regime in relation to trade in services within its territory, including financial services. More specifically, based on the principle of the EU passport, a regulated financial firm having its head office in a Member State may establish branches and/or provide cross-border banking services in any other EU Member State, provided that the home Member State's competent authorities deem that the conditions laid down in EU law are fulfilled. The EU passport is one of the key benefits arising from access to the integrated EU single market, which the UK would lose if it were to be granted third-country status. In such a case, UK financial firms intending to provide investment services in the EU will need to:

•either choose to establish themselves through a subsidiary in a Member State and operate across the EU making use of the EU passport through this subsidiary; or

•comply with the different legislative framework of each Member State, given that the relevant legislation does not provide for the application of a uniform legislative framework for third-country enterprises.

E. CONCLUSIONS

2. A second main conclusion is that the participation of the UK government, the BoE and other UK administrative authorities in international organisations and international financial fora, which constitute the international institutional framework governing the financial system, is a guarantee that the UK financial system and UK financial law will continue both to influence and be influenced and shaped by international regulatory developments with regard to safeguarding financial stability and attaining other policy objectives concerning financial regulation, supervision and oversight. This may prove a safe haven for the shaping of the future EU-UK relationship in financial services, to the extent that the financial system and the financial law of the (other) EU Member States are also influenced by these international regulatory developments (either directly as a result of their participation in the above-mentioned international organisations and financial fora or through the transposition of the (international) soft law elaborated by these international financial fora into EU law).