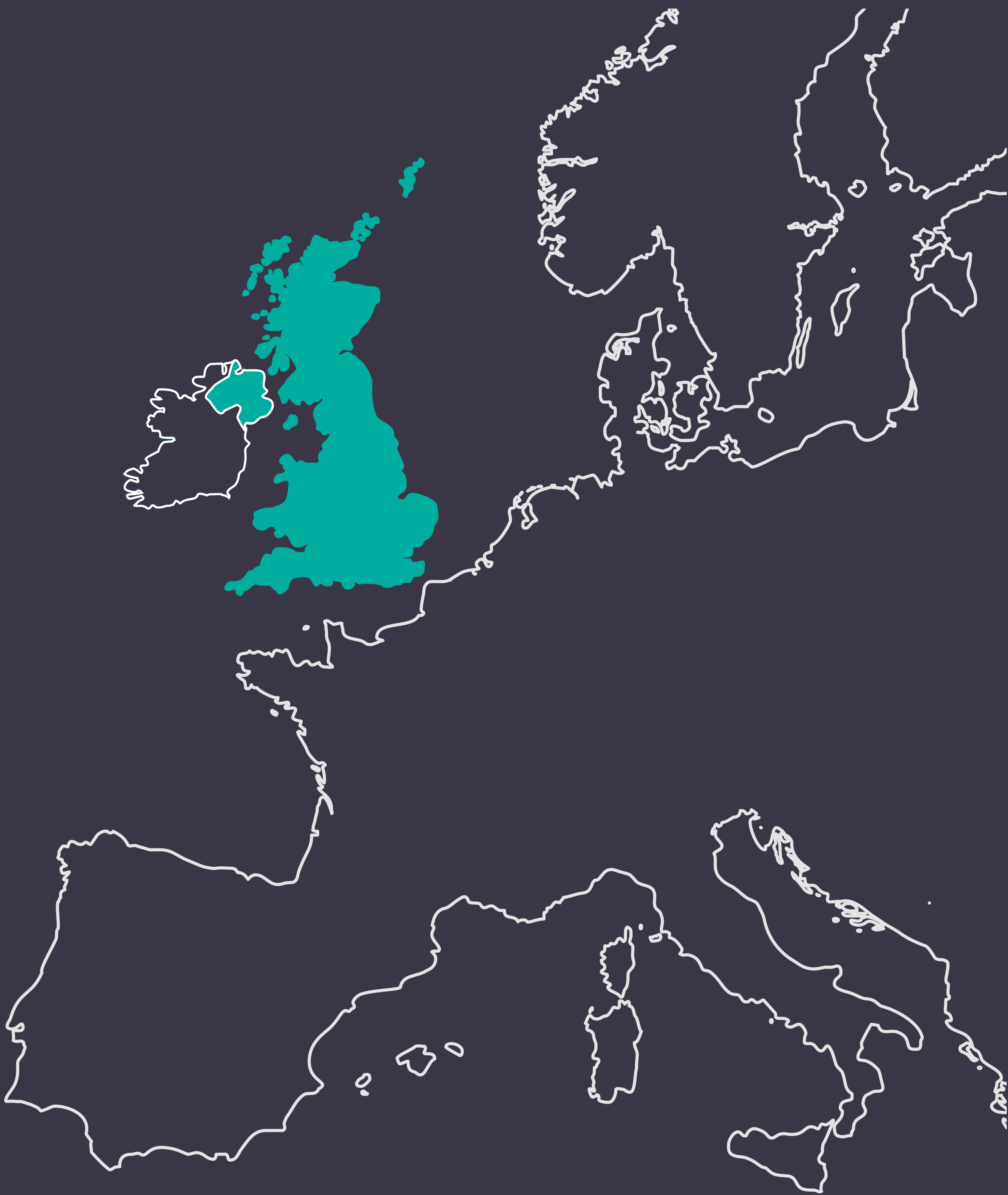
UK exit from the EU:

An orderly transition for banking

UK FINANCE



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Note: Any reference to UK Finance shall also include those of its predecessor trade associations, including Asset Based Finance Association, the British Bankers' Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association.

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Foreword

The British electorate has voted to leave the European Union ('EU'), and their wishes must be respected. The UK and the EU27 must now work together to agree a new, successful, partnership that works for UK and EU customers, businesses and the economy. The shape of this new relationship will have enormous influence upon the future for the UK and the EU27.

The emergence of the new relationship is likely to involve a period of uncertainty as its shape is agreed. It will be in the interests of all concerned to minimise this and work to avoid instability and disruption to businesses and customers on both sides of the Channel that benefit from the flow of trade and services across the UK and Europe. In relation to financial services, the EU's single market has enabled the free flow of the funding, risk management and other services that support businesses and customers and deliver substantial benefits for them.

Failing to preserve the mutual market access enabled by the single market either during the shaping of the new relationship or subsequently would have significant adverse consequences for the provision of the financial services that are so valuable for many businesses and customers in the UK and EU27. Consequently, there will be sound reasons to avoid this as an outcome and to agree a successful new arrangement that enables mutual market access to and from the EU single market to be preserved. There are means available to those responsible for negotiating the new partnership to accomplish this.

By preserving broad reciprocal cross-border market access rights, providing regulatory certainty and operational flexibility we can ensure businesses and households continue to benefit from an integrated European financial services sector. An ambitious, innovative and cooperative agreement between the UK and EU27 would achieve these aims.

To inform this debate, UK Finance has worked with Clifford Chance and Global Counsel to identify the impacts of the UK's withdrawing from the EU upon the products and services provided by the banking industry that are of greatest value for businesses and customers in the UK and EU27. The report considers the options to minimise the potential disruption for customers and businesses in the UK and EU27 that might otherwise occur should there be a disorderly exit and the tools available to deliver the most positive outcome for the UK's and EU27's citizens.

Executive summary

The outcome of the UK referendum will reshape the markets of the UK and the European Union ('EU'). Both the UK and the EU27 have an interest in this transition being an orderly one for banking and the hundreds of thousands of businesses and millions of individual customers that currently benefit from the banking services which flow between the EU and the UK and that are potentially implicated by a UK exit.

Limiting disruption to services for business must be an important part of any exit strategy for the UK as well as for the EU. The most significant mechanism for ensuring the free flow of financial services between the UK and EU (and vice versa) is for the UK to retain reciprocal access to the EU single market. In order to limit disruption for businesses and citizens in the UK and EU, and maintain the benefits from these services for jobs and growth creation, any exit arrangement should have as a key objective maintaining the existing broad access to and from the EU single market.

It is important to both maintain an orderly process and establish a degree of certainty about the chosen destination as quickly as possible. The need to reassure customers and investors, regulatory demands to demonstrate continuity of service, and the practical and legal issues related to relocation mean there will be pressure to implement contingency plans on all sides well in advance of the outcome of the negotiations. For this reason, the more clarity that the UK and EU authorities can give early in the process on the agreed aims for maintaining cross-border banking business, the greater the possibility of minimising this disruption.

The basic choice: EEA and Third Country options

The exit of the UK from the EU presents the UK with a basic choice that has profound implications for financial services

The exit of the UK from the EU presents the UK with a basic choice that has profound implications for financial services. The UK's essential choice is between requesting continued membership of the European Economic Area ('EEA'), based on membership of the European Free Trade Association ('EFTA'), or a range of scenarios built upon the UK reverting to 'third country' status with respect to the EU. The different models have widely divergent implications for the ability to trade and operate freely between the two markets for financial services. The former retains the UK's access to the EU's passporting regime for cross-border financial services trade. The latter does not.

The loss of passporting would reshape the way financial services are traded between the EU and the UK. For many years, financial services businesses in the UK and EU have based business models on the rights conferred by the EU Treaties and EU financial services legislation and manifested in the freedom to passport services throughout the EU and the EEA with minimal additional authorisation. These rights have been a major incentive for foreign banks to locate in the UK to sell onward into other EU markets and firms based elsewhere in the EU have used the same rights to provide services in and from the UK, market or sell products in the UK, and establish their own footholds in the deep capital, financial services and business services markets built around London. These passports are the essence of open trade in financial services in the EU.

Becoming a 'third country' has significant implications for banks trading between the UK and the EU27 and for the services provided to their customers

EEA membership would provide a high level of operational continuity for both the EU and the UK, but comes at a high price for UK autonomy in rule-making. EEA membership would leave a single overarching regulatory framework in place for banks in the UK and EU in a way that facilitates cross-border operation to a very significant degree. EEA membership provides some scope for the UK to recalibrate its relationship with the EU in other areas, including agricultural and justice and home affairs policy, and would return to the UK scope to negotiate trade agreements of its own with other countries. However, it would also come with obligations to contribute to the EU budget, incorporate elements of EU legislation into UK law with only limited influence over that legislation and to guarantee freedom of movement for other EEA nationals.

In contrast, becoming a third country with respect to the EU has significant implications for banks trading between the UK and the EU27. It would place the UK in a similar position with respect to the EU market as any other World Trade Organisation ('WTO') member (notwithstanding the need to clarify the UK's WTO status), outside of the coverage of the EU Treaties and the preferential terms conferred on members of the EU and EEA with respect to accessing the EU single market. It would remove the assumption of regulatory equivalence broadly embedded in EU financial services frameworks. It would remove access to the system of EU passports for financial services trade. It would end the binding institutionalised arrangements for regulatory cooperation between UK regulators and EU27 regulators. These all have serious operational continuity implications for banks and the businesses and customers they serve in both the EU27 and the UK.

Table 1: EEA and third country frameworks for financial services: UK rights in the EU27

	In EU/EEA	Third country
Rights of establishment	Guaranteed by EU Treaties and law, and affirmed by EEA passporting regime	EU market open to foreign banks for local establishment.
Rights to sell cross-border	Guaranteed by Treaties and law, and affirmed by EEA passporting regime	EU market relatively closed for cross-border activity. Some local licensing regimes permit cross-border activity.
Regulatory equivalence	Shared EU/EEA rulebook via transposition	Subject to assessment of regulatory framework and mutual recognition
Host regulator prepogratives	Defined by EU law – obligation to treat all EU/EEA branches the same for prudential purposes.	Defined by WTO rules – wide scope for regulators to subject foreign bank branches to tougher prudential requirements at their discretion.
Cross-border cooperation between regulators	Established through EU institutions and EU agencies (although EEA arrangements more problematic – see p.20 below)	Based on international supervisory cooperation agreements. UK regulators would have to resume functions currently performed by EU/EEA regulators

Behind every 'lost' trading right in this scenario are established services that EU and UK clients and customers depend on, and jobs created to undertake that activity. These services will need to be restructured, reauthorised and reviewed. That will be disruptive, costly and time-consuming. In some cases services maybe lost altogether as the higher cost or complexity for providing them by alternative means makes them uneconomic. The ecosystem of other roles that depend on them will be disrupted too. The UK's viability for servicing the single market as a third country will fall sharply and this will inevitably impact the jobs created in the UK and the services provided from the UK. The global reach and scale of London's markets helps ensure that EU businesses have access to deep, liquid capital markets. Some of this liquidity may migrate to the EU; some may move elsewhere. But less depth and less liquidity could also mean higher costs to EU businesses raising money and transacting.

A constructive and pragmatic approach to third country status for the UK could limit some of this damage to established arrangements for business. There are a range of tools in the EU policy framework that would enable the two sides to recognise their mutually high standards in a way that facilitates cross-border trade and operation. Perhaps most importantly, a uniquely ambitious bilateral agreement between the two sides covered by sufficient transitional arrangements could take this much further, building cross-border rights for firms on both sides. This would be based not on a single rulebook, but on close alignment of standards, robust regulatory cooperation and a shared commitment to the highest banking standards in the world.

Mitigating the impact on financial services: The UK as an 'enhanced third country'

A narrow range of existing mechanisms could be used to provide reciprocal market access for some banking services – but these are very limited

If the UK ultimately chooses to leave the EU/EEA and adopt third country status with respect to the EU/EEA, an existing series of limited mitigants are potentially available to it. They provide, however, a much narrower and more restricted range of services than those currently available in the UK and EU27 via participation in the single market. Most key EU financial services regulatory regimes do not currently have third country mechanisms similar to the passporting regimes established for EU/ EEA states. However, a number of existing EU third country regimes for certain limited services are potentially available to facilitate trade in some financial services between the EU and the UK. These frameworks are based on the concept of equivalent regulatory regimes. For example, among the most relevant for financial services are:

- Potential cross-border rights for UK-based investment firms under the third country market access regime in the second Markets in Financial Instruments Directive ('MiFID II') and Regulation ('MIFIR');
- Potential cross-border access for Alternative Investment Funds ('AIFs') and Alternative Investment Fund Managers ('AIFMs') to the single market via the proposed third country market access regime in the Alternative Investment Funds Manager Directive ('AIFMD');
- Potential mutual recognition of EU and UK market infrastructure for clearing derivatives under the European Market Infrastructure Regulation ('EMIR'); and
- Potential mutual recognition of data protection standards and freedom to move client data between the two jurisdictions.

These mitigants potentially re-establish – to a limited degree, and in a generally weaker form – the cross-border rights and operational freedoms created under the EU Treaties for EU-domiciled businesses in these areas. These mitigants also have some limitations. For example, rights based on 'equivalence' can be seen as inherently riskier as they can be withdrawn suddenly if a party considers that the other party's regulatory regime no longer provides a sufficiently comparable outcome. The UK and the EU could aim to agree the activation of these regimes and others like them for the UK in a way that ensures that these operational rights are appropriately secure at the point of a UK exit from the EU.

The EU and the UK should build on the precedent established by existing third country frameworks to develop a uniquely ambitious, broad and far-reaching, new form of bilateral agreement

However, a bilateral UK-EU agreement could also be used to go much further to enhance cross-border financial services trade privileges between the EU and the UK and even to replace existing third country regimes with a more bespoke framework. The EU and the UK should build on the precedent established by existing third country frameworks to develop a uniquely ambitious new form of bilateral agreement that creates the prospect of new third country regimes for the EU and the UK reflecting the unique level of alignment in the two sides' regulatory approaches, which is much greater than any two previous FTA partners in the global economy. The EU has signed a similar agreement with Switzerland in the area of non-life insurance. This creates rights for Swiss insurers to operate branches inside the EU as if they were EEA firms. In return, Switzerland commits to maintain regulatory standards equivalent to those of the EU. There is every reason for the EU and the UK to be more ambitious for their bilateral agreement.

An orderly transition for the UK out of the EU will depend on adequate time to adapt to the changed terms of third country trade

Such agreements could be built on a range of possible models of mutual recognition between the EU and the UK. They could be based on formal equivalence agreements between the two sides, or other forms of mutually agreed understanding that firms from each market operate at similarly high and robust standards. This would be perhaps easiest to agree in areas such as corporate banking or the provision of certain services to professional investors. But it could also be explored in other areas such as asset management, payments services or other banking services.

While it is true that this would break new ground in trade policy terms, there are in most respects no two markets as closely aligned in banking standards in the global economy as the EU27 and the UK. Regulators will inevitably be cautious about extending cross-border market access to firms from outside their regulatory jurisdiction, but reciprocal rights, an initial focus on areas serving professional and corporate clients and close cooperation between regulators could all help to mitigate this, along with various forms of agreement to closely align standards. There would be no question of either side retaining market access while allowing regulatory standards to drift or fall below a high joint standard – this would be policed by mutual recognition and perhaps formal equivalence in some cases. But a pragmatic and constructive approach could help keep vital services available to business customers.

A bilateral agreement could also be used to ensure that these reciprocal rights cannot be removed without due consultation and warning. This is important, because businesses relying on these conditional rights need some confidence that they cannot be withdrawn suddenly or without warning. Similarly, rights of consultation and input on future regulation would also provide additional reassurance against the risk of conditionality.

While the scope to negotiate such a bilateral agreement in parallel with a withdrawal agreement is currently contested, it would be preferable for both sides to explore this possibility. Even if such an agreement cannot be signed and ratified until the UK has left the EU, preparatory negotiations would allow for minimal disruption at the point of exit, especially if a transitional period allowed a managed transition to new arrangements.

For financial services, as for any other sector, an orderly transition for the UK out of the EU will depend on adequate time to adapt to the changed terms of third country trade. Because there is likely to be a gap between the formal date of the UK's exit from the EU and the signing and coming into force of an EU-UK FTA or other bilateral agreement – not least while the UK reconfirms its status and profile in the WTO – it is important that this gap is covered by a transitional arrangement that confirms temporary rights and obligations for firms trading in both directions and their home markets. Such a transitional arrangement will also provide regulators with the additional time that they will need for the potentially large volume of reauthorisation of firms that are transitioning from EEA/EU status to a new framework.

To support these processes, the UK authorities should signal a commitment to regulatory stability and long term alignment between UK and EU standards. The UK should be willing to provide EU27 counterparts with clear commitments that, in the period before the withdrawal agreement comes into force, the UK will legislate to confirm standards currently in the legislative pipeline or requiring transposition from directly effective EU law. The UK government and UK regulators will facilitate negotiations if their strategy is to keep the existing regulatory framework substantively unchanged with – at most – clearly identified, limited, targeted amendments, leaving the evolution of the regulatory framework to future governments and future regulatory action. The establishment of regulatory cooperation mechanisms between EU and UK authorities before the point of exit is also necessary and important. This would facilitate mutual recognition agreements and establish the future architecture of supervision for cross-border operations.

The UK as a third country: Relations with non-EU markets

The UK will want to re-establish its own position in the WTO – a potentially lengthy process – and take steps to prioritise and protect arrangements with other third countries that currently rely on EU based arrangements

The UK will need to re-establish its own position in the WTO. This will be an effective precursor for most subsequent UK bilateral trade negotiations, as it will stabilise the UK's basic trade profile in a way that facilitates negotiations on preferential terms. This may be a protracted process, but could be facilitated by the UK adopting the EU GATS services schedule in a way that confirms the market access rights of third country firms operating in the UK.

The UK should also confirm its adherence to and application of the GATS Understanding on Financial Services. The UK should commit to maintaining access to its financial services market for third country firms on current terms where judgements of equivalence are not involved. Where they are not based on assessments of supervisory equivalence, the rights of third country firms operating in the UK should be affirmed and the UK should commit to maintaining a market access regime for third country firms that is not more restrictive than the status quo. This will also facilitate negotiations on the UK's WTO market access schedule.

The UK should commit to seeking before the point of exit mutual recognition arrangements for services currently provided under EU equivalence-based regimes. Some Swiss, US and other non-EU businesses currently operate cross-border in the UK under the auspices of EU market access regimes based on equivalence judgements with their home regulators. The UK will need to replace these rights with a regime of its own and this will involve confirming mutual recognition of standards with home regulators and confirming the rights of businesses operating under these terms.

The UK should review, prioritise and seek bilateral negotiations to replace EU FTAs. The UK's priorities in seeking to replace the current coverage of EU FTAs for UK-based businesses will no doubt be dominated by the question of restoring preferential tariffs on goods trade. However, there are a number of protections for financial services businesses in key EU FTAs that it will be important to restore as quickly as possible. This will inevitably be conditioned by the willingness of other third countries to engage in bilateral negotiations with the UK as a matter of priority, but in principle both parties have an incentive to replace the current EU FTA framework expeditiously.

The UK as a third country: business impacts and mitigations

Firms in the UK will, post-exit and in the absence of mitigation, be unable to provide services to businesses or customers in an EU27 country where those services are regarded, by the country concerned, as being performed in that country. This could catch a wide variety of activities from risk hedging to corporate finance advice.

Investment banking – notably securities and derivatives trading – may be able to continue (with wholesale counterparties at least) if the UK maintains equivalent status under the MiFID II third country access regime. However there is no guarantee that this route will be available. If it is not, the position is highly unclear as to what business these institutions will be permitted to do with EU customers, since the issue will be determined country-by-country rather than at the EU level.

Many banking services offered by UK-based banks may become unavailable for EU27 businesses and customers if the UK becomes a thrid country without ambitious mitigating arrangements

The impact is likely to be most severe with regard to banking activities, since there is no third country equivalence regime in the EU banking directives, and both lending and deposit taking in EU27 countries will be prohibited on this basis. This will catch not only traditional banking services, but also payments, custody and other services for whom the provision of credit and the management of cash balances are an inherent part of the overall service which they provide. This will also adversely affect credit card business, which is more international than retail banking business.

Private Wealth Management, which cannot benefit from the MiFID II third country safe harbour because it does not apply to dealings with retail customers, will be particularly badly affected.

The impact will be less severe for asset managers' collective investment scheme ('UCITS') management – however portfolio management activities for EU27 pension and other funds may be adversely affected.

The position of payments business is as yet uncertain. It is highly unclear whether UK banks can remain participants on equal terms in the Single Euro Payments Area ('SEPA') and Target 2, and this is to some extent a decision for the operators of those systems. However if obstacles are placed in the way of access to these systems, the ability of UK banks to provide payment services to their customers could be significantly harmed.

Resetting UK domestic regulation

A major overhaul of UK domestic regulation will be required. This should reflect the UK's strategic objectives for the negotiations

Brexit will trigger a major overhaul of domestic regulation. The exit of the UK from the EU will require the UK government and UK regulators to evaluate the extent to which the UK should retain, revise or revoke provisions of the existing financial services legislative and regulatory framework that are based on EU legislation in the light of the UK's new status. The UK should consult on this review and any changes proposed to the existing legislative and regulatory framework.

The review will also need to identify where changes may adversely affect the negotiations with the EU27 on equivalence assessments. The UK should retain existing third country regimes under EU legislation which should become regimes addressing the treatment of all foreign states, including the EU27. The parties to the negotiations will need to take account of the continuing EU legislative agenda on financial services. The UK remains an EU Member State with full voting rights until the date the withdrawal agreement under Article 50 enters into force.

Table 2: Recommendations		
Proposed approach for the UK and EU27	UK	• The UK government should not trigger Article 50 precipitously • The UK government should signal a willingness to maintain legislative stability to the extent necessary to facilitate mutual recognition discussions in key areas
	UK and EU27 – Withdrawal agreement	• The EU and the UK should set out a clear negotiation framework with established timeframes where possible • Agree an adequate transitional period and status for the UK for the implementation of any agreement • Activate existing third country regimes under EU legislation with effect from the date that the UK leaves the EU • Establish regulatory cooperation mechanisms, especially for prudential supervision

		• Agree that respective UK-EU27 data protection regimes are mutually recognised as adequate for cross-border data transfer. Where mutual recognition of other standards – for example anti moneylaundering rules – can help facilitate an orderly transition and future cooperation, this should ideally be done before formal exit
	UK and EU27 – Bilateral agreement	• Enhance protections against unilateral change to existing equivalence-based market access rights and rights of consultation on future rulemaking • Develop additional mutual recognition based market access freedoms between the UK and the EU27, and potentially bespoke versions of existing third country rights
	Other	• Make clear commitments regarding common objectives for an orderly transition and its key attributes at an early date to avoid precipitous implementation of industry contingency plans
Proposed approach for the UK and third countries	UK	• The UK should expedite the codification of its WTO profile by committing to retain the EU GATS schedule • The UK should commit to maintaining access to its market for third country firms on current terms where judgements of equivalence are not involved
	UK and third countries	• The UK should commit to seeking before the point of exit mutual recognition arrangements for services currently provided under EU equivalence-based regimes • The UK should review, prioritise and seek bilateral negotiations to replace EU FTAs
	UK and EEA-EFTA States	• The UK should seek to align its EEA exit negotiations as closely as possible with those with the EU27
	Other	• The UK should commit to recognising the adequacy of non-EU regimes, e.g. for data protection and CCPs, currently recognised by the EU

1. Introduction

The outcome of the UK referendum will reshape the markets of the UK and the European Union ('EU'). Managing this process in a way that sustains financial market confidence and stability, avoids unintended consequences and minimises unnecessarily disruptive change must be a priority for the UK and the continuing Member States of the EU ('EU27'). There will be interests on both sides who see the exit of the UK from the EU as an opportunity to secure short term competitive advantage. This is short-sighted when set against the wider interest of an orderly transition for the businesses, customers and investors who currently depend on banking services traded between the two markets. It potentially neglects the important role that the UK can continue to play as a financial centre closely aligned and integrated with the EU.

The UK and the EU have a number of important tools at their disposal to manage the exit process which can be used to avoid unnecessary disruption for customers. Article 50 of the Treaty on European Union creates a mechanism for a negotiated exit from the EU. While there is much to negotiate, the parties should agree a timeframe that permits key issues to be addressed and provides for a managed transition. The close alignment between the two systems, close links between officials and a common body of practice can all help make the changes ahead less disruptive than they might otherwise be.

Do the UK and the EU27 have a mutual interest in an orderly transition for banking?

Both the UK and the EU27 have an interest in an orderly transition for banking. The need to reassure customers and investors, regulatory demands to demonstrate continuity of service, and the practical and legal issues related to relocation mean there will be pressure to implement contingency plans on all sides well in advance of the outcome of the negotiations. For this reason, it is important to both maintain an orderly process and establish a degree of certainty about the destination as quickly as possible. The more clarity that the UK and EU authorities can give early in the process on the agreed aims for maintaining cross-border banking business, the greater the possibility of minimising this disruption.

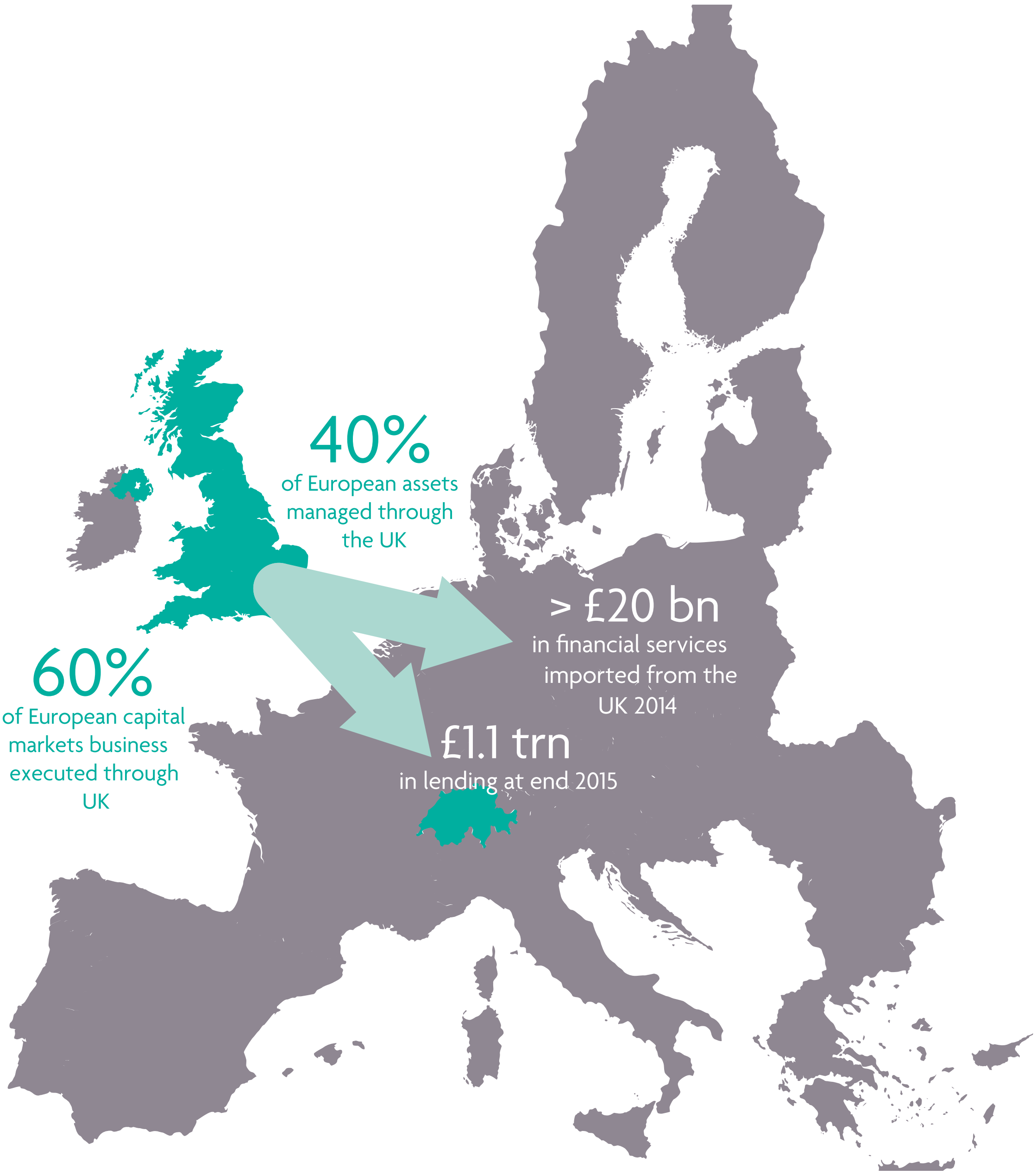
It is in the interests of the UK and the EU27 to have an orderly transition for banking

In the medium-to-long term, the question of the UK's transition out of the EU for the purposes of trade in banking services raises important prudential, practical and political issues for policymakers. The UK and the EU27 find themselves in a position that is fundamentally new and different from the conventional dynamic of market access negotiations in which states discuss the augmentation of terms from an established baseline, with little innate sense of time constraint.

Businesses in both the UK and the EU27 face the prospect of a rescinding of market access rights and a negotiation conducted on a constrained timeframe and under political pressure – something that creates significant uncertainty and which is potentially highly disruptive and damaging.

The introduction of new regulatory barriers to business in markets that have up to now operated as a single market will increase costs, raise barriers to entry and reduce customer choice. The UK currently functions as the EU's principal financial centre and the creation of regulatory barriers between that centre and the many customers and counterparties that depend on its services across the EU risks significant disruption of business relationships. Hundreds of thousands of businesses and millions of customers currently depend on the cross-border trade in financial services between the UK and the EU27. How should these interests be addressed?

Figure 1: The interconnection of the UK & EU27 markets for financial services



Source: Bank of England, European Commission, HMT, UK ONS

There may inevitably also be interests in the UK and the EU that see potential competitive advantage in restricting trade or freedom of operation in banking services between the two markets. However, reciprocal regimes based on mutually recognised standards already exist for financial services trade between the EU and third countries and these create an important precedent for developing a bespoke and ambitious approach to mutual recognition and reciprocal market access rights between two jurisdictions that are the most closely aligned of any in the global economy.

Working together to facilitate this in a way that ensures a minimal unnecessary loss of rights for businesses in both directions at the point of withdrawal makes sense from the point of view of business continuity, market stability and an orderly transition.

Banking and the transition

This report is intended to make a constructive and substantive contribution to this process of managing the UK's withdrawal from the EU from the perspective of the banking industry in the UK and its millions of clients and customers. Like many industries, banking has developed dense networks of cross-border business in both directions within the EU. The breaking of these links carries a cost in disruption that will affect customers and investors as well as the banking industry. This disruption can be minimised to the mutual benefit of both sides, however, if a number of simple aims for the exit process are agreed at the outset. This also applies with respect to actions the UK could commit to with respect to non-EU trading partners that would help with an orderly transition out of the EU.

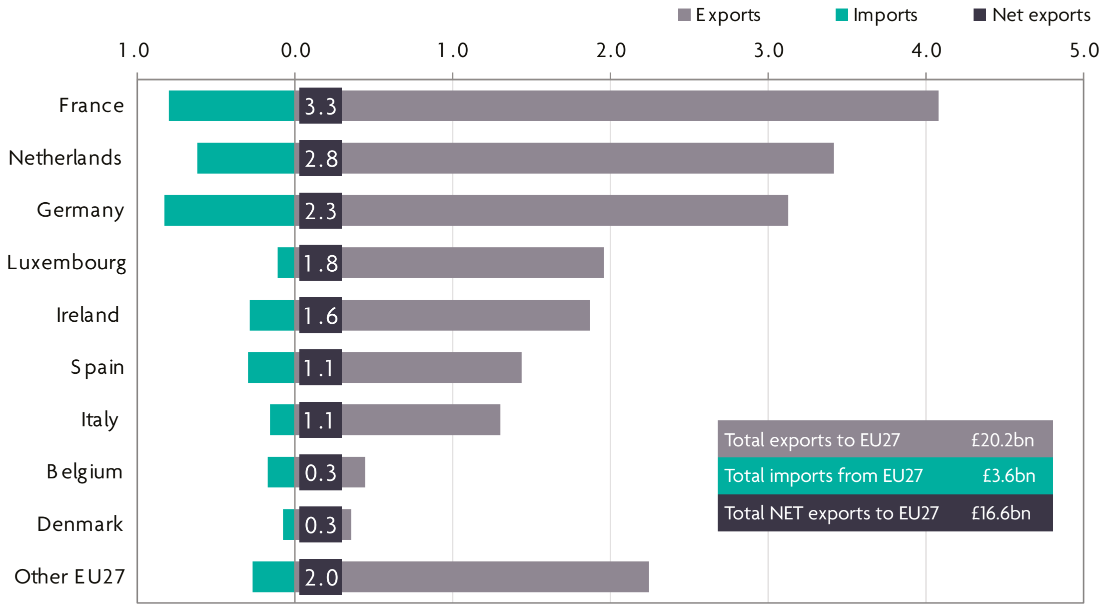
The banking industry covers a huge range of activities and is bound into every part of the UK and EU economies. Alongside taking deposits, offering credit, and managing payments and settlement, banks operating in the UK play a wide range of roles from providing investment services to facilitating activity on the UK and EU's exchanges and trading venues. In 2014, EU businesses imported £20 billion in day to day banking services from the UK[1] (see Figure 2). At the start of 2016, UK-based banks were providing more that £1.1 trillion in cross-border lending to the EU[2] (see Figure 5, P47). This report focuses in detail on certain of these activities to illustrate some of the specific challenges ahead. It seeks to identify solutions that would minimise disruption for the hundreds of thousands of UK and EU companies and millions of individuals that rely on the banking sector's services.

The banking industry is a crucial part of the UK economy and a significant export sector. It is a major enabler of the EU and UK economies through the myriad of services it provides. The potential disruption of services provided by banks has wider implications; including for market confidence, financial stability, productivity, jobs and growth in the UK and also across the EU. But banking is just one of a range of vital interests that the UK government must balance in agreeing a future framework for relations with its EU counterparts. This report has been written with that reality at the centre of its analysis. It views the question of the UK's transition out of the EU not from the perspective of competitive advantage but the shared interest in business continuity, market stability and an orderly exit of the UK from the EU. The most significant mechanism for ensuring the continued free flow of financial services between the UK and EU (and vice versa) is by the UK retaining full access to the EU single market on mutually acceptable terms.

[1] UK Office for National Statistics

[2] Bank of England In the case of some trade

Figure 2: 2014 Cross-border trade in financial services with EU countries (excluding insurance & pensions) £bn



Source: ONS Pink Book 2015

Wherever possible the UK and EU should seek to minimise the adverse effects of the UK exit from the EU

The premise for this report is that, wherever possible, the UK and the EU should seek ways to minimise the adverse effects of the UK exit from the EU. There are a range of pragmatic choices that could be acceptable to both UK and EU27 interests that would materially reduce the level of disruption experienced by banks, their customers and investors in the UK and the EU during and after the point of the UK exit from the EU. This report sets out those choices and presents the reasons to make those that are the most constructive in their purpose and ambitious in their reach.

Maintaining the existing broad access to and from the EU single market, for financial services provided to businesses and customers across the UK and the EU27, should be seen as a key objective. Many of the issues raised in this report are important not just for banks, but for any business that trades between the UK and the EU. Many of the solutions proposed are also relevant and directly applicable to the interests of other sectors.

2. The EEA and third country options

The exit of the UK from the EU presents the UK with a basic choice between obtaining continuing access to the EU through membership of the European Economic Area ('EEA') (based on membership of the EFTA) or a range of scenarios built upon the UK reverting to 'third country' status with respect to the EU.

The different models have widely divergent implications for the ability to trade and operate freely between the two markets for financial services. They also put a range of different constraints and obligations on the UK.

The status quo

For many years, financial services businesses in the UK and EU have based business models on the rights conferred by the EU Treaties and EU financial services legislation and manifested in the freedom to passport services (see Box 1) throughout the EU and the EEA with minimal additional authorisation. These rights have been a major incentive for foreign banks to locate in the UK to sell onward into other EU markets – as one of many examples, 90% of US investment banking staff in the EMEA region are currently based in the UK.

Firms based elsewhere in the EU have used the same rights to provide services in and from the UK, market or sell products in the UK, and establish their own footholds in the deep capital, financial services and business services markets built around London. These passports are the essence of open trade in financial services in the EU.

Box 1: What is passporting?

For over 20 years, financial services businesses in the UK have based their business models on the rights conferred by EU legislation to 'passport' their services across the EU and the EEA. In particular, this legislation gives UK and other EU incorporated and authorised banks and investment firms the right to provide a broad range of banking and investment services to customers and counterparties across the EU and the EEA – either cross-border or through branches – without the need for additional local authorisations. In addition, this legislation significantly limits the extent to which other Member States can impose additional regulatory requirements on banks or investment firms exercising their passport rights.

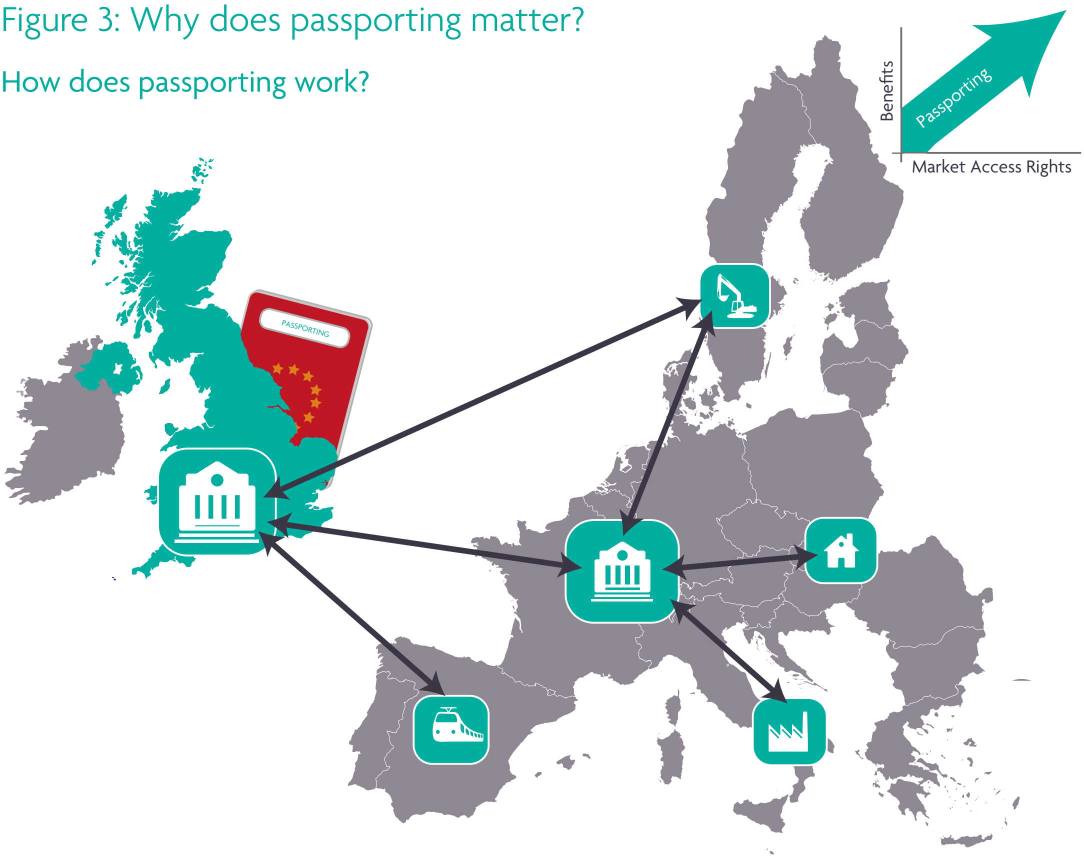
These passports are not available to 'third country' firms, i.e. firms incorporated outside the EU. Non-EU firms face significant regulatory barriers to providing cross-border banking and investment services to customers and counterparties in many EU Member States. In many Member States it is either not possible or practical for a non-EU firm to obtain a licence to provide cross-border banking or investment services to local customers or counterparties. Even if the non-EU firm does obtain a licence to establish a branch in a Member State, that licence will only authorise it to do business in that Member State. It will not confer any rights for the non-EU firm to do business from that branch with customers and counterparties in other Member States. Member States may also impose a wider range of regulatory requirements on non-EU firms doing business through a local branch or, where this is possible, cross-border with local customers and counterparties.

The passport rights given to EU firms have been a major incentive attracting numerous businesses with differing profiles to the UK. Non-EU banks have established UK subsidiaries in order to both provide services from these subsidiaries into other EU and EEA markets and to base themselves in Europe's financial centre. Many international banks have chosen the UK as their main location for doing business throughout the EU and often also the entire EMEA region, benefitting from the combination of London's strengths as a global financial centre and the right to passport across the EU and EEA. Firms based elsewhere in the EU have also used the same rights to establish branches in the UK from which they can provide services into other EU and EEA markets, as well to provide services into the UK and to access the deep capital, financial services and business services markets built around London.

Recent EU legislation has created some 'third country regimes' which allow non-EU firms to provide services into the EU if their home country regulatory regime is 'equivalent' to EU standards (see Box 3: What is equivalence?). However, these regimes cover a more limited range of services and provide fewer additional rights than the existing passports for EU firms. These regimes may also be subject to additional conditions. For example, they may include requirements for home country regulators to establish regulatory cooperation arrangements with EU regulators or requirements that the home country provides an equivalent reciprocal mechanism under which EU and other foreign firms can access the third country market on similar terms. Unlike an EU passport which is based on a presumption that a home regulator applies EU standards, the rights under these regimes can (and sometimes must) be withdrawn at any time if a home country deviates materially from EU standards (and the EU legislators can amend or revoke these regimes at any time by the ordinary legislative process).

Figure 3: Why does passporting matter?

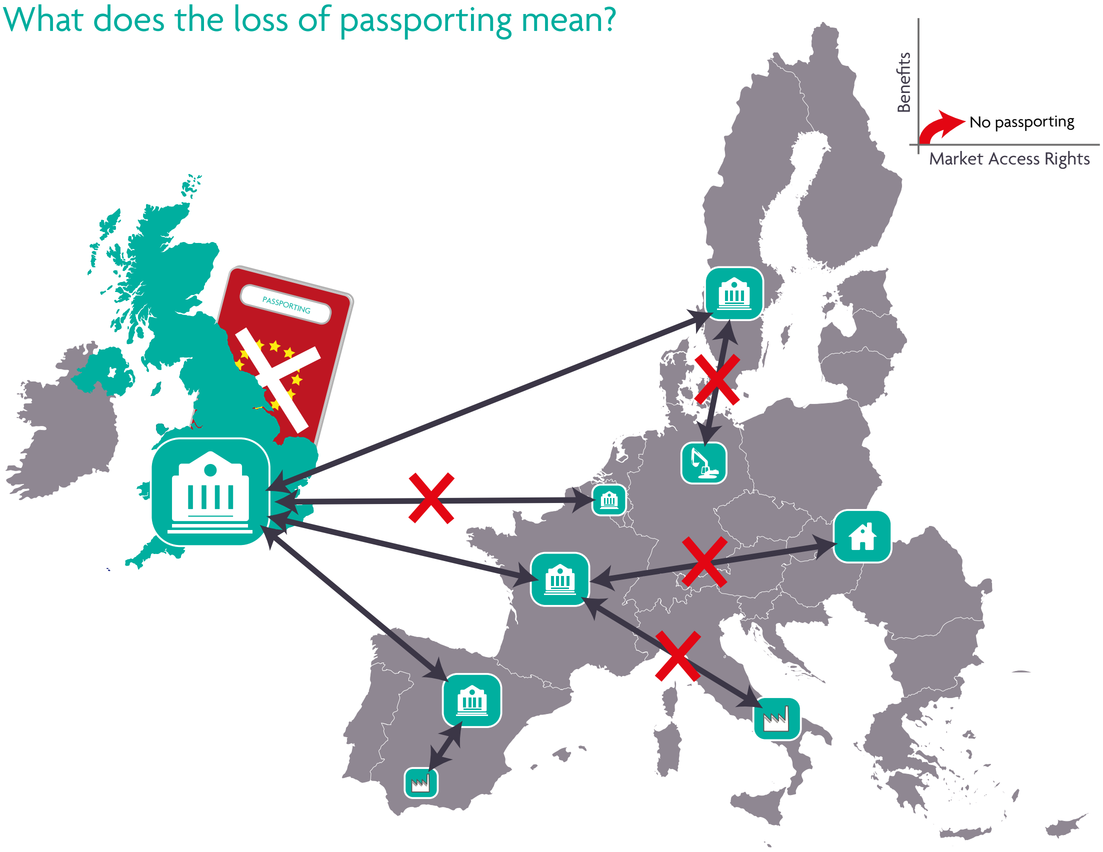
How does passporting work?



A 'passported' UK based bank has broad and well understood rights. It can:

- Provide its customers with the widest range of banking services across the UK and all 27 EU countries
- Establish a branch in any other EU country from which it can offer cross-border banking services across all other EU countires
- Do so efficiently, without duplication and at low cost

What does the loss of passporting mean?



Once outside the EU, a UK based bank has no ‘passport rights’. Instead it must apply for a licence for each EU country:

- A licence is not available in many EU countries
- The range of licenced banking services is much more limited
- The licence is usually limited to one country at a time (i.e. no cross-border rights)
- Duplication and substantial additional costs

The status quo

One of the UK's potential options on leaving the EU is the possibility of joining – or technically remaining a member of – the EEA. This would involve the UK negotiating membership of the European Free Trade Association ('EFTA'), and then the terms of its membership of the EEA.

Viewed simply from the point of view of continuity of UK rights in the EU market (and vice versa) membership of the EEA implies a high degree of stability and continuity with the status quo:

- It would allow the UK to retain full access to the single market, based on the acceptance of the 'four freedoms' for trade in goods, services, and capital and the movement of workers established in the EU treaties, and would leave the rights of EU businesses in the UK market broadly unchanged;
- It leaves a single overarching regulatory framework for financial services in place for the UK and the EU which facilitates cross-border operation to a very significant degree and removes many of the third country issues discussed below (although there remain outstanding issues with respect to the implementation of the EU financial service framework in the EEA-EFTA States and the functioning of the European Supervisory Authorities ('ESAs'), as further described below); and
- It may also be easier to negotiate and in a relatively short timeframe, given that the necessary structures already exist, thus avoiding many of the business continuity issues addressed above.

Even for non-EU EEA members, passporting rights remain contingent on a willingness to maintain EU standards, with only limited influence over them

The EEA option would also create some additional freedoms for the UK with respect to the status quo:

- It would allow the UK to withdraw from some EU programmes such as the Common Agricultural and Common Fisheries Policies and Justice and Home Affairs policy and potentially from a range of other social policies covering areas such as education and research; and
- It would allow the UK to negotiate bilateral trade agreements of its own, although conditioned by the requirements of onward trade into the EU and at the cost of putting the UK outside of the Common Commercial Policy and the current system of EU FTAs (see Chapter 4 below).

However, the market rights that come with membership of the EEA are likely to come with contingent conditions similar to those accepted by current EEA-EFTA States. These states are subject to requirements which involve:

- A significant contribution to the EU budget;
- An agreement to incorporate all relevant EU legislation into their law with only limited influence on its drafting. The UK would cease to be a rule-maker and become a rule-taker. The EEA Agreement does provide for consultation of EEA-EFTA States before new legislation is adopted by the EU, for example, through participation in committees of experts or the submission of comments on legislative initiatives, but with little actual influence on decision-making by the EU. This commitment is subject to surveillance by the European Surveillance Authority and oversight by the EFTA Court, which typically follows the rulings of the European Court of Justice. For the UK, this would be a very large concession over the governance of the UK financial services sector, as it would be in other sectors. This will concern policymakers and regulators as well as firms; and
- A general commitment to provide freedom of movement for all EEA nationals.

In principle the UK could seek to alter the terms of EEA membership in negotiating its own ascension, but these are likely to be issues on which the existing EEA members and the EU27 show limited flexibility. Existing EEA-EFTA States would inevitably have their own conditions and expectations for UK membership. Support for UK accession would have to receive the unanimous approval of all its members, which include Iceland and Lichtenstein, in addition to Norway and the EU Member States. This would not be a trivial decision for the three EEA-EFTA states as current EEA arrangements for contributing to EU lawmaking are based on the provision of a single view of the EEA-EFTA states agreed by consensus. The current members of the EEA might have concerns about the weight of the UK's voice in this process and the consensus-based processes for EEA input into EU law-making would leave the UK potentially constrained by vetoes from individual EEA states.

The EEA's regulatory integration into the EU's single rulebook has not always been unproblematic. A long-running dispute with the EU over the incorporation of the Capital Requirements Directive IV ('CRD IV') and European Markets Infrastructure Regulation ('EMIR') and the extension of the coverage of the ESAs to the EEA has moved slowly towards resolution, but highlights the nature of the political and policy trade-offs that are required to facilitate EEA member's unusual status in the single market for financial services.

It is also a reminder that even for non-EU EEA members, passporting rights remain contingent on a willingness to maintain EU standards, with only limited influence over them.

The UK as a third country

The basic alternative to continued membership of the EEA is third country status for the UK. Becoming a 'third country' with respect to the EU has some key implications for banks providing services between the UK and the EU.

Single market access rights

Third country status places the UK outside of the coverage of the EU Treaties and the preferential terms conferred on members of the EEA with respect to accessing the EU single market. This means that businesses trading between the EU and the UK lose the freedoms of operation and establishment that are conferred by the EU Treaties and the EU legislation adopted under them.

These would be replaced in the first instance by the market access terms that the EU and the UK, as members of the WTO, extend via their national licensing regimes and on a non-preferential basis to all other countries and other signatories of the General Agreement on Tariffs and Trade ('GATT') and the General Agreement on Trade in Services ('GATS') with whom they do not have preferential trading agreements, for example, under FTAs.

UK-based banks would have to rely on 'third country regimes' created under UK law or established in bilateral agreements

In banking services the baseline for trade would be the commitments in the EU and the UK's respective GATS schedules, which would be expected to be based on the GATS Understanding on Financial Services ('GATS Understanding'). As is typical in international trade in financial services, these provide very limited market access for the cross-border provision of financial services, although they provide in principle for a good degree of freedom of local establishment subject to local regulatory prerogatives (and with no commitment to recognise the equivalence of home state supervision).

In addition, bilateral and multilateral trade agreements generally allow states a broad discretion to regulate for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom fiduciary duties are owed by financial services suppliers, or to ensure the integrity and stability of the financial system ('prudential carve-out'), even if this has an impact on the market access of non-resident firms.

Regulatory equivalence

Third country status removes the assumption of regulatory equivalence that is broadly embedded in EU financial services frameworks. Instead, UKbased banks (and EU banks trading in the other direction) would have to rely on particular 'third country regimes' created under UK law or established in bilateral agreements which recognise close alignment in rules as the basis for market privileges or rights. This is important in banking because the intra-EU framework for banking is based on the assumed equivalence of EU legislation, and this condition limits host regulators in the EU with respect to the requirements that they may make of banks operating and branching between EU states. In contrast, there are significant national restrictions in many EU Member States on the extent to which third country banks can provide cross-border services to local customers and counterparties. At present there are only limited EU 'third country regimes' allowing third country banks access even where they are from equivalent jurisdictions. While many EU Member States do allow non-EU banks to establish local branches, they can impose significant regulatory and capital requirements on those branches and those branches do not generally benefit from rights to provide services into other Member States.

Regulatory cooperation

Third country status ends the binding institutionalised relationships between UK regulators and regulators across the EU27 as well as with the ESAs, the European Central Bank ('ECB') and the Single Resolution Board ('SRB').

EU financial sector legislation imposes an extensive range of obligations on national and EU authorities requiring them to share information and co-operate in the supervision (and resolution) of financial institutions. In some cases, the EU legislation will provide for the establishment of formal colleges of regulators through which EU regulators cooperate in the supervision of particular institutions under binding rules. In contrast, with respect to third countries, EU authorities have to rely on non-binding cooperation arrangements (including arrangements for regulatory colleges) which have to be agreed on a case-by-case basis with third country regulators. In many cases, it is necessary to put agreements of this kind in place before third country firms can obtain access to the EU under third country regimes created by EU legislation.

Treaty freedoms

Third country status ends the freedoms conferred by the EU treaties on UK and other EU nationals, notably the right of free movement of labour, as between the UK and the EU27. The movement of skilled workers between the banking sectors of the two markets would instead be governed by domestic migration policy on both sides, and potentially numerical quotas or other forms of restriction.

Single market frameworks

Leaving the EU would place UK-domiciled companies outside the single market for data with no automatic legal framework for moving customer data between the EU27 and the UK

Third country status removes the UK from a number of frameworks that cover cross-border business activities in the EU. In particular, leaving the EU would place UK-domiciled companies outside the single market for data with no automatic legal framework for moving customer data between the EU27 and the UK for storing or processing data. In this and other areas alternative arrangements would be required to replace the legal framework provided by the existing EU regimes. Further down the line it could also place the UK outside of the Single Euro Payments Area ('SEPA'). SEPA increases the efficiency and reduces the cost of cross-border payments in euros.

Third country status also puts at risk access to TARGET2 (interbank RTGS payment system for the clearing of cross-border transfers) and EURO1 (large-value payment system for single, same-day euro transactions at a pan-European level).

Protection from discrimination

Third country status places the UK outside the protection of the general principles of the EU Treaties that prohibit discrimination between Member States as enforced by the European Court of Justice ('ECJ') (as well as the specific agreements on non-discrimination reached in the context of other Council and EU agreements). The most obvious example of the UK benefiting from this protection was the rejection of the ECB's clearing location policy by the ECJ when it said that the market infrastructure for euro or euro-denominated central counterparty ('CCP') clearing and settlement did not need to be located within the euro area.

It is likely that any long-term bilateral agreement between the UK and the EU27 would only provide limited protection against requirements for the location in the EU27 of clearing services (for example) currently operated by entities in the UK or other similar action (in particular because any such agreement is likely to contain a prudential carve-out).

Third country trade agreements

Third country status removes the UK from the network of trade preferences created by the EU's system of FTAs and from any other advantages conferred by the EU common commercial policy (including the arrangements with the EEA-EFTA States). The UK outside the EU will be free to negotiate its own bilateral trade agreements, but UK-based firms may lose the existing preferential terms negotiated for the UK as part of the EU, such as the arrangements negotiated with the US authorities with respect to EU CCPs discussed in Chapter 4 below.

International standards

Third country status in principle returns to the UK a level of potential autonomy in some aspects of financial services regulation. However, this would be subject to the international standards set by bodies such as the Financial Stability Board, the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Accounting Standards Board. In addition, it would be subject to any decision to maintain mutual recognition with the EU27 and others to facilitate market access.

Box 2: What is the General Agreement on Trade in Services?

The GATS is a WTO agreement that covers the trade in services, including banking and financial services. Like other WTO market access agreements it acts principally to bind WTO Members to guarantee levels of market access and non-discriminatory treatment for businesses from other WTO members. WTO members can chose what services they put in their GATS 'schedule', but once they have defined market access rights in this way, they are bound to provide them and constrained in their freedom to revise them. GATS signatories are also obliged to treat all other GATS signatories in an equivalent way, unless two GATS signatories have signed a comprehensive bilateral agreement that deepens trade liberalisation between them materially across a wide range of sectors.

If the UK and the EU27 were to become third countries with respect to each other, trade in services between them would, in the first instance, be governed by their respective GATS schedules. The EU GATS schedule (which presently includes the UK) provides access to banking services markets for banks willing to establish a commercial presence inside the EU in the form of a branch or subsidiary; it is more restrictive in allowing crossborder trade into the EU for financial services, often for prudential reasons. In principle, the EU and the UK could improve on these 'basic' GATS rights in a bilateral agreement. The UK might be expected to adopt the EU GATS schedule subject to confirmation of its new trade profile in the WTO, as this is its current external framework (but see the discussion in Chapter 4 below).

The GATS Understanding on Commitments in Financial Services also includes an important qualification to the rights extended as part of the wider GATS framework. This establishes the principle that states may treat branches of third country banks differently in prudential terms from branches of domestic ones, and may impose any prudential conditions on their operation that they judge proportionate in prudential terms. EU regulators may, however, choose to recognise the supervisory standards of a home state as equivalent to EU standards (but EU legislation prevents them treating a non-EU bank more favourably than an EU bank). Agreement on such recognition would be an important part of the transition from a regime in which branches of UK and EU27-based banks in the others' market benefit from 'passport' rights to one in which they were governed by GATS terms.

The decision to leave the single market

Notwithstanding the issues set out above, the EEA option needs careful consideration from the point of view of the UK's future opportunities in the EU market and the rights of EU businesses to trade in the UK. It would objectively minimise the economic impact on trade that would follow from a UK exit from the EU, while establishing a degree of new autonomy from the EU in some areas. From the perspective of preserving the operational rights of UK-based banks in the EU and the ability of EU businesses and customers to be served from the UK, remaining closely integrated into the EU single market provides guarantees of operational freedom that are not available for third countries. However, as noted, this may come at a price that is unacceptable to the UK.

In any event, the line between EEA membership and the choice of third country status is the most material for commercial interaction between the UK and the EU, and the decision to cross it should be done deliberatively and in recognition of the implications. Only with this in mind does the scale of the task required to minimise disruption to businesses and customers in a UK transition to third country status become clear.

3. The UK as a third country: Possible mitigants

For the banking sector, the primary mitigants to the disruption caused by rolling back of market access rights implied by a reversion to third country status lie in the scope for UK-based firms to build on the market access or operational freedoms already accepted in existing 'third country regimes' in EU legislation, and to augment these rights with an ambitious and far-reaching bilateral free trade agreement that covers financial services in a material way. These could re-establish, to some degree, and in some cases a weaker form, the cross-border rights created under the EU treaties for EU-domiciled businesses.

The EU's existing third country regimes

Most key EU financial services regulatory regimes do not currently have third country equivalents for the passporting regimes established for EU and EEA states. The Capital Requirements Directive ('CRD') regime for banking, UCITS regime for asset management, Payment Services Directive regime for payments and Insurance Distribution Directive regime for insurance sales are all examples of EU areas of regulation for which passporting rights are an integral part of the single market framework, but for which no third country rights exist.

Third country regimes do exist and establish a useful principle of reciprocal third country market access privileges under certain terms

However, a number of existing third country regimes do exist and establish a useful principle of reciprocal third country market access privileges under certain terms. These regimes are usually structured so as to allow access for firms that are authorised in a third country that has been determined by the European Commission to have a regulatory regime that is 'equivalent' to that in the EU, and to have an effective equivalent reciprocal mechanism for access by EU and other foreign firms (see Box 3, below).

In addition, these regimes will often only be available if the relevant supervisor in the third country has entered into a regulatory cooperation agreement with the relevant Member State or EU authority. In other cases, third country regimes relieve EU firms from restrictions or requirements that would otherwise affect their ability to engage in transactions with non-EU entities or otherwise equalise the treatment of cross-border business with a non-EU element, but only where the relevant non-EU jurisdiction is assessed to have an 'equivalent' regulatory regime to that in the EU. Three key regimes are set out below.

The Markets in Financial Instruments Regulation

The new Markets in Financial Instruments Regulation ('MiFIR') – expected to take effect in January 2018 – contains provisions under which non-EU firms authorised in an equivalent third country can provide investment services covered by the new Markets in Financial Instruments Directive ('MiFID II') to wholesale counterparties and professional customers (but not retail customers) in the EU.

MiFID II covers a range of services related to securities, funds, derivatives and emission allowances, including trade execution, portfolio management, investment advice, underwriting and placing of new issues and operation of trading facilities, as well as ancillary services such as custody, credit and foreign exchange services, corporate finance advice and investment research. Qualifying third country firms can provide these services cross-border from outside the EU (or from branches in an EU Member State which has adopted optional provisions in MiFID II for regulating EU branches of third country investment firms), subject to registration with the European Securities and Markets Authority ('ESMA') and to compliance with certain specified EU rules.

However, the MiFID II third country framework does not fully replicate the services covered by the EU MiFID passport – for example, it does not cover remote access to trading venues. The third country framework also applies only to firms with their headquarters outside the EU, so it may have limited mitigating value for EU firms with operations in the UK looking to service the single market from the UK. Moreover, it would need to be resolved at what point, and on what basis, the UK could trigger an Article 46 MiFID request for mutual recognition, and whether it must be outside the EU to do this. In this respect transitional arrangements (see below) may be critical in minimising unnecessary disruption. It would also need to be considered whether it would be preferable to secure a market access arrangement for these services via a bespoke EU-UK bilateral agreement.

The European Market Infrastructure Regulation

The European Market Infrastructure Regulation ('EMIR') provides a mechanism under which ESMA can grant recognition to non-EU CCPs and trade repositories authorised in equivalent jurisdictions[3]. EU firms subject to clearing and reporting obligations under EMIR must use EU authorised or recognised third country CCPs and repositories and EU banks and investment firms face significantly higher capital charges where they or their consolidated subsidiaries clear transactions on CCPs that are not authorised or recognised under EMIR. UK-based CCPs are currently authorised under EMIR, but would have to be newly recognised under this mechanism when the UK leaves the EU, in particular if they wish to continue to provide clearing services to EU27 clearing members.

The Data Protection Directive

The Data Protection Directive gives the European Commission the power to determine whether a third country ensures an adequate level of protection by reason of its domestic law or of the international commitments it has entered into. The effect of such a decision is that personal data can flow from EU and EEA Member States without any further safeguards. The Commission has recognised a number of third countries under these powers (including Argentina and Jersey). In addition, the Commission has approved a set of model contract clauses that can be used to legitimise transfers to organisations in countries not deemed adequate and has approved a new EU-US Privacy Shield to legitimise transfers to organisations in the US who sign up to the requirements of the Shield (although both these are subject to potential legal challenge). The new General Data Protection Regulation that will replace this directive will further regulate the way in which the European Commission makes these decisions.

[3] repositories, there must also be a treaty in place between the EU and the third country on exchange of information.

Box 3: What is equivalence?

EU and Member State financial services legislation contain some provisions treating non-EU firms in a similar way to EU firms (or applying fewer regulatory burdens to EU firms entering into transactions with non- EU persons or with another non-EU element) where the regulatory and supervisory standards of the relevant non-EU jurisdiction are regarded as being 'equivalent' in key respects to those of the EU. For example, the resulting treatment may involve enhanced market access for non-EU firms operating cross-border into the EU, less burdensome local regulatory requirements for branches of non-EU firms within the EU, recognition of market infrastructure in third countries for EU firms meeting their EU clearing and reporting requirements, fewer restrictions on transfers of personal data to the third country and lower capital requirements for EU firms with financial exposures to third country entities.

In these cases, EU and national legislation provides mechanisms for recognising that, where non-EU states have equivalent regulatory and supervisory standards to those in the EU, it is appropriate to rely on the enforcement of those standards, instead of the EU (or the Member State) seeking to apply its own requirements or imposing restrictions on the transactions concerned.

These mechanisms in some cases provide for unilateral recognition of the equivalence of non-EU regulation and supervision. In other cases, it is a condition of recognition that the relevant non-EU state has an effective equivalent mechanism for recognising the equivalence of EU regulation and supervision or the implementation of the mechanism may be explicitly contingent on mutual recognition. EU legislation generally requires that the European Commission makes the determination of equivalence, but in some cases this may be left to Member States or their national regulators.

EU authorities generally assess the equivalence of the regulatory and supervisory arrangements of a non-EU state using an outcomes-based approach. This means that the rules in the non-EU state achieve the same objectives as the corresponding EU rules. It does not mean that identical rules are required to be in place in that state.

Even when equivalence has been recognised, neither side is committed or obliged to leave rules unchanged or mirror changes in the rules of the other party – the discretion to change rules remains, subject to the acknowledgement that market access or operational privileges may be lost as a result. As a consequence rights based upon equivalence may have an inherent risk of fragility as they can be withdrawn suddenly if a party considers that the other party's regulatory regime no longer provides a sufficiently comparable outcome.

Equivalence or similar forms of mutual recognition will potentially play an important part in trade in financial services between the EU and the UK following the exit of the UK from the EU. The willingness of the UK and the EU27 to recognise each other's standards as equivalent could underpin certain market access rights and forms of preferential treatment of banks in the UK and EU27.

Figure 4: What is equivalence?

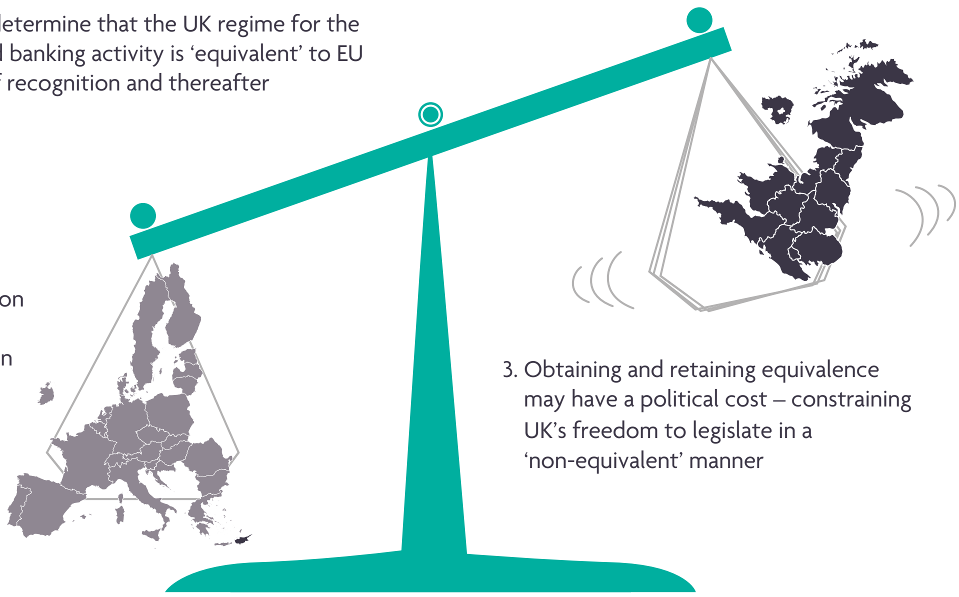
How can equivalence help?

‘Equivalence’ may sometimes provide an alternative for a UK based bank without ‘passport rights’

Recognition as ‘equivalent’ typically conveys broader rights than a country licence but is narrower than a passport

But...

1. EU must determine that the UK regime for the requested banking activity is ‘equivalent’ to EU at time of recognition and thereafter



2. Recognition can be withdrawn

3. Obtaining and retaining equivalence may have a political cost – constraining UK’s freedom to legislate in a ‘non-equivalent’ manner

New market access rights beyond existing third country regimes

The EU and the UK could explore the option of extending the scope of market access rights based on mutual recognition into other areas where third country rights at the EU level do not currently exist. Such agreements would be preferential for the UK and the EU, so would need to be embedded in or agreed alongside a free trade agreement or similar broadbased trade agreement. The precedent established by the existing EU third country regimes is important one: suggesting the possibility that it should be possible to agree market access in some cases based not on a single rulebook, but on the basis that the two systems are so closely aligned as to provide regulators on both sides with a very high level of confidence in the standards that govern and discipline the firms permitted to trade.

No two markets are as closely aligned in banking standards as the EU27 and the UK

The EU has in fact signed a similar agreement with Switzerland in the area of non-life insurance (see Box 4, below). This creates rights for Swiss insurers to operate branches inside the EU as if they were EEA firms. In return, Switzerland commits to maintain regulatory standards equivalent to those of the EU. This is a precedent that the UK and the EU should explore, reflecting the unique level of alignment in the two sides' regulatory approaches.

Such agreements between the EU and the UK could be based on a range of different approaches to mutual recognition. As with the current third country regime for MIFID, they could be established on the basis of formal equivalence agreements between the two sides. But they could also be based on other forms of mutually agreed understanding that firms from each market operate at similarly high and robust standards. This would be perhaps easiest to agree in areas such as corporate banking or the provision of certain services to professional investors. But it could also be explored in other areas such as asset management, payments services or other banking services.

While it is true that this would break new ground in trade policy terms, there are in most respects no two markets as closely aligned in banking standards in the global economy as the EU27 and the UK. Regulators will inevitably be cautious about extending cross-border market access to firms from outside their regulatory jurisdiction, but reciprocal rights, an initial focus on areas serving professional and corporate clients and close cooperation between regulators could all help to mitigate this, along with various forms of agreement to closely align and consult on standards.

There would be no question of either side retaining market access while allowing regulatory standards to drift or fall below a high joint standard – this would be policed by mutual recognition and perhaps formal equivalence in some cases. But a pragmatic and constructive approach could help keep vital services available to businesses and other customers.

A bilateral agreement should also be used to ensure that these reciprocal rights cannot be removed without due consultation and warning. This is important, because businesses and customers relying on these conditional rights need some confidence that they cannot be withdrawn suddenly or without warning. Rights of consultation of future rules would also be important.

Vehicles for mitigants

There are three main vehicles by which the UK and EU27 might implement mitigants like those noted above to minimise disruption to business following a UK transition to third country status.

Withdrawal agreement

The UK government may seek to agree and implement appropriate mitigants as part of the withdrawal agreement under Article 50 of the Treaty on European Union. Such an agreement could avoid abrupt changes to the regulatory and business environment at the point of exit. However, there are limits to what can be done under a withdrawal agreement.

Bilateral agreement

The market access and other privileges created by the agreements between the EU and Switzerland are contingent on commitments that the UK may find politically difficult to accept

The future relationship between the EU and the UK will likely be based on a bilateral agreement of some kind. At the core of this agreement will be a comprehensive FTA or similar agreement that will establish the preferential trading arrangements between the two markets in a way that is compatible with Article 24 of the GATT and Article 5 of the GATS. The agreement may be extended to include other thematic areas of political cooperation similar to the EU's Neighbourhood Policy or could be augmented over time with a series of additional flanking agreements in others areas similar to those that make up the wide ranging treaty architecture of the EU-Switzerland relationship. However, it needs to be recognised that the market access and other privileges created by the agreements between the EU and Switzerland are contingent on commitments in areas such as contributions to the EU budget and freedom of movement that the UK may find politically difficult to accept. The EU itself also has problems with the Swiss approach, seeing it as lacking coherence and being difficult to enforce. Nevertheless, it is important and inevitable that such agreements are the core of the future EU-UK relationship.

It is possible that negotiations on a bilateral agreement could begin in parallel with the Article 50 process. However, there are potentially constraints on such negotiations under Article 218 of the Treaty on the Functioning of the European Union as the Treaty only provides a process for negotiating and concluding an agreement with a third country. This can be taken at this stage to mean that negotiations could only proceed on an informal basis before the UK leaves the EU. There is no obvious legal basis for a wider bilateral agreement being reached and ratified contemporaneously with the withdrawal agreement (without an amendment to the Treaties).

Unless political agreement on the question of negotiating two agreements in parallel can be found, the UK and EU27 would need to agree appropriate transitional and other arrangements in the withdrawal agreement in order to bridge the gap to the conclusion and ratification of the bilateral agreement to avoid unnecessary disruption to business and financial market volatility.

Standalone solutions

The activation of third country regimes that already exist does not need to be embedded in a bilateral agreement, or agreed as part of a withdrawal agreement package, and can in principle be done at any time after the UK has left the EU. However, this could result in disruption to business during the gap pending the new arrangements being activated, unless this can be achieved during a transitional period negotiated under the withdrawal agreement.

Recommendation 1: A transitional period

The withdrawal agreement should include an appropriate transitional period under which the UK and EU27 will allow existing business to continue for a specified period broadly under current arrangements. This period should be long enough to allow firms to make and implement plans for alternative arrangements for their business, and for regulators to establish alternative regulatory arrangements in respect of cross-border business. It must also be long enough to allow for the activation of any third country regimes that are not immediately activated and provide an adequate opportunity to negotiate and conclude a bilateral agreement that addresses a long-term framework.

The starting point for negotiation should be a transitional period of several years after the date the withdrawal agreement comes into force

The starting point for negotiation should be a transitional period of several years after the date the withdrawal agreement comes into force during which existing businesses are able to continue to do business under the current arrangements.

An important driver of the transitional period requirement is the necessity of ensuring continuing effective regulation of the European financial markets. A substantial body of regulatory reporting requirements, and in many cases reporting (and in some cases supervision) is direct to and by EU27 authorities. It is essential that authorities co-operate to build reporting systems and reporting requirements which continue to deliver sufficient systemic transparency.

Also, these systems are an integral part of the way in which firms run their operations, and significant changes to this regulatory framework would require equally significant changes to firm's own systems. Finally, in order to avoid unintended adverse impacts on banks' financial structures and lending capacities, there should be no 'jump' in capital requirements applying to UK/EU27 intra-bank exposures, and this implies that the transitional period should not end until at least bank capital regulation is deemed to be equivalent.

Importantly, the parties would need to respect Article 24 of the GATT and Article 5 of the GATS when constructing these transitional arrangements. This means the UK could only be given preferential trade treatment as part of a comprehensive trade deal agreed as a single undertaking. Time-limited transitional arrangements that are intended to anticipate the likely scope and content of the final bilateral agreement may be consistent with these constraints. Finding a legal solution that allows a smooth transition to a new bilateral agreement would be in the political, commercial and economic interests of both the UK and the EU27.

Box 4: Transitional arrangements in the Switzerland-EU agreement on market access for insurance businesses

The Swiss-EU agreement on market access for direct (non-life) insurance businesses provides an example of such a transitional arrangement. This agreement provides a mutual recognition framework under which Swiss insurance companies can establish branches in the EU without being subject to full EU prudential requirements while EU insurance companies can establish branches in Switzerland without being subject to full Swiss requirements. Either party can terminate the agreement by one year's notice, following which there is a further one year transitional period. During that transitional period, existing branches can continue to operate under the regime established by the agreement and only at the end of that period will the country in which the branch is located be able to apply the full set of rules applicable to branches of other third country insurers to such entities.

The EU27 may stipulate that UKbased firms would not benefit from the full length of the transitional period unless UK regulation continues to be equivalent to EU rules

In contrast to the one year period contained in the Switzerland-EU agreement on market access for insurance businesses (See Box 4, above), the exit of the UK from the EU is likely to require a much longer transitional period than one year, given the range and scale of affected businesses in both the UK and the EU27 and the significant challenges for both UK and EU27 supervisors. For example, EU27 supervisors would need to adapt their supervision of large numbers of branches and subsidiaries of UK-based banks to reflect the new relationship with the UK. Similarly, UK supervisors would need to adapt their supervision of large numbers of branches and subsidiaries of EU27-based banks to reflect the new relationship. It may also be appropriate to agree different transitional periods for different purposes.

The UK and the EU27 may consider subjecting transitional periods of this kind to conditions, at least if the transitional period is lengthy. For example, the EU27 may want to provide that UK-based firms would not benefit from the full length of the transitional period unless UK legislation and regulation continues to be equivalent to relevant EU rules. Similarly, the UK may want to provide that EU27-based firms should lose the benefit of the full length of the transitional period if EU27 or relevant national legislation ceases to be equivalent to UK legislation during that period. In any event, neither party is likely to accept continued access by firms that are not authorised or regulated in an appropriate way.

There is a risk that any transitional period might be viewed as a new preferential arrangement for recognising the prudential arrangements of another country contrary to the general GATS (and GATT) principle that preferential treatment may only be extended bilaterally between WTO members on the basis of comprehensive FTAs.

In addition, the GATS Annex on Financial Services requires WTO members creating new recognition arrangements (outside a comprehensive FTA) to afford other interested WTO members an adequate opportunity to negotiate their own accession to the arrangement, or to negotiate comparable arrangements.

However, the UK and the EU27 may argue that, if the transitional period is limited to existing firms benefiting from the previous EU arrangements, these are arrangements that cannot be made available to other countries (in any event, it may be difficult to justify extending transitional periods to firms that did not benefit from the privileges of EU membership). In addition, the UK and the EU27 may argue that, so long as these arrangements are strictly limited in time to what is necessary for the UK to disengage from the EU (and to negotiate an alternative bilateral framework), they are compatible with the GATS as they can still be seen as part of a comprehensive agreement compliant with the GATS. They may argue that if such an agreement can provide transitional provisions at the outset of the agreement, it also can provide for transitional provisions at its termination, dealing with the unwinding of the relationship between the parties.

The UK could also consider seeking 'grandfathering' arrangements in appropriate cases, i.e. arrangements that allow existing treatment to continue indefinitely notwithstanding the UK exit from the EU. However, it is likely to be more difficult to agree such arrangements and more difficult to justify them under the GATS.

Recommendation 2: Regulatory cooperation

In parallel with the negotiations on withdrawal, the UK authorities should seek to establish cooperation arrangements with Member State regulators and EU authorities (most importantly, the ESAs, the ECB and the SRB) to replace the institutionalised relationship that exists under EU legislation. These arrangements will address matters such as exchanges of information, confidentiality of supervisory information and coordination and mutual assistance with respect to supervision, inspection and enforcement.

It will be important that, so far as possible, these are agreed before the UK leaves the EU, to take effect when the UK leaves the EU. However, the non-binding nature of these arrangements may affect the way in which the UK and EU27 authorities cooperate and the extent to which the parties are willing to rely on each other in relation to supervision.

The establishment of cooperation arrangements will be essential in order for UKbased firms to take advantage of third country regimes

In addition, the UK regulators may have to establish or join new supervisory colleges of regulators for particular firms and groups. Colleges are an important way in which groups of regulators cooperate in the supervision of particular institutions or groups which operate in different jurisdictions. EU legislation requires the establishment of colleges of regulators and colleges of resolution authorities for certain institutions and groups that operate across the EU. However, this legislation does not regulate relationships with regulators in non-EU jurisdictions where firms or groups operate both in the EU and in non-EU jurisdictions. Where firms or groups operate in the UK and the EU27, UK regulators and resolution authorities will need to consider whether it is necessary to create new colleges or change the composition of existing colleges of international regulators to reflect the UK's new status.

Although these are matters for regulators, they will be critical to firms as they will affect the extent to which regulators will be prepared to defer to home state supervision. In many cases, the establishment of cooperation arrangements will be essential in order for UK-based firms to take advantage of third country regimes such as those mentioned above (and in some cases the relevant EU legislation may specify the required contents of those agreements).

The parties should consider formalising at least some elements of these cooperation arrangements in the withdrawal agreement and the eventual bilateral agreement between the UK and the EU27. For example, EMIR envisages that the EU should enter into international agreements with third countries regarding mutual access to, and exchange of information on, derivative contracts held in trade repositories. Including provisions on regulatory cooperation in the withdrawal agreement and the bilateral agreement between the UK and the EU27 may support other arrangements in that agreement on continued market access for UK and EU27 firms. The agreements could create a formal framework for regulatory dialogue and a formal dispute resolution process to address issues that arise in the implementation of the agreements.

In the area of prudential supervision of banking and investment firms, it will also be important that the UK and key EU27 regulators recognise the equivalence of each other's regulatory framework and supervisory approach to the extent permitted under EU legislation. This will be critical to the ongoing effective supervision of branches and subsidiaries of UKbased firms in EU27 countries (and of EU27 firms in the UK).

Underlying the question of regulatory cooperation is the basic point that it will be of considerable importance for cross-border trade that the EU and UK regimes continue to advance as much as possible in alignment. Market access arrangements based on mutual recognition place a considerable obligation on policymakers on both sides to work collaboratively and transparently.

Recommendation 3: Activation of third country regimes

The withdrawal agreement should include provisions activating appropriate existing third country regimes under EU legislation

Unless it is anticipated that such rights are to be covered by a bilateral agreement and covered by transitional provisions, the withdrawal agreement should include provisions activating appropriate existing third country regimes under EU legislation with respect to the UK (and activating with respect to the EU27 the analogues to those regimes that may be created under UK legislation) with effect from the date that the withdrawal agreement enters into force. This would address the concerns about disruptions to business if these arrangements are only activated after the UK has left the EU or after the expiry of the relevant transitional period in the withdrawal agreement.

For example, it would mean that firms authorised in the UK would continue to be able to provide investment services such as custody or investment advice to wholesale clients in the EU27 under MiFIR even after the expiry of the transitional period. This would avoid them facing a period when they might have to cease providing those services pending the activation of the MiFIR regime for third country firms by an appropriate Commission decision on the equivalence of the UK regulatory regime.

The mechanism for doing this would depend on the structure of the third country regime. However, in most cases, it would at least involve an agreement by the EU27 to regard the UK as having sufficiently aligned in its regulatory regime for the purposes of the relevant EU third country regime (and a corresponding agreement by the UK with respect to the EU27 regime). The commonality of the two systems should make it possible to agree that the regimes meet this criteria relatively easily. However, the UK may need to commit to take appropriate steps before the withdrawal agreement comes into force to maintain the existing regulatory regime notwithstanding the exit of the UK from the EU. This agreement may also need to be coupled with a framework to deal with evolution of EU law in the gap between signing of the withdrawal agreement and the date it comes into force (which may involve some commitment on the part of the UK to transpose legislation adopted in that period).

It might be argued that, if the EU27 gives the UK expedited equivalence treatment (and the UK gives corresponding treatment to the EU27), this is preferential treatment to other applicants for equivalence contrary to the GATS Annex on Financial Services. However an agreement to confer on the UK third country equivalence already available to others would be unlikely to breach this condition even if the process is somewhat different, as the Annex on Financial Services only requires a member to give other countries a right to negotiate comparable arrangements.

As a general matter, to avoid a WTO challenge it would probably be important to ensure that the withdrawal agreement does not create narrowly-based new preferential access for the UK (or vice versa). New forms of equivalence-based reciprocal trading rights could be addressed in WTO-compatible bilateral agreements.

Recommendation 4: New market access privileges via a bilateral agreement

Gaps in existing third country regimes should be addressed by a bilateral agreement

An ambitious and far-reaching bilateral agreement should extend the scope of mutual recognition based cross-border market access rights, via a bilateral treaty, in a way that replicates the existing passport or other rights of firms under the current EU legislative framework.

This could address gaps in the access given to third countries under existing EU third country regimes. For example, the CRD does not contain a regime under which third country banks can provide cross-border banking services (such as deposit taking, lending and payment services) to EU customers, even to corporate or business customers and even when the third country state has a closely aligned regulatory framework.

A new arrangement could enable UK-based banks to continue to provide these banking services to EU27 businesses and customers and vice versa. Similar agreements could be considered in other areas, including in payments or asset management services.

These would be based on a recognition that the EU27 and the EU operate regulatory regimes at a similar level of robustness, based on a shared set of principles, often codified at the G20 level.

These arrangements would probably need to be conditional on the continued mutual recognition of regulation and appropriate regulatory cooperation arrangements and would need to be reciprocal. They would be underpinned by close regulatory cooperation, including consultation rights on regulation. These arrangements would go significantly beyond conventional FTAs or indeed any existing bilateral agreement between countries. However this would be a reflection of the fact that the UK and the EU are as closely aligned as any two jurisdictions in the world. Maintaining these forms of preferential treatment would affect the legislative and regulatory freedom of the parties in ways that may not be politically acceptable to either party following the UK's exit from the EU. However, the Swiss experience – which includes a similar bilateral agreement in non-life insurance – reinforces that they should not be ruled out.

This close link to regulatory standards also means that the parties may not be willing to agree that these market access arrangements will have a life defined by the overall life of the bilateral agreement and may wish to be able to bring them to an end independently of the bilateral agreement as a whole (in a similar way to the EU-Swiss agreement on direct non-life insurance).

Recommendation 5: Protecting reciprocal third country privileges

Firms will require certainty that mutual recognition endures

Where the EU27 has activated third country regimes under EU legislation (e.g. under MiFIR, EMIR or the data protection legislation), or where an EU-UK bilateral agreement had created new preferential access in certain areas, an EU-UK bilateral agreement should protect these in certain ways. It could create a framework such that neither side can withdraw or amend those regimes or mutual recognition determinations without prior notice and consultation, and subject to appropriate dispute settlement mechanisms.

It could also create mechanisms and rights of consultation on new laws. The EU27 would likely expect similar treatment from the UK with respect to any analogous regimes under UK law. These arrangements would enhance the certainty that mutual recognition is firmly and durably based and would be an important mitigation to the inevitable concern that equivalence is contingent and can be withdrawn or lost.

Would these mitigants impose unacceptable political constraints on the EU and the UK?

As noted above, there is an unavoidable element of compromise in these approaches for both sides.

For the UK

The UK would likely need to be willing to provide EU27 counterparts with clear commitments that, in the period before the agreement comes into force and where relevant to mutual recognition judgements, the UK will legislate to confirm standards currently in the legislative pipeline or requiring transposition from directly effective EU law. Where equivalence is relevant, the UK would also likely need clearly to communicate that the UK regulatory framework will not change in the relevant areas pending the confirmation of equivalence, if this has been provided conditionally. The UK government and UK regulators will facilitate negotiations if their strategy is to keep the existing regulatory framework substantively unchanged with – at most – clearly identified, limited, targeted amendments, leaving the evolution of the regulatory framework to future governments and future regulatory action. This will likely also be required as part of any package securing a transitional arrangement.

In addition, EU27 negotiators will want to know whether the UK will provide treatment for EU27 firms operating in the UK which reciprocates the treatment for UK-based firms that the UK government is seeking from the EU27. This will require the UK to define how it will apply its rules to cross-border business between the EU27 and the UK, in particular how it will apply – vis-a-vis the EU27 – the third country regimes that the UK would retain if it maintains the existing EU regulatory framework as part of UK law.

Is this an acceptable situation for a UK seeking to re-establish an element of autonomy over its rule-making on leaving the EU? Ultimately this is a question for the UK Parliament to answer. It is important to note that the alignment and mutual recognition of standards required to secure equivalence as currently defined by the EU, while rigorous in some areas is not the same as transposing EU law – it is a question of judging the closeness in intent and outcome of two sets of rules. Other forms of mutual recognition are less prescriptive. Some form of alignment with export market standards is an integral part of almost all trade, especially in regulated goods and services.

However, the UK and the EU27 would both retain the discretion to develop and change their respective legal and regulatory frameworks after the agreement comes into force, and can chose to diverge materially at any point if they wish, subject to the loss of market access rights.

For the EU27

For the EU27, in the immediate term, the possible migration of the UK to existing third country mutual recognition regimes simply offers to the UK rights that are broadly available to any state able to meet the requirements of mutual recognition. Even the additional mitigants proposed as part of a potential future bilateral agreement, while possibly going further than the EU has with any other trading partner in some areas, would be reciprocal and based on mutual acceptance of robust standards. They would also fall short of the current operational freedoms in place between the UK and the EU for banks – a fact that should be recalled by any EU states inclined to ensure that a UK exit does not in any way 'reward' the UK.

Table 3: Summary of recommendations for managing a transition to third country status for the UK	
UK	
The UK government should not trigger Article 50 precipitously	While it is clearly important to respect voters' decision to leave the EU, and for EU partners to have a clear sense of UK intentions, the UK should only initiate the formal exit process with a clear view of what it seeks to achieve.
The UK government should signal a willingness to maintain legislative stability to the extent necessary to facilitate equivalence discussions in key areas	Successful negotiation on expediting mutual recognition-based market access in the EU for UK-based banks will depend on a willingness by UK policymakers to signal that during the course of the negotiation and any subsequent assessment period the UK will commit to not revising legislative frameworks relevant to equivalence. Such commitments would not bind the UK beyond this, subject to the desire to maintain mutual recognition where it chose.
UK and EU27 – Withdrawal agreement	
Agree an adequate transitional period and status for the UK	The limited scope for a withdrawal agreement under Article 50 to address adequately all business continuity issues means that it will be important that the withdrawal agreement establishes transitional arrangements in which existing firms can continue to do business cross-border or through branches, subject to the parties maintaining equivalent legislative and regulatory frameworks. A sufficiently firm public commitment to this principle made by all parties at an early stage could reduce the risk of precipitate business relocation decisions in both directions and potential impacts on market and financial stability. An appropriate transitional period after the withdrawal agreement comes into effect would also provide time during which the UK and the EU27 could agree a bilateral agreement regulating their long-term relationship.
Design new regulatory cooperation mechanisms, especially for prudential supervision	UK and EU regulators should aim to establish new cooperation arrangements (including arrangements for regulatory colleges) to replace current EU frameworks and underpin the granting of equivalence-based market access rights. EU and UK regulators should recognise the equivalence of each other's banking regulatory frameworks for the purposes of assessing prudential requirements for branches and subsidiaries in each market.
Consider provisions to activate existing third country regimes under EU legislation with effect from the date that the UK leaves the EU	This would migrate the UK to the small number of existing third country market access or operational frameworks in an expedited way to minimise the disruptive impacts the limited services covered under these frameworks for firms trading between the two markets. It would secure for UK-based firms reciprocal rights that the UK would be eligible for in any case as a third country and could be expected to seek.
UK-EU27 data protection adequacy agreement	The UK and the EU27 should expedite agreement that their respective regimes provide adequate levels of data protection for the purposes of their data protection legislation. This should remove the prospect of a highly disruptive 'gap' during which businesses transferring client and/or employee data cross-border (in either direction) would have to implement additional safeguards (e.g. entering into a seriel of model contracts).

UK and EU27 – Bilateral agreement	
Additional mutual recognition-based market access rights between the UK and the EU27	An ambitious and far-reaching bilateral agreement provides the vehicle for establishing deeper financial services trade between the UK and the EU27 than would be available under a GATSonly regime and the extension of the current equivalence-based market access rights for third countries. The UK-EU27 bilateral agreement should contain provisions granting cross-border market access in other areas such as banking services, subject to the parties maintaining equivalent legislative and regulatory frameworks. It could also develop bespoke versions of the existing EU third country regimes. The UK and the EU27 should actively consider the scope for these freedoms to extend into areas such as corporate and retail banking, reflecting the high and closely aligned standards of supervision and regulation on both sides.
Enhanced protections for equivalence-based market access rights	The UK-EU27 bilateral agreement should contain provisions protecting third country rights granted to each other from unilateral amendment or withdrawal without prior notice and consultation. It should also create rights of consultation on new rules.

4. The UK as a third country: Relations with non-EU markets

The UK is a major global market for financial services and a large exporter of banking services. Firms and individuals from around the world transact business in the UK or with UK-based firms. The terms on which they do so reflect both UK and third country law, but also EU frameworks. The exit of the UK from the EU will affect the UK's relationship with countries other than the EU27 in a number of ways and these will be relevant for banking services. These impacts can be categorised in four basic ways:

- The UK will need to establish and confirm the general terms on which third country firms or individuals can transact, operate or establish in the UK;
- The UK will need to consider how to re-secure any preferential terms lost for UK-based businesses 'withdrawn' from the scope of EU Free Trade Agreements ('FTAs') by the UK's exit from the EU Common Commercial Policy;
- The UK will need to establish its own approach to third country equivalence and mutual recognition and the market access rights based upon it, both for regulated activities and activities requiring an overarching legal framework such as cross-border data transfer; and
- The UK will need to negotiate exit from the EEA and the terms of market access for trade by EFTA states.

The UK's external profile for services trade

The UK will need to re-establish its own position in the WTO

As a first step, the UK will need to re-establish its own position in the WTO. This is not straightforward as the UK's current WTO commitments are made through the EU. The WTO has no established protocol for 'reconfirming' the status of an existing GATT or GATS signatory after a change in its legal form of membership, but it can be assumed that the rest of the WTO membership will be required to affirm acceptance of the UK's market access profile in some way. It will be important that UK-based firms continue to benefit from the market access, national treatment and most favoured nation commitments made by other WTO members, even if the extent of those commitments is limited in the context of financial services (especially cross-border financial services) and is subject to the prudential carve-outs discussed above.

For example, the GATS Understanding on Financial Services (see Box 2: What is the General Agreement on Trade in Services?) forms the basis of many WTO members' commitments on financial services. The Understanding includes important principles on public procurement; restrictions on new financial services; temporary entry of personnel; nondiscriminatory measures and national treatment with respect to access to official payment and clearing systems, official funding and refinancing facilities, and self-regulatory bodies, even if the benefits mainly apply to foreign financial services suppliers that have established themselves in the territory of a member.

To facilitate the re-establishment of its WTO position, the UK should continue to apply the EU services schedule as its own until such time as this is codified and affirm its commitment to the GATS Understanding.

Bilateral trade agreements

Currently, the UK participates in trade negotiations and trade agreements as a Member State of the EU and its exit from the EU will affect its ability to continue to rely on those agreements. The UK will wish to start negotiations as soon as possible with non-EU trade partners in order to preserve existing levels of preferential access that the UK companies obtain in other markets through the UK's membership of the EU. However, these negotiations may not be fully substantiated until the UK has established its new market access profile and other details of its unilateral policy regime in the WTO as trading partners will want to negotiate against this new template.

Trade agreements provide relatively limited market access for crossborder financial services

While existing EU trade agreements may provide relatively limited market access for cross-border financial services they do provide basic protections that are important and protection for other UK industries that are not financial services. In the context of financial services, many of the provisions of bilateral agreements do not significantly go beyond the commitments of the parties under the GATS if they have implemented the Understanding on Financial Services. However, there are examples of more extensive commitments relevant to the banking sector that the UK would wish to preserve, such as:

- The EU-South Korea FTA includes provisions on data processing that requires each party to permit financial services suppliers of the other party to transfer information in or out of its territory for data processing where such processing is required in the ordinary course of business. This addressed certain restrictive provisions in Korean financial services law. The Comprehensive Economic and Trade Agreement recently agreed between the EU and Canada includes similar provisions but adds that each party shall maintain adequate safeguards to protect privacy, in particular with regard to the transfer of personal information. It also provides that, if the transfer of financial information involves personal information, such transfers should be in accordance with the legislation governing the protection of personal information of the territory of the Party where the transfer has originated. Agreements with Singapore and Vietnam include similar provisions.

- The EU-Singapore FTA includes a specific commitment requiring Singapore to allow EU financial services suppliers to provide investment advice and certain portfolio management services to a related party in Singapore that is a manager of a collective investment scheme. It also includes a number of commitments on market access regarding access to local banking and other licences in Singapore.

- The EU-Canada agreement includes a number of provisions on national treatment and most-favoured nation treatment, limitations on market access, restrictions on board memberships for establishments in Canada as well as commitments on the cross-border provision of portfolio management services to Canadian collective investment schemes.

- In addition, a number of EU agreements restrict the use that can be made of the 'prudential carve-out'. For example, the Canada- EU agreement introduces a proportionality test. The EU-Singapore agreement provides that prudential measures 'shall not be more burdensome than necessary to achieve their aim', and that they 'shall not constitute a means of arbitrary or unjustifiable discrimination against financial service suppliers of the other Party.' The EU-Korea and EUColombia and EU-Peru agreements also include similar protections.

- The EU-Canada agreement also establishes a Financial Services Committee to review and decide on the reasonableness of the use of the prudential carve-out and also to perform a wider role in an EUCanada dialogue on financial services. The EU-South Korea agreement provides for a dispute resolution panel of 15 members.

- Some agreements include additional measures on transparency of regulation. For example, the EU-Canada agreement contains provisions on 'effective and transparent regulation' that require parties, 'to the extent possible' to 'publish in advance' any measures relating to the 'laws, regulations, procedures, and administrative rulings of general application' with respect to covered financial services, to 'provide an interested person and the other Party a reasonable opportunity to comment on these proposed measures' and to 'allow reasonable time between the final publication of the measures and the date they become effective.' There are similar provisions in the EU-Singapore and the EU-South Korea agreements. These measures go further than the comparable measures on transparency in the GATS.

Other third country regimes

In addition to formal negotiations on trade agreements with third countries, the UK will need to address bilateral relationships that up to now have been dealt with at the EU level. As already noted above, EU legislation establishes a number of third country regimes where the EU has recognised the equivalence or adequacy of non-EU regulatory regimes and in some cases has recognised specific entities in other countries. Where the UK continues to include versions of those regimes in its domestic legislation following its exit from the EU, UK law will also need to provide transitional provisions for third country entities that have been recognised in the EU but now need to be recognised in the UK as well. This will be important to prevent disruption to business that relies on these existing arrangements.

These arrangements may need to be underpinned by new regulatory cooperation agreements between UK regulators and non- EU regulators

For example, this will be relevant to the recognition of non-EU CCPs under EMIR and to non-EU credit rating agencies under the Credit Rating Agencies Regulation. It is also potentially relevant to non-EU central securities depositories under the Central Securities Depository Regulation and non-EU benchmarks under the Benchmarks Regulation (if any third country central securities depositories or benchmarks have been recognised in the EU by the time of the UK exit). The UK is also likely to wish to continue to recognise the adequacy of non-EU data protection regimes already recognised by the European Commission under the EU data protection legislation.

In some cases, this may require non-EU entities to submit new applications for recognition to the UK authorities and UK law will need to provide transitional provisions to allow for this. These arrangements may need to be underpinned by new regulatory cooperation agreements between UK regulators and non-EU regulators.

In addition, in some cases, the recognition of the non-EU regime may be based on formal or informal commitments from the non-EU authorities. For example, the current EU recognition of the adequacy of the US data protection framework under the EU-US data Privacy Shield is based in part on formal commitments by the US authorities about access to EU data in the US. The UK may need to seek similar commitments. If the UK accepts less stringent standards on data flows to the US, this might affect whether the European Commission is prepared to recognise the adequacy of the UK data protection framework.

In other cases, the current EU recognition of non-EU entities may be based on reciprocal arrangements with the non-EU authorities and the UK is likely to wish to agree similar arrangements with those authorities. For example, the EU recognition of the equivalence of US CCPs was based in part on the commitments made by the US regulators to make a substituted compliance framework available for EU CCPs that are also registered in the US, together with a comparability determination with respect to certain EU rules and related no-action relief. The UK is likely to wish to enter into discussions with the US regulators to ensure that similar arrangements will apply to UK CCPs even after the UK has left the EU.

Withdrawal from the EEA

Finally, if the UK is not seeking to remain a member of the EEA, it will need to enter into negotiations with the EEA-EFTA States on arrangements for withdrawal in parallel with its negotiations with the EU27.

The UK has the right to withdraw from the EEA by giving twelve months' notice but would want to ensure that the arrangements that are negotiated with respect to the EEA are aligned, so far as possible, with the arrangements negotiated with the EU27. However, this is not straightforward as negotiations may also have to involve Switzerland by virtue of the EFTA Convention.

Table 4: Summary of recommendations for trading relations between the UK and non-EU markets

UK	
The UK should expedite the codification of its WTO profile by retaining the EU GATS schedule	The process of re-establishing the UK's WTO profile should begin as quickly as possible and can be facilitated by the adoption by the UK of the EU GATS services schedule in a way that confirms the market access rights of third country firms operating in the UK. The UK should also confirm its adherence to and application of the GATS Understanding on Financial Services.
The UK should commit to maintaining access to its market for third country firms on current terms where judgements of equivalence are not involved	Where they are not based on assessments of supervisory equivalence, the rights of third country firms operating in the UK should be affirmed and the UK should commit to maintaining a market access regime for third country firms that is not more restrictive than the status quo. This will also facilitate negotiations on the UK's WTO market access schedule.
UK and third countries	
The UK should commit to seeking before the point of exit mutual recognition arrangements for services currently provided under EU equivalence-based regimes	Some Swiss, US and other non-EU businesses currently operate cross-border in the UK under the auspices of EU market access regimes based on equivalence judgements with their home regulators. The UK will need to replace these rights with a regime of its own and this will involve confirming mutual recognition of standards with home regulators and confirming the rights of businesses operating under these terms. The UK should also expedite the creation of its own mutual recognition regime for market infrastructure, to facilitate the use of US and other CCPs by UK-based businesses and the rights of third country firms for clear and report in the UK. The UK should also seek to replace current EU data protection adequacy agreements with its own equivalents, in a way that helps ensure the agreement of a similar agreement with the EU27. All of the above mitigants for trade disruption will to some degree be facilitated by seeking the same forms of mitigation with respect to the EU27 as the rights extended to EU27 firms in the UK's new basic framework would potentially apply to all third countries (except to the extent that the rights granted to EU27 firms are granted under a comprehensive FTA meeting GATS standards).
The UK should review, prioritise and seek bilateral negotiations to replace EU FTAs	The UK's priorities in seeking to replace the current coverage of EU FTAs for UK-based businesses will inevitably be dominated by the question of restoring preferential tariffs on goods trade. However, there are a number of protections for financial services businesses in key EU FTAs that it will be important to restore as quickly as possible. This will inevitably be conditioned by the willingness of other third countries to engage in bilateral negotiations with the UK as a matter of priority, but in principle both parties have an incentive to replace the current EU FTA framework expeditiously.
UK and EEA-EFTA States	
The UK should seek to align its EEA exit negotiations as closely as possible with those with the EU27	In exiting the EEA, the UK should aim to align its withdrawal terms and any future market access terms to the EEA-EFTA States with those that it is seeking with the EU27.

5. The UK as a third country: Business impacts and mitigants

This chapter of the report considers the potential impacts of the UK exit from the EU on the banking sector and its customers. It identifies the potential actions that could mitigate these impacts, by analysing a number of important banking business areas, reviewing how they may be affected by the UK exit and considering potential mitigants. Many of the impacts and the proposed mitigants will be relevant to other banking business areas and, in some cases, other industry sectors.

The business areas discussed here are:

- Corporate and business banking: deposit taking, lending, trade finance
- Investment banking: equities and fixed income sales and trading
- Investment banking: M&A advisory, capital markets
- Retail banking: payments, mortgage lending, credit, deposit taking
- Private wealth management
- Asset management
- Market infrastructure
- Payment systems

There are significant linkages between all these business areas. For example, investment banking activities support corporate and business banking customers and access to market infrastructure is a critical component for all business areas. Also, since 'retail customers' is a class which includes ultra-high net worth individuals and some institutions as well as broad retail, measures which in principle only affect retail business may have a significant effect beyond those aspects of the business which are focussed on broad retail.

In addition to considering the impacts that are specific to the business areas reviewed, this chapter also considers some cross-cutting issues that are relevant to more than one business area and, in some cases, to other industry sectors.

This chapter of the report analyses the potential impact of the UK exit from the EU under EU legislation on the basis that the UK becomes a third country without any steps being taken to mitigate that impact. It then considers whether there are steps that could be taken to mitigate that impact outside the context of any Treaty arrangements, under a withdrawal agreement under Article 50 of the Treaty on European Union or in any longterm bilateral agreement negotiated between the UK and the EU27 (on the basis that this takes the form of a comprehensive FTA compliant with GATS standards).

This chapter mainly focuses on the impacts of the UK's exit from the EU on banking services provided from banks located in the UK and what the UK may request from the EU27 to mitigate those impacts. The EU27 is likely to seek reciprocal commitments from the UK, although it may have less need for some of those commitments if the UK continues its current regulatory approach which is relatively liberal as regards cross-border business.

This chapter also focuses on the existing EU legislative framework to seek to identify privileges that the UK will lose as a result of leaving the EU. Banks located in the UK may also be affected by future legislative changes. This chapter assumes that the UK is not seeking to continue to be a member of the EEA through accession to the European Free Trade Association.

This chapter does not discuss all the impacts of the UK's exit from the EU that will have to be addressed by domestic legislation in the UK, e.g. the ability of banks located in the UK to use market infrastructure in the EU27 to comply with clearing, trading, reporting or other obligations that will (after the UK ceases to be an EU Member State) be solely matters of UK law (this is discussed in Chapter 6 below).

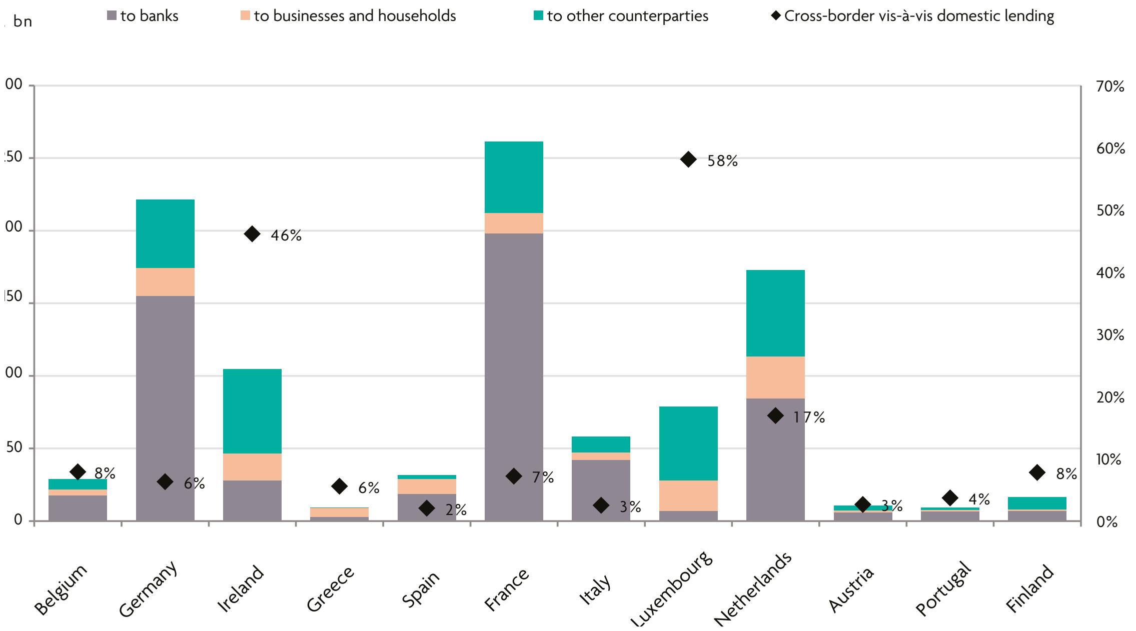
Corporate and business banking: deposit taking, lending, trade finance

The corporate and business banking businesses of UK-based banks provide services to a wide range of corporate and business customers, including deposit taking, lending and other credit facilities and trade finance, as well as payment services. These are the core services that UKbased banks provide to businesses in the real economy both in the UK and the EU.

£147 billion
gross lending to large corporates in the UK in 2015

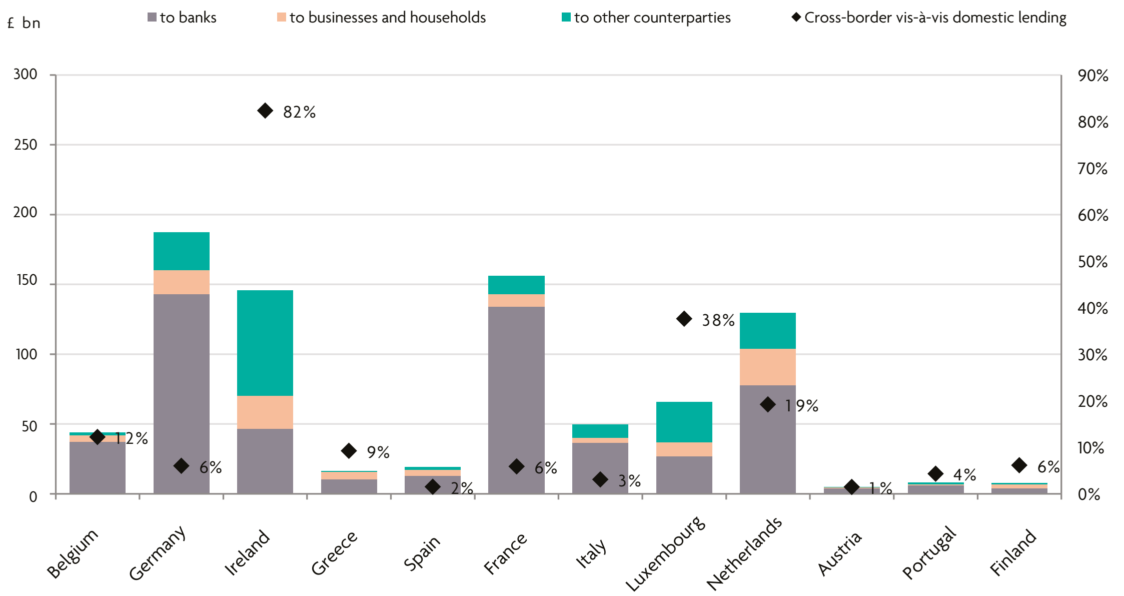
Source: Bank of England

Figure 5: UK banking sector cross-border lending v domestic lending in selected EU countries at end-2015 (including inter-bank counterparties)



Source: Bank of England, European Central Bank, UK Finance calculations

Figure 6: Cross-border deposits placed with UK banking sector v domestic deposits in selected EU countries at end-2015 (including inter-bank counterparties)



Source: Bank of England, European Central Bank, UK Finance calculations

£58 billion
gross lending to small companies in the UK in 2015

Source: Bank of England

Impact 1: UK-based banks lose passport for cross-border provision of CRD services from UK into EU27

The exit of the UK from the EU means that banks incorporated and authorised in the UK will no longer benefit from a passport to provide the services covered by the CRD cross-border from the UK into the EU27. The CRD covers a range of banking services, including deposit taking, lending and other forms of financing (including guarantees), financial leasing, payment services as well as corporate finance advisory services. In addition, the CRD covers some trading services, such as spot foreign exchange not connected to the provision of investment services, which do not fall within the scope of the passport under the Markets in Financial Instruments Directive ('MiFID').

CRD does not include a third country regime allowing non-EU banks to provide these services cross-border to customers

The CRD does not include a third country regime allowing non-EU banks to provide these services cross-border to customers in the EU. Therefore, in the absence of mitigating steps, following the UK exit from the EU, UK-based banks providing these services to customers in the EU27 would face differing licensing regimes across the EU27 and may be subject to a wider range of local requirements when conducting that business.

The approach taken by individual EU27 Member States to licensing these services varies significantly. Some Member States do not impose licensing requirements on all these services whereas others impose requirements but do not significantly restrict cross-border business or provide exemption or licensing regimes which allow non-EU banks to provide cross-border services to customers in their territory. However, a significant number of Member States have strict rules requiring entities providing deposit taking, credit, payment and foreign exchange services to either obtain a local licence or to benefit from a passport, in ways that would in practice prevent UK-based banks seeking new business from local customers and in some cases including existing customers. This would significantly disrupt the ability of UK-based banks to continue services to customers in these Member States by providing cross-border services from the UK.

The withdrawal agreement should provide for a transitional period during which the EU27 will allow UK authorised banks that benefit from the CRD passport to continue to provide services

Mitigants

Outside the context of any treaty, the UK regulators could work with national regulators in EU27 Member States to help UK-based firms take advantage of available national exemption or licensing regimes for crossborder business.

The withdrawal agreement under Article 50 should provide for a transitional period during which the EU27 will allow UK incorporated and authorised banks benefitting from the passport under CRD at the date the UK leaves the EU to continue to provide services covered by the CRD and to provide payment services. This transitional period should cover business with both existing and new customers in the EU27. As discussed above, these rights may be subject to the UK maintaining an equivalent regulatory regime during the transitional period.

Since there is no existing third country regime, the UK government should seek to include new market access arrangements in the bilateral agreement. These arrangements should seek so far as possible to replicate the passport for the provision of CRD services (including the ability to provide payment services), although there will be differing considerations in relation to services to business and corporate customers and retail customers. The arrangements may include provision for notification to EU27 regulators where a UK-based bank exercises its rights under the new regime (or ceases to do so). These arrangements would need to be conditioned on the continued equivalence of regulation and appropriate regulatory cooperation arrangements and would probably need to be reciprocal.

Currently, the CRD allows the EU Member State into which a service is provided to regulate cross-border business by EU-based firms from other Member States 'in the interests of the general good' (subject to any other provisions of EU law, e.g. under MiFID II). Under both the transitional arrangements and the bilateral agreement, the EU27 Member State into which the service is provided should retain a similar right to require UKbased banks to comply with its other rules adopted 'in the interests of the general good', on a non-discriminatory basis. Similarly, the UK should retain the same rights to regulate cross-border business into the UK 'in the interests of the general good' as it does today.

Impact 2: UK-based banks with branches in EU27 lose passport for crossborder provision of CRD services from those branches into other EU27 Member States

Under the CRD, UK-based banks which have branches in the EU27 can use their passport to provide CRD services to customers and counterparties in other EU27 Member States. The exit of the UK from the EU would mean that those firms would lose these rights. They would therefore face similar licensing restrictions affecting their business with customers in other EU27 Member States as discussed under Impact 1 above. This would significantly disrupt the ability of UK-based banks to continue services to customers in relevant Member States by providing cross-border services from their branches in the EU27.

Mitigants

The mitigants discussed above should address this impact.

There is a risk that EU27 banks with branches in the UK would lose their passport rights

The EU27 Member State in which the branch is located and the EU27 Member State into which the services is provided should continue to be able to require the UK-based bank to comply with their rules adopted 'in the interests of the general good', on a non-discriminatory basis (in the same way as for EU27 banks operating through a branch in another EU27 Member State and providing cross-border services into the territory of a third Member State).

Impact 3: EU27 banks with branches in the UK lose passport for crossborder provision of CRD services from those branches into other EU27 Member States

The transitional period in the withdrawal agreement should be structured to cover the provision of services by a UK branch of an EU27 bank to customers in other EU27 Member States

Under the CRD, EU27 banks which have branches in the UK currently can use their passport under the CRD to provide CRD services from those branches to customers in other EU27 Member States. For example, a French or German bank may establish a branch in the UK and then provide CRD services from that branch to customers in Italy or the Netherlands without being required to obtain additional Italian or Dutch authorisations.

In contrast, it is currently unclear whether a French or German bank that has established a branch in a non-EU state (e.g. Switzerland or the United States) can use its passport under the CRD to provide CRD services from that non-EU branch to customers in other EU Member States, without triggering requirements for additional local authorisations in the EU Member States where those customers are located. An interpretation that would allow this may be seen as facilitating the location of business outside the EU and outside the direct supervision of EU supervisors, as well as going beyond the need to facilitate the provision of services between Member States.

Therefore, there is a risk that the exit of the UK from the EU would mean that EU27 banks with branches in the UK would lose their passport rights to provide CRD services from those branches to customers in other EU27 Member States. The loss of these rights would have a significant impact on EU27 banks that use their branches in the UK as a hub from which to provide services into other Member States and the customers served by those banks in this way. Uncertainty as to the position may have a similar impact as banks may be reluctant to continue to structure their business to rely on the CRD for this business if it is unclear whether this is acceptable.

Mitigants

The UK should explore with the relevant Member States (and possibly subsequently the European Commission) whether it would be possible to interpret the single market directives in a way that allows UK branches of EU27 banks to rely on the CRD passport to provide services from the branch to customers in EU27 Member States when the UK is no longer an EU Member State.

In any event, the transitional period in the withdrawal agreement should be structured so as to cover the provision of services by a UK branch of an EU27 bank to customers in other EU27 Member States (to put these branches on the same basis as UK-based banks). Similarly, if the UK and the EU27 agree to include new market access arrangements in the bilateral agreement under which UK-based banks can provide cross-border CRD services into the EU27 (as proposed above), these arrangements should also extend to services provided by UK branches of EU27 banks (to put these branches on the same basis as a UK bank).

It is not usual for trade agreements to require a participant to give market access to overseas establishments of its own firms. However, in this case, these arrangements would avoid the result that the exit of the UK from the EU imposes greater disadvantages on EU27 firms as compared with UK-based firms.

Investment banking: equities and fixed income sales and trading

The equities and fixed income sales and trading businesses of investment banks involve a wide range of trading and investment activities for and with wholesale customers and counterparties. These involve trading in equity and fixed income securities and derivatives, as well as foreign exchange and physical commodities, with or for customers and counterparties, either on own account or in an agency capacity.

In order to serve customers and to manage their own positions, investment banks participate directly or indirectly as members of stock and futures exchanges and other trading platforms and clearing and settlement systems, both in the UK and on a remote basis. UK-based banks and investment firms provide these services crossborder to customers and counterparties across the EU, as well as through branches in the EU.

Impact 1: UK-based firms lose passport for cross-border provision of MiFID services from UK into the EU27

The exit of the UK from the EU would mean that UKbased firms dealing with customers and counterparties in the EU27 would face differing licensing regimes

The exit of the UK from the EU means that banks and investment firms incorporated and authorised in the UK would no longer benefit from a passport to provide the services covered by MiFID cross-border from the UK into the EU27. MiFID currently confers these rights on investment firms and banks benefiting from corresponding rights under the CRD. The implementation of MiFID II will extend these rights to cover a somewhat broader range of services.

MiFID and MiFID II cover a broad range of services related to securities, funds and derivatives (and, under MiFID II, emission allowances), including trade execution, portfolio management, investment advice, underwriting and placing of new issues and operation of trading facilities, as well as ancillary services such as custody, credit and foreign exchange services, corporate finance advice and investment research.

Firms benefiting from the passport can provide these services on a cross-border basis to customers and counterparties in other Member States without the need for additional local authorisations and largely on the basis of their home state rules (especially conduct rules).

Therefore, in the absence of mitigating steps, the exit of the UK from the EU would mean that UK-based firms dealing with customers and counterparties in the EU27 would face differing licensing regimes for engaging in cross-border business with local customers and counterparties and may be subject to a wider range of local requirements when conducting that business. The approach taken by individual EU27 Member States varies significantly. Some have regimes which allow cross-border business (at least with some customers or counterparties), in some cases subject to local registration or exemption regimes.

Other Member States have more restrictive rules which may in practice prevent UK-based firms seeking new business from local customers and counterparties, in some cases including existing customers and counterparties.

MiFIR will introduce a third country regime under which third country firms will be able to provide MiFID II services on a cross-border basis to wholesale customers and counterparties (i.e. eligible counterparties and professional clients under MiFID II). This is contingent on the European Commission determining that the relevant third country has an equivalent regulatory framework (providing a reciprocal access mechanism), the firm being authorised and subject to effective supervision in the relevant third country, ESMA and the relevant third country regulator having established cooperation arrangements and the firm registering with ESMA (and complying with limited additional rules when conducting business with EU customers and counterparties).

Non-treaty mitigants

The primary mitigant for the loss of the passport for MiFID services would be the activation of the third country regime under MiFIR with respect to the UK. This would at least allow UK-based firms to provide MiFID services on a cross-border basis to wholesale customers and counterparties, subject to registration with ESMA. However, even assuming that MiFIR is implemented in January 2018 as currently planned, the European Commission would not be able to make an equivalence determination under MiFIR with respect to the UK (and ESMA would not be able to register UK-based firms) until after the UK left the EU. Any gap would be likely to be disruptive to business, particularly where local licensing regimes could affect business with existing customers.

In addition, the UK regulators could work with national regulators in EU27 Member States to help UK-based firms take advantage of available national exemption or registration regimes (such as those in Germany and the Netherlands).

Withdrawal agreement

The withdrawal agreement should provide for the activation of the MiFIR third country regime with effect from the date that the withdrawal agreement enters into force

The withdrawal agreement under Article 50 should provide for a transitional period during which the EU27 would allow UK incorporated and authorised banks and investment firms benefitting from the passport under CRD or MiFID at the date the UK leaves the EU to continue to provide the services covered by their passport at that date on a cross-border basis to customers and counterparties in the EU27 during the transitional period, without requiring them to be authorised or registered in the EU27. In addition, the agreement should provide that the EU27 may not impose additional requirements on such firms in respect of matters covered by MiFID II. As discussed above, these rights would be subject to the UK maintaining an equivalent regulatory regime during the transitional period.

The eventual bilateral agreement should protect the MiFIR third country regime from unilateral amendment or withdrawal

In addition, the withdrawal agreement should provide for the activation of the MiFIR third country regime with effect from the date that the withdrawal agreement enters into force. As discussed above, this would involve agreement by the EU27 that the UK shall be considered equivalent for the purposes of the MiFIR regime and arrangements to ensure that the UK maintains an equivalent regulatory regime with effect from the date that the withdrawal agreement enters into force. UK-based firms could then register under the third country regime after that date, but rely on the transitional provisions until that time.

Bilateral agreement

The eventual bilateral agreement should, at least, include provisions protecting the MiFIR third country regime from unilateral amendment or withdrawal without prior notice and consultation.

Alternatively or additionally, the UK government could seek to include new market access arrangements in the bilateral agreement similar to the market access arrangements proposed above in relation to banking services covered by the CRD. These arrangements should seek so far as possible to replicate the passport for the provision of MiFID services under CRD and MiFID II, although there will be differing considerations in relation to services to business and corporate customers and retail customers. These arrangements may include arrangements for notification to EU27 regulators where a UK bank exercises its rights under the new regime (or ceases to do so). These arrangements would need to be conditioned on the continued equivalence of regulation and appropriate regulatory cooperation arrangements and would need to be reciprocal. In line with the current arrangements under MiFID, the agreement could provide that the EU27 may not impose additional requirements on firms taking advantage of the arrangements in respect of matters covered by MiFID II.

This arrangement could give somewhat broader rights than reliance on the MiFIR third country regime, in particular in relation to branches of UKbased firms in the EU27 and in relation to services provided to retail clients. It would also dispense with even the limited conduct requirements that apply to non-EU firms under the MiFIR third country regime (such as the status disclosure requirements that apply to such firms).

Impact 2: UK-based firms with branches in the EU27 lose passport for cross-border provision of MiFID services from those branches into other EU27 Member States

Under MiFID (and MiFID II) and the CRD, UK-based firms which have branches in the EU27 can use their passport to provide MiFID services from those branches to customers and counterparties in other EU27 Member States. The exit of the UK from the EU would mean that those firms would lose these rights.

The MiFIR third country regime will allow third country firms that qualify under the regime and which have a branch in an EU27 Member State to provide cross-border services from that branch to wholesale customers and counterparties in other EU27 Member States. However, this right is only available where the branch is authorised under the optional regime for the authorisation of branches of third country firms under MiFID II. It is expected that not all EU27 Member States will opt to introduce this regime.

Mitigants

The mitigants discussed above will address this impact, at least where the branch is established in a Member State that opts to introduce the authorisation regime for branches of third country firms under MiFID II. In other cases, the firm should benefit from the transitional period and, if implemented, the arrangements replicating the passport for MiFID services discussed above.

Impact 3: UK-based firms lose rights of access under MiFID to market infrastructure in the EU27

There is no existing third country regime which replicates these rights

Under MiFID (and MiFID II) UK-based firms have rights to access regulated markets in the EU27 (including without having a local presence) and the right of access to CCPs and clearing and settlement systems on a non-discriminatory basis.

There is no existing third country regime which replicates these rights. In addition, these rights are significantly broader than those that are typically given by GATS commitments or FTAs. These are typically modelled on the GATS Understanding and only ensure national treatment as regards rights of access to payment and clearing systems operated by or on behalf a public sector body for financial services firms that have established a branch or subsidiary in the territory of a WTO member.

Mitigants

The withdrawal agreement should provide for a transitional period during which the EU27 shall allow UK incorporated and authorised banks and investment firms benefitting from the passport under CRD or MiFID at the date the UK leaves the EU to continue to exercise these rights.

In addition, the UK government should seek to ensure that, if it is successful in including new market access arrangements for MiFID services in the bilateral agreement (as discussed above), those arrangements include corresponding rights of access to market infrastructure for UK-based firms.

Impact 4: EU27 firms with branches in the UK lose passport for crossborder provision of MiFID services from those branches into other EU27 Member States

Under MiFID (and MiFID II) and the CRD, EU27 firms which have branches in the UK can use their passport to provide MiFID services to customers and counterparties in other EU27 Member States. The exit of the UK from the EU would mean that those firms would likely lose these rights, although this depends on the interpretation of the directives which is not entirely certain (in a similar way to the position under the CRD).

Mitigants

The UK should explore with relevant Member States whether it would interpret the single market directives in a way that allows UK branches of EU27 firms to rely on the MiFID II passport to provide services from the branch to customers in EU27 Member States once the UK has left the EU.

In any event, the transitional period in the withdrawal agreement should be structured so as to cover the provision of MiFID services by a UK branch of an EU27 bank to customers in other EU27 Member States (to put these branches on the same basis as UK-based banks). Similarly, if the UK and the EU27 agree to include new market access arrangements in the bilateral agreement under which UK-based banks can provide cross-border MiFID services into the EU27 (as proposed above), these arrangements should also extend to services provided by UK branches of EU27 banks (to put these branches on the same basis as a UK bank), in a similar way to what is proposed above in relation to the CRD.

Impact 5: UK-based firms lose benefit of intragroup exemptions under EMIR for transactions with affiliates in the EU27

EMIR provides certain exemptions from clearing and margining for transactions between members of the same group. These are subject to conditions, including a requirement that where an EU firm is entering into transactions with an affiliate in a third country, the EU firm can only benefit from the exemption if the European Commission has determined that the relevant third country has equivalent rules on the clearing, reporting and risk mitigation of OTC derivatives which are being applied in an equitable and non-distortive manner. In addition, different procedures apply where parties seek to rely on the intragroup exemption as between an EU firm and a non-EU affiliate.

Therefore, the exit of the UK from the EU would mean that UK-based firms would lose the benefit of the intragroup exemption for transactions with affiliates in EU27. This would have a significant impact on intragroup transactions between UK-based firms and their EU affiliates.

Mitigants

The withdrawal agreement should provide for the activation of the EMIR third country regime with effect from the date that the withdrawal agreement enters into force

If nothing were included in the withdrawal agreement, the UK would seek to mitigate the impact by seeking to persuade the Commission to adopt an appropriate implementing decision for the UK determining that the UK is equivalent.

However, the withdrawal agreement should provide for the activation of the EMIR third country regime with effect from the date that the withdrawal agreement enters into force. As discussed above, this would involve agreement by the EU27 that the UK should be considered equivalent for the purposes of these elements of the EMIR regime and arrangements to ensure that the UK maintains an equivalent regulatory regime with effect from the date that the withdrawal agreement enters into force. In addition, it would be necessary to ensure that UK-based firms and their EU27 affiliates that had already qualified for the intragroup exemption before the UK left the EU are treated as if they had qualified for the exemption under the provisions applicable to transactions with third country affiliates.

The bilateral agreement should include provisions protecting this third country regime from unilateral amendment or withdrawal without prior notice and consultation.

If the UK is regarded as having equivalent rules on the clearing, reporting and risk mitigation of OTC derivatives for the purposes of EMIR, that should also confer relief from the corresponding EU rules where there are transactions between an EU counterparty and a UK counterparty (even if the two counterparties are not affiliates). EMIR contains a mechanism giving relief from duplicative or conflicting rules where one of the parties to the relevant transaction is established in a jurisdiction that is determined to have equivalent clearing, reporting and risk mitigation rules.

Impact 6: UK-based firms lose benefit of market making exemption under the Short Selling Regulation in reliance on membership of a UK trading venue

The Short Selling Regulation imposes certain disclosure and trading restrictions on market participants, including market participants located outside the EU. It also provides exemptions for market making activities by certain firms that are members of EU trading venues or of non-EU venues that have been declared to be equivalent by the European Commission.

The exit of the UK from the EU would mean that UK-based firms would no longer be able to rely on their membership of UK trading venues to meet the conditions of the exemption unless those venues were declared equivalent by the European Commission.

Mitigants

The UK should seek the inclusion of a transitional period in the withdrawal agreement to address this impact. In addition, the withdrawal agreement should provide for the immediate activation of provisions treating UK markets as equivalent for these purposes. The bilateral agreement should contain provisions protecting those arrangements from unilateral amendment or withdrawal without prior notice and consultation.

Investment banking: mergers and acquisitions advisory, capital markets

The mergers and acquisitions advisory businesses of investment banks provide corporate finance and other advisory services in relation to mergers and acquisitions and corporate finance. The capital markets businesses of investment banks engage in the underwriting and placing of newly issued securities (or secondary offerings of securities), including the initial trading of these securities in the aftermarket.

UK-based banks and investment firms provide these services crossborder to customers and counterparties across the EU, as well as through branches in the EU.

Source: FCA, 2015 data

Table 2: Recommendations

Activity	Service	Number of transactions[4] in 2014
ECM	IPOs	163
	Follow-on-offerings	516
	Other ECM	85
DCM	Corporate high-yield bonds	227
	Corporate investment grade bonds	594
	Medium Term Notes	2370
	Other DCM	1053
	M&A	883
	Corporate lending	1387
	Total	7278

Although some advisory activities fall outside the scope of the mandatory authorisation requirements of MiFID, many of the activities in this business area will fall within the scope of authorisation under MiFID and UK-based firms are usually organised in a way that enables them to avail themselves of the MiFID passport. Therefore, they are likely to face many of the same issues as are faced by the sales and trading business.

[4] Includes all activities undertaken from or in the UK regardless of the location of the client or the legal entity from which the activity is booked. Note that for IPOs all UK listings (irrespective of the location of the bank executing the listing) are included.

Impact 1: UK-based firms lose passport for cross-border provision of MiFID services from UK into the EU27

Impact 2: UK-based firms with branches in the EU27 lose passport for cross-border provision of MiFID services from those branches into other EU27 Member States

Impact 3: EU27 firms with branches in the UK lose passport for crossborder provision of MiFID services from those branches into other EU27 Member States

Mitigants

See the corresponding mitigants above in relation to the discussion of the sales and trading business.

Retail Banking

Retail banking involves a number of activities which are impacted (although not generally substantively regulated) by EU law. These include:

- Payments
- Mortgage lending
- Consumer credit
- Distance marketing
- Credit card issuance
- Deposit taking
- Deposit Guarantee Schemes
- Foreign Exchange services

Retail banking is also the sector most affected by money laundering regulation.

Digital is expected to result in an increase in crossborder retail services

As the European Commission pointed out in its 2015 green paper on Retail Financial Services, the current level of direct cross-border transactions in retail financial services is limited, with consumers largely purchasing these products in their domestic market and firms overwhelmingly serving markets in which they are physically established.

This being said, digital providers are increasing the range of products and services that they provide cross-border and this will result in higher levels of customer take-up over time. The share of consumers who purchase banking products from another Member State is around 3% for credit cards, current accounts and mortgages. In consumer credit only 5% of loans are obtained cross-border. Cross-border loans within the euro area account for less than 1% of the total household loans in the area. Moreover, what retail cross-border business does exist is generally found in those areas close to land borders to other Member States, where customers do part of their shopping in their ‘local’ cross-border areas; an issue which (aside from Northern Ireland) does not arise in the UK. Consequently, the issues raised in this chapter are relevant rather than significant for the retail banking sector.

Retail Banking – Retail Payment Services

Preserving (or at least not harming) UK banks' ability to provide these services should be an important issue

The provision of payment services is the basis of most retail banking relationships. The provision of sterling payment services to UK customers is unlikely (in the short to medium term) to be affected by the UK withdrawal from the EU. However, UK customers will have a requirement to make payments to EU27 persons, to receive payments from such persons, and to make payments in euros even where neither party to the transaction is in the Eurozone. There will be an impact on how we access eurodenominated clearing and settlement mechanisms. Fundamentally, this will be based on the settlement negotiated with the EU27 and whether the UK retains access to the single market. Preserving (or at least not harming) UK banks' ability to provide these services should be an important issue. Furthermore, it is worth noting that even where changes may take place at a prudential level, it has consequences for how retail financial services are provided (e.g. CRR, CRDIV, BRRD) as it will affect what services can be accessed and as a direct result, what can be provided to customers.

Impact 1: UK-based institutions lose the passport for the provision of payments services from the UK into the EU27

UK banks providing payment services in the EU rely on the CRD IV passport

The Payment Services Directive ('PSD') (and its successor, ('PSD II'), currently being transposed) provides the legal foundation for the creation of an EU-wide single market for payments. The PSD impacts providers and users of payment services within the EEA, in addition to: market infrastructures, card schemes, software vendors and other ancillary service providers. The PSD applies to all EU and EEA currencies (this includes the Swiss Franc, since it is the legal currency of Lichtenstein) while PSD II will extend the application to non-EEA currency payments between EEAdomiciled payment service providers ('PSPs') and to one-leg transactions (where one of the PSPs is located outside of the EEA) in any currency.

In addition to providing the legal foundations for the Single Euro Payments Area ('SEPA'), PSD introduced a new licensing regime to encourage non-banks to enter the payments market, set common standards for terms and conditions with a focus on high levels of transparency, established maximum execution times for payments in euro and other EU currencies (including sterling), and encouraged the adoption of more efficient payment types.

The PSD specifies the categories of payment service providers (e.g. credit institutions, payment institutions and electronic money institutions) which may legitimately provide payment services. Consequently UK banks providing payment services today in the EU do so in reliance on the CRD IV passport. As noted above (see 'Corporate and Business banking: deposittaking, lending and trade finance'), the exit of the UK from the EU means that banks incorporated and authorised in the UK would no longer benefit from a CRD passport.

In addition to CRD passporting for banks, PSD supports passporting for non-bank PSPs for the provision of payment services; this could include money remitters, non-bank credit card issuers, and non-bank merchant acquirers. The scope of business activities covered by PSD II has been extended to include two additional types of payment services (payment initiation services and account information services), providers of which require suitable authorisation but also benefit from the PSD II passporting regime.

Neither the CRD nor the PSD include a third country equivalence regime allowing non-EU banks to provide these services based on a determination of equivalence. Clearly, a UK bank or PSP operating a branch in another EU country would have to apply for local authorisation of the activities of that branch, and that authorisation would include the provision of payment services to local customers. A question does arise, however, where the UK bank wishes to provide payment services to UK customers in respect of payments to be made to or from customers of EU27 banks. This raises the question of when a UK bank might require PSD authorisation to provide this service. Given the growth of cross-border services, this could increase complexity for those firms who would traditionally be able to passport their services.

Since there is no existing third country regime in either the CRD or the PSD, the UK government should seek new market access arrangements

Mitigants

The mitigants discussed above with respect to the CRD apply in respect of payments services in the same way and to the same extent – the withdrawal agreement under Article 50 should provide for a transitional period during which the EU27 will allow UK incorporated and authorised banks and PSPs benefitting from the passport under CRD or PSD at the date the UK leaves the EU to continue to provide services covered by the CRD and PSD and to provide payment services. This transitional period should cover business with both existing and new customers in the EU27.

Also, since there is no existing third country regime in either the CRD or the PSD, the UK government should seek to include new market access arrangements in the bilateral agreement, or at least equivalence. These arrangements should seek as far as possible to replicate the passport for the provision of CRD and PSD services (including the ability to provide payment services), although there will be differing considerations in relation to services to business and corporate customers and retail customers.

Impact 2: UK banks may face increased obstacles to providing euro payment services for their customers

If the UK ceases to be in the geographical scope of SEPA, it is possible that the cost of providing euro payments services could rise, as a result either of required changes in systems or to other euro area banks being less willing to deal with them

The PSD (and 'PSD II') is intended in part to support SEPA. Although SEPA relates only to euro payments its geographical scope encompasses all EU Member States together with Norway, Iceland, Liechtenstein, Switzerland, Monaco, San Marino and the UK Crown Dependencies. SEPA is supported by the SEPA Regulation. A large number of UK banks currently offer SEPA Direct Debits and SEPA Credit Transfers both to consumers and also to corporate customers.

The UK should seek to remain a member of SEPA

This raises important issues as to the mechanisms by which UK banks can provide euro payments for their UK consumer and corporate clients post-withdrawal. Expansion of the geographical scope of the SEPA Schemes beyond the EU and the EEA is determined on a case-by-case basis by the European Payments Council (the SEPA Scheme Manager) provided that the level playing field criteria in the regulatory context for SEPA Payments are met.

In order to remain part of SEPA, the UK would need to demonstrate strong economic links with the EU and have a strong legal relationship with the EU, including treaties and bilateral agreements, as well as the practice of adoption of EU norms or standards in national legislation in the area of payment services, banking and financial regulation, including:

- Titles III and IV of the Payment Services Directive 2007/64 (as and if amended);
- Regulation (EC) 1781/2006, i.e. the Funds Transfer Regulation (as and if amended), and those of Article 5 and the Annex;
- The SEPA Regulation (EU) 260/2012;Banking or financial regulation in the country or territory from which it operates is functionally equivalent to the CRD 2013/36/EU;
- Regulation of other payment services providers is functionally equivalent to PSD 2007/64/EC (as and if amended);
- Anti-money laundering processes in the country or territory from which it operates are functionally equivalent to the AMLD 2005/60/EC and 2006/70/EC;
- United Nations Security Council financial sanctions are implemented in the country or territory from which it operates to the same extent as implemented by Regulation in the EU; and
- The country or territory from which it operates has either ratified the Rome Convention on the Law Applicable to Contractual Obligations of 19 June 1980.

Mitigant

The geographical scope of SEPA is not restricted solely to the EU. The UK should seek to obtain agreement from the European Commission and from the SEPA Scheme Manager (the European Payments Council) that it can remain a member of SEPA, and that UK PSPs can continue to interact with other SEPA PSPs, on the same terms as were in place prior to exit. This would be likely to involve a commitment by the UK to continue to regulate and implement UK payment services, banking and financial regulation that is the same or equivalent to the counterpart EU legislation.

Retail Banking – Mortgage Lending

UK banks making mortgage loans in the EU today rely, where necessary, on the CRD passport as regards the right to make such loans. However not all mortgage lending is originated directly by the bank, and some of it passes through mortgage intermediaries.

The Mortgage Credit Directive ('MCD') is a relatively recent directive which aims to regulate the terms on which residential mortgages are offered, and the disclosure documents with which they are sold. It is also expressed to mandate appropriate admission process and supervision of all creditors providing credit agreements and credit intermediaries, although it is explicit that it does not create a 'passport' for lenders over and above that which is already created by the CRD IV. It does, however, contain a passporting measure which permits credit intermediaries established in one Member State to conduct business in another, whether by the establishment of a branch or through the provision of crossborder services. Given the increasing importance of intermediation in the mortgage market, however, it seems likely that this passport may be of increasing importance over time.

Impact 1: Given that CRD IV does not contain a third country equivalence regime, UK banks will lose the ability to originate mortgages directly in EU countries

Since the MCD deliberately does not create the possibility of a non- CRD passport, there is no EU law route by which a UK bank which had lost its CRD passport would be able to make mortgage advances in EU countries. It would be possible for a UK bank to comply with the disclosure requirements of the MCD on a voluntary basis, but such compliance would not of itself be sufficient to permit product offering in the EU27.

Mitigant

Arrangements should seek to replicate the passport for the provision of CRD services

The mitigants discussed above with respect to the CRD apply in respect of mortgage credit offerings in the same way and to the same extent. The withdrawal agreement under Article 50 should provide for a transitional period during which the EU27 will allow UK incorporated and authorised banks benefitting from the passport under CRD at the date the UK leaves the EU to continue to provide services covered by the CRD, including mortgage lending. This transitional period should cover business with both existing and new customers in the EU27.

Also the UK government should seek to include new market access arrangements in the bilateral agreement.

These arrangements should seek so far as possible to replicate the passport for the provision of CRD services (including the ability to originate mortgages), although there will be differing considerations in relation to services to business and corporate customers and retail customers. The agreement should also clarify when a mortgage is caught by EU regulation, and, in particular, that an offer of a mortgage to a UK customer where the sole connecting factor with the EU27 is that the secured property is in the EU27 is not caught by the MCD.

Impact 2: Mortgage intermediaries in the EU may be unable to offer mortgages offered by banks which are not subject to CRD or MCD

The MCD imposes obligations on mortgage originators which go well beyond information provision and disclosure, and address conduct of business obligations, staff training and competence, product design, customer creditworthiness obligations and so on. If UK mortgage lenders are not subject to these obligations, it may be difficult or impossible for mortgage intermediaries within the EU27 to recommend borrowers to UK mortgage providers. Thus, a French mortgage broker advising a French customer on a mortgage on a UK property might be unable to recommend a UK bank.

Mitigant

In addition to the general mitigants described above, the UK should seek recognition that UK mortgage providers are, and will continue to be, regulated in their internal processes to a standard at least equal to that applied under the MCD, and that as a result mortgages originated by UK banks should not be regarded as any less capable of being recommended, on that ground alone, as any other mortgage.

Impact 3: UK mortgage originators will lose the right to passport into the EU27 under the MCD

The MCD passport was created to permit mortgage originators who are not banks to passport across the EU. The UK has introduced enabling legislation facilitating this process. Since the ability of mortgage originators to access a particular national market is an important determinant of which mortgages will be introduced in that market, it is likely that the inability of UK mortgage intermediaries to operate in the EU27 except by establishing locally regulated businesses will significantly reduce the ability of UK mortgage lenders to access the EU27 markets.

Mitigant

Current UK regulation of mortgage intermediaries is significantly stronger than that prescribed by the MCD. The UK should seek recognition of this, and in consequence seek the agreement of the EU27 authorities that UK mortgage intermediaries should be permitted to intermediate mortgage business in the EU. In addition, it should be clarified that UK intermediaries may deal with EU borrowers in respect of UK mortgages wherever the discussion is effected.

Retail Banking – Payment Accounts

The EU Payment Accounts Directive ('PAD'), in particular, imposes obligations on banks in relation to the terms on which bank accounts are provided to customers. It lays down rules on the transparency and comparability of fees charged to consumers on payment accounts, rules on switching payment accounts within a Member State (but not across borders) and rules to facilitate cross-border payment account-opening for consumers. It also sets out a framework for the rules and conditions according to which Member States are required to guarantee a right for consumers to open and use basic bank accounts. In particular, it includes a requirement to 'ensure that consumers legally resident in the Union, including consumers with no fixed address and asylum seekers...have the right to open and use a payment account with basic features with credit institutions located in their territory.'

This directive imposes no explicit limitation on cross-border business, since it applies only to products which in practice are only offered across borders in the EU only under the CRD passport.

Impact: The position of UK payment accounts as regards equivalence might be impaired (or rendered nugatory) if the provisions of the PAD are not applied in the UK

If the mitigants suggested above are all rejected as regards CRD services, the PAD directive will be irrelevant. However, if some progress can be made in respect of CRD services, it will become important to ensure that UK bank payment accounts are not regarded as nonequivalent by reason of their failure to comply with the PAD.

Mitigant

Current UK regulation of bank payment accounts is stronger than that prescribed by PAD. The UK should seek recognition of this, and in consequence seek the agreement of the EU27 authorities that, where UK firms are, through concession, local regulation or otherwise, permitted to offer payment accounts in the EU27, UK payment accounts on UK terms should be capable of being offered, provided that the UK maintains a level of regulation of such accounts which is at least equal to the PAD and any successor.

Retail Banking – Consumer Credit

EU consumer credit business by UK banks is currently done either under the CRD passport or through local licensing. The EU Consumer Credit Directive ('CCD'), whilst not harmonising the licensing position, does provide a harmonised framework for consumer credit agreements. There are other ancillary Directives which harmonise other areas of consumer credit, such as the calculation of APR, across the EU.

The CCD is primarily aimed at harmonising consumer credit documentation within the EU. It contains provisions which broadly replicate existing UK consumer credit law, and does not provide for passporting of any form. The European Commission's report on the implementation of this Directive across the EU described the total amount of cross-border credit granted in the EU as 'negligible'.

As with the PAD, the CCD imposes no explicit limitation on crossborder business, since it applies only to products which in practice are only offered across borders in the EU only under the CRD passport. However, again as with the PAD, it is likely that even if the other mitigants set out in this report were to be implemented, they would only be applied to consumer credit products if the terms of the CCD were applied to UK credit products.

Impact: The position of UK credit products as regards equivalence might be impaired (or rendered nugatory) if the provisions of the CCD are not applied in the UK

Mitigant

The CCD is largely modelled on the UK consumer credit regime, and current UK regulation of credit provision is significantly stronger than that prescribed by CCD. The UK should seek recognition of this, and in consequence seek the agreement of the EU27 authorities that, where UK firms are, through concession, local regulation or otherwise, permitted to offer consumer credit products in the EU27, UK consumer credit services on UK terms should be capable of being offered, provided that the UK maintains a level of regulation of such services which is at least equal to the CCD and any successor.

Retail Banking – Distance Marketing

The Distance Marketing Directive regime ('DMD') creates a series of rights for consumers to cancel contracts entered into as a result of distance marketing (i.e. not as a result of a face to face meeting with a salesman). The original directive did not apply to financial services, but was applied to them by the Distance Marketing of Financial Services Directive of 2002. It is generally accepted that the rights created by the DMD arise when a supplier in a Member State deals with a consumer in (the same or a different) Member State. The key provisions of the DMD relate to precontract information provision and the requirement to give the consumer a right to cancel within a cooling-off period. As regards financial services, these rights were, as they were created, congruent with the rights already accorded to customers under English law and regulation. There is no passporting or third country arrangement within the DMD.

The DMD applies to any contract concerning financial services, and 'financial service', for this purpose, means any service of a banking, credit, insurance, personal pension, investment or payment nature. Consequently the DMD applies to a wide variety of products sold under a number of different EU regimes, including CRD IV, MiFID, Solvency 2, UCITS, AIFMD (where permissible) and a number of other regimes.

The DMD is of most concern as regards direct-offer advertisements in printed media, by mailshot or through the internet.

Post-withdrawal UK firms will no longer be subject to a direct EU law obligation to provide pre-contract information or cancellation rights to EU27 consumers. Currently, the effect of UK law is to impose exactly this obligation, and at the moment the UK law obligations in respect of distance selling are significantly greater than the minimum level specified under the DMD.

The position as regards distance marketing of financial products by UK firms to EU27 consumers is therefore very similar to that which arises as regards CCD and PAD. If the UK were to dismantle or remove any element of the DMD framework, it is very likely that any equivalence, substitution or passporting arrangement negotiated in respect of CRD services generally will not be extended to any retail service in respect of which the supplier is not obliged to deliver the protections set out in the DMD.

Impact: The position of financial products offered or sold from the UK as regards any putative equivalence might be impaired (or rendered nugatory) if the provisions of the DMD are not applied in the UK

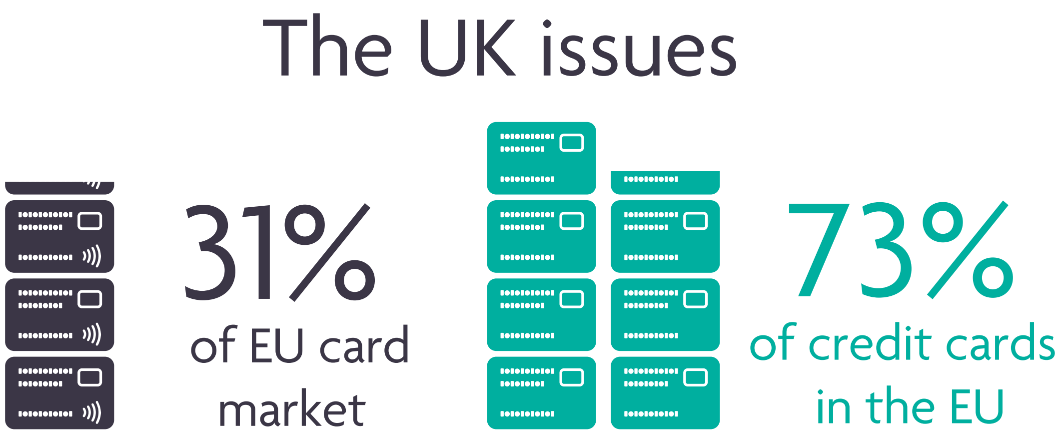
Mitigant

The DMD is largely modelled on the UK retail protections. These were put in place many years before its implementation, and current UK regulation of distance marketing on financial products is significantly stronger than that prescribed by CCD. The UK should seek recognition of this, and in consequence seek the agreement of the EU27 authorities that, where UK firms are, through concession, local regulation or otherwise permitted to offer financial services to customers in the EU27, they should be treated as being subject to distribution regulation at least equal to that applied to products marketed by EU firms subject to the DMD, and should not be discriminated against.

Retail Banking – Credit card issuance

Credit card issuance involves the provision of both credit and payment services. At an EU level, the provision of credit is not fully harmonised. Some Member States require the provider of credit to non-consumers to be authorised (typically, where this is the case, as a credit institution under CRD IV). Most Member States require the provider of credit to consumers to be authorised, as a credit institution, or as a local 'consumer credit' firm.

The UK accounts for 31% of the EU card market and 73% of its credit card market. Card issuers provide credit and payment services to card holders. The impacts and mitigants for this business are therefore those which have already been identified as regards payment and consumer credit services.



Source: UK Cards

There is, however, an EU regulation which is directly applicable to credit and debit cards, the Interchange Fees Regulation ('IFR'). This places an upper limit on the amount that may be charged to a merchant in respect of a credit or debit card transaction. The IFR currently applies across the EU, including the UK. Card payments systems are globally interoperable and therefore when the UK leaves the EU, cards issued in the UK will be dealt with in the same way as cards currently issued by issuers in other non EU third countries.

Impact: UK card service providers may find it difficult to maintain their existing position in the UK, as they provide a range of services to companies in the EU27 which will be concerned that UK institutions, not being subject to the IFR, may change their terms of business. UK issued cards may be less accepted in the EU27 since they will incur higher costs for retailers

UK card acquirers and commercial card issuers provide a range of services to multinational companies, operating in multiple jurisdictions. Locating these businesses in the UK may be problematic, since differential regulation will apply that may have impacts on the terms of business they can offer. The IFR provides that retailers, who accept cards, cannot discriminate against regulated cards. It is likely that this would have a detrimental impact on the acceptance of UK issued cards, which would be unregulated.

In principle, this is an issue which could be dealt with privately between the parties; UK card issuers, post-withdrawal, will be neither constrained nor compelled to change their terms of business with other banks, and in order to avoid discontinuities of service and breakdowns of agreement between card service providers, it might be entirely in the interests of all parties if they were to agree to continue to deal with each other on the basis of the IFR fee caps. It would certainly be in the interests of UK retailers to maintain a low interchange environment, comparable with that in the EU. However, this could create continuing uncertainty amongst EU27 banks that the UK participants in the various card systems could unilaterally change their terms of businesses at some point in the future, possibly at short notice, and this would result in the UK losing its leading market share of the EU card market.

Mitigant

The UK could avoid this problem by entering into a public commitment to maintain a domestic charging regulatory regime equivalent to the IFR regime.

Retail Banking – Deposit taking

The issues for deposit taking are the same for retail business as for wholesale business

The issues which arise as regards deposit taking are the same for retail business as for wholesale business. As noted above, deposit taking requires authorisation in all EU jurisdictions, and is only permitted under a CRD IV passport or a local authorisation. In general, a deposit is treated as having been made at the branch of the institution at which it is accepted. Thus, a sterling deposit made at the Paris branch of a UK bank is currently regarded as being permitted under French law by reason of the passport that CRD confers on the UK bank.

However, post-withdrawal, the question of whether that branch is permitted to accept that deposit will be a matter of French law. Conversely, a sterling deposit made by a French depositor with a London branch of an English bank will be regarded as subject to English law, and the question of whether the UK bank has a CRD passport will have no relevance.

This does not, however, eliminate all of the issues which arise from retail deposit business. Internet banking, in particular, makes it possible for a person in one country to place a deposit with a bank in another without there being any identifiable 'place' where the deposit is accepted, and it will be important, in the context of retail banking, to agree a set of rules identifying where at least internet retail deposits are accepted. This issue is not, however, confined to internet banking – if a Frenchman based in London is employed by a German company, his German employer may well pay money to a French bank at a German branch, with the French bank promptly recording the credit to the account maintained at its English branch, and the question of whether this would involve the provision of deposit taking services in France, Germany, the UK or all three is not entirely straightforward.

The European Commission has in fact given some guidance on this issue[5]. This gives some comfort that banking services are provided in the place where the bank actually provides the service (the 'characteristic performance' test). Thus, in the example given above, the banking service would be provided in the UK, and the bank providing it would not require authorisation in either France or Germany. However, the interpretative communication has not invariably been followed by national EU regulators, and its authority is not free from doubt.

Impact: Uncertainty about the regulatory position as regards the provision of banking services involving elements in more than one country could inhibit both UK banks' ability to provide deposit taking services to customers, and non-UK banks' ability or willingness to engage with UK banks in multi-jurisdictional transactions

Mitigant

This issue could be addressed through a public (and possibly formal) agreement between the UK and the EU27 clarifying exactly which activities do – and more importantly, which activities do not – require authorisation in which jurisdictions as regards the provision to retail customers of services involving multiple jurisdictions.

Retail Banking – Deposit Guarantee Directive

Cross-cutting impact 2 (below) addresses the issue of EU27 branches of UK banks having to join local deposit protection schemes. However, a symmetrical issue arises as regards UK depositors in UK branches. The Deposit Guarantee Schemes Directive currently provides that, if a UK bank fails, EU authorities should pay compensation to depositors at branches of the UK bank in their jurisdiction up to the directive limit, subject to being reimbursed in advance by the operator of the UK scheme, and the operators of the UK scheme are subject to a symmetrical obligation as regards UK depositors in UK branches of EU banks. The disruption of this arrangement would create significant uncertainty in the UK market, in particular for customers who are not completely familiar with the legal status of the bank branch with which they deal.

Impact: Any disruption in respect of depositor protection arrangements could have a negative effect on depositor and consumer confidence in the UK

Mitigant

Arrangements between the UK and the EU as regards separation should explicitly address the issue of depositor protection and any accrued rights of depositors to make claims, as well as making clear that there will be no lacuna in protection for any depositor in either the UK or the EU27.

[5] European Commission Interpretative Communication on Freedom To Provide Services And The Interest Of The General Good In The Second Banking Directive SEC(97) 1193, the 'Interpretative communications'

Retail Banking – Money Laundering

EU authorised firms can place some reliance on other authorised firms to perform due diligence on a customer. However this is only permissible with third country intermediaries where the intermediary is subject to rules and supervision equivalent to those set out in 4MLD

Cross-cutting Impact 10 (below) addresses the risk of non-recognition of the UK money laundering regime as equivalent by the EU27. In the context of retail financial services, however, there is a further specific issue which requires consideration. The 4th Money Laundering Directive ('4MLD'), which is in the process of being implemented, significantly tightens the restrictions placed on banks interactions with customers. In general, this Directive applies to relations between banks and their customers. However it does make provision for the circumstances in which an EU person subject to the 4MLD can rely on another person to have performed due diligence on a customer. This is relevant where, for example, a regulated intermediary seeks to introduce his client to a bank for the purposes of purchasing a financial product. In general, EU authorised firms can place some reliance on other authorised firms to perform due diligence on a customer (although responsibility for identifying the customer always ultimately rests on the person dealing with him). However this is only permissible with third country intermediaries where the intermediary is subject to rules and supervision equivalent to those set out in 4MLD.

Impact: UK banks dealing with EU intermediaries, and EU banks dealing with UK intermediaries, may be prohibited from relying on customer due diligence on individual customers performed by that intermediary, thus significantly increasing the regulatory burden on customers and disincentivising cross-border business

Mitigant

EU and UK firms should be permitted to treat each other as being regulated under an equivalent regime to the other (for as long as that remains the case), and in consequence to be able to rely on each other.

Private Wealth Management

The legal issues which arise in the context of private banking are similar to those which arise in the context of retail banking. Private banks, like retail banks, provide deposit taking, credit and payment services. In particular, the customers of private banks are generally categorised for regulatory purposes as retail customers, and a different set of mitigants are generally required. We have not repeated them here. However, the distinguishing features of a private bank in this regard are:

- a greater focus on portfolio management and advisory services;
- a greater focus on the sale of structured and complex products;
- the provision of risk management services and products, often in the form of derivatives; and
- a cross-border client base, a substantial portion of which is not resident in the country of incorporation of the bank, and which cannot always easily be allocated to a particular jurisdiction.

Sales to retail customers are rarely completely covered by passporting; most jurisdictions have retail investor protection rules which are applied alongside EU financial regulatory legislation, so that any firm selling a product in a jurisdiction is likely to have to have regard to local law as well as the home state rules to which they are subject under MiFID. However, since the third country MiFID framework is not available in respect of sales to retail investors, private banks will only be able to sell products on this basis in countries where it is possible for them to obtain authorisation to operate on a cross-border basis. This means that there will be some countries in which it will be in practice impossible for UK private banks to offer their services.

In the context of private banking, this issue will throw into sharp relief the question of where private banking services are in fact conducted. Private banking services are generally offered by the private banker travelling to the place of business or residence of the client, and not vice versa as is typically the case in broad retail banking. The best practical mitigant available in this circumstance would be the general acceptance, in the form of a binding commitment by the UK and the EU27, to recognise the principles set out by the European Commission in its Interpretative Communication as to when activities require regulation. This provides as follows:

'A bank may have non-resident customers without necessarily pursuing the activities concerned within the territory of the Member States where the customers have their domicile. Consequently, the fact of temporarily visiting the territory of a Member State to carry on an activity preceding (e.g. survey of property prior to granting a loan) or following (incidental activities) the essential activity does not, in the Commission's view, constitute a situation that is liable in itself to be the subject of prior notification. The same is true of any visits which a credit institution may pay to customers if such visits do not involve the provision of the characteristic performance of the service that is the subject of the contractual relationship. Furthermore, the Commission considers that the fact of temporarily visiting the territory of a Member State in order to conclude contracts prior to the exercise of a banking activity should not be regarded as exercising the activity itself. Prior notification would not be required in such circumstances. If, on the other hand, the institution intends to provide the characteristic performance of a banking service by sending a member of its staff or a temporarily authorized intermediary to the territory of another Member State, prior notification should be necessary.'

Impact 1: Private Banks may not be able to provide the MiFID services of portfolio management, arranging transactions in securities, entering into derivatives and giving investment advice to the majority of their clients in the territory of other Member States post-withdrawal, since the MiFID branch equivalence regime will not cover any of these services when provided to retail investors

Impact 2: Private Banks will not be able to accept deposits from investors in the EU, since the CRD does not contain a third country equivalence regime

Mitigants

The issues faced by private banks in this respect are similar to those faced by investment banks, and the mitigants identified above with regard to the loss of the MiFID passport will apply equally to private banking. However the primary mitigant available to investment banks – reliance on the MiFID third country branch framework – is not available to private banks, since that passport does not extend to dealings with retail investors.

If the mitigants discussed above as regards the CRD – that is, an agreement to create a parallel equivalence regime for UK banks to operate in respect of CRD services – were to be given effect, these would substantially mitigate this issue. Portfolio management, advice and other MiFID services are all comprised in the CRD passport, and a grant of a CRD passport equivalent to a UK private bank would broadly enable it to continue to operate as it does today.

Impact 3: Any such equivalence-based regime would only operate in practice if the UK maintained product governance, regulation and other measures as set out in the range of EU product and service directives

The directives referred to have been identified in the chapter on retail banking. However, an example which may be more specific to private banking is the 'PRIIPS' ('Packaged Retail Investment and Insurance Products') regulation. This regulation imposes requirements which must be satisfied by all product providers before they exercise a passport right to sell products in any EU jurisdiction. Other examples are the DMD and the CCD. It is generally possible for a firm to comply with information provision and marketing requirements of this kind on a voluntary basis. However, where marketing is conducted over the internet, and particularly where the client is mobile between countries, it is not always easy to determine whether the sale is being made in the EU27 or the UK.

Mitigant

It is therefore important that the UK rules do not diverge from the EU rules so as to make voluntary compliance with the EU rules contrary to the UK rules, and vice versa.

Impact 4: Private bankers are much more likely to travel to their clients than retail bankers or traders. The uncertainty of different national regimes as to what is permitted in which jurisdiction could have a chilling effect on the provision of these services

Mitigant

As noted above, a public recommitment by the UK and the EU27 to the principles set out in the interpretative communication would significantly facilitate the provision of these services.

Asset Management

UK share of EU fund management

Source: Blackrock, 2016

Because of a quirk of the UK tax laws, UK fund management business is already structured in a way which largely minimises the impact of Brexit. The 'offshore funds rules' effectively made it impossible to sell non-UK retail funds to UK retail investors. As a result, most fund management houses structured their business with a dedicated UK fund vehicle producing funds for UK sale, and an EU vehicle (generally established in Luxembourg or Dublin) producing funds for sale elsewhere in Europe. These funds have a locally established and authorised management company, which delegates the activity of portfolio management to the London manager.

UCITS rules do not require the appointment of an EU entity as a portfolio manager for a UCITS, since this would be impractical for funds which invest primarily or exclusively in non-EU markets. Consequently, provided this continues, it should be possible for UKestablished managers to continue to be appointed as portfolio managers of EU UCITS funds post-withdrawal. However, portfolio management itself is a MiFID service, and UK managers will have the same difficulties marketing portfolio management services in the EU post-withdrawal as any other UK firm promoting any other MiFID service.

Asset Management – UCITS

In order to be eligible for the UCITS passport, the UCITS must be registered in an EU state. This would no longer apply to any UK-registered UCITS post-withdrawal.

In order to continue to have access to the passport, UK based UCITS would have to be redomiciled to an EEA country, notwithstanding there may be negative tax consequences in doing so.

Any UK based 'management companies' of such UCITS will also have to be redomiciled as they will no longer have the relevant authorisation under the UCITS regulation. If the UK portfolio manager of the UCITS was to continue in this function, the redomiciled management company would have to delegate such a role to such UK entity.

An alternative would be for such funds to be marketed as alternative investment funds ('AIFs') under the AIFMD private placement regime as EEA regulators would treat a 'UK UCITS' as an 'EEA AIF'.

This would require the UK management company (acting as alternative investment fund manager to the AIF) to register the AIF in each EEA country into which it wished to market. Different EEA countries have implemented the AIFMD private placement rules differently, and in some countries it is not permitted at all. It is also intended that in due course, the private placement regime will be closed entirely.

Once registered, non-EEA AIFM must comply with various of the AIFMD obligations during the life of the AIF, including the disclosure and reporting rules, restrictions on asset stripping, additional requirements on portfolio company disclosure and there must be co-operation agreements in place between the relevant regulators (between the home regulator in which the marketing will take place and the relevant third country regulator of the AIFM (i.e. the FCA)), and, where relevant, the non-EEA AIF must not be established in a country designated as non-cooperative by Financial Action Task Force ('FATF').

The UK is an important source of investors for European asset managers distributing UCITS

However, the marketing of the fund to retail investors as an AIF may also be accompanied by a more stringent compliance burden than that of marketing to professional investors. Moreover, certain countries may prohibit the marketing of AIFs to retail investors. If so, marketing the fund as an AIF, rather than as a UCITS, may limit the potential investor base to professionals.

It is also the case that a practice has developed among the global investor base that they are only permitted to invest in 'retail funds' such as UCITS given that such funds are more extensively regulated. UK AIFs would no longer meet this criteria.

Finally, the UK is an important source of investors for European asset managers distributing UCITS. Such asset managers presumably would be keen to ensure they can continue to distribute UCITS without any additional impediments (such as having instead to comply with the UK's private placement rules that apply to the distribution of funds to retail investors).

Impact: UK UCITS-equivalent retail funds would not be classified as UCITS in the EU27, despite being identically regulated. This could result in significant investor transfers between UK and EU27 funds

Mitigant

The UCITS directive does not contain a third country regime. This is because it does not limit the sale of retail funds in Member States, but merely provides a 'kite-mark'. Member States are currently free to permit any other form of fund that they desire to be distributed retail in their individual territories, although such funds are not entitled to a passport.

If it were possible to reach an agreement with the EU27 to the effect that UK funds subject to UCITS-equivalent regulation could be accepted as UCITS across the EU, in a sort of quasi-third country arrangement, that would resolve the issue. This is similar to the proposals made above to address the lack of a third country passport in CRD IV. This would involve some amendment to either the UCITS or the AIFMD regulations (or both).

Asset Management – Management Companies

A UCITS is established in the place of establishment of its management company. Such management companies may be (and frequently are) established in convenient EU centres (Luxembourg and Dublin are both common), and delegate either 'portfolio management' or 'risk management' to a third party. Such third parties may be established outside the EU. Indeed, the attractiveness of UCITS to non-European asset managers has been the ability to establish a fund structure within one state of the EU which can then be passported across the EEA, but is ultimately portfolio managed outside of the EEA.

For example, US hedge funds have been active in establishing UCITS that mirror private 'hedge fund' strategies but can be sold to retail investors. EEA-regulators have been comfortable with such non-EEA asset managers acting as portfolio managers to EEAUCITS where the local regulatory environment as provided by, for example, the US Securities and Exchange Commission, is considered sufficiently robust.

The current structure of UCITS regulation would, post-withdrawal, accommodate a continuation of a business model based on the establishment of local management companies and delegation of portfolio management to London

When the UK leaves the EU, it should therefore be possible for UK portfolio managers to continue to provide management services to UCITS whose management companies are established within the EU. As a general principle, the management company must remain in charge of some of its basic functions, i.e. it must not delegate so many of its functions that it is no longer considered, in substance, as the management company or it is reduced to a so-called 'letter-box entity'.

In addition to the letter-box entity test, any delegation of its functions by the management company will be subject to prior notification to their competent supervisory authorities, appropriate disclosure to investors and subject to compliance with the specific conditions of the UCITS regulation. In particular, where the delegation relates to portfolio management or risk management, it may only be made to undertakings which are authorised or registered for the purpose of asset management and subject to prudential supervision.

If the delegation is given to a third country undertaking (as would apply to the any delegation to a UK portfolio manager), there must also be a co-operation agreement in place between the competent supervisory authorities of the management company and of the delegate.

Furthermore, the UK portfolio manager will be required to comply with certain aspects of the UCITS regulation. This includes ensuring it is subject to a remuneration regime that is broadly equivalent to that set out in the UCITS regulation (subject to certain proportionality tests, although how these are to be implemented remains an area of debate).

Impact: The current permissive structure for EU27 UCITS may change

The current structure of UCITS regulation would, post-withdrawal, accommodate a continuation of a business model based on the establishment of local management companies ('mancos') and delegation of portfolio management to London. Delegation of manco responsibilities to third country entities has hitherto not been an area of significant review by ESMA, but given that such delegation structures are likely to proliferate post UK-withdrawal, it may become an area of greater interest for EEA regulators.

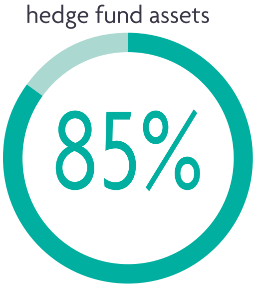
Since the removal of the overseas funds rules, the UK has become an increasingly important source of investors for European asset managers distributing UCITS. Such asset managers presumably would be keen to ensure they can continue to distribute UCITS without any additional impediments (such as having instead to comply with the UK's private placement rules that apply to the distribution of funds to retail investors).

Mitigant

The UK should seek some degree of public comfort that there is no intention to change the existing EU UCITS regime. This should be in a form which can provide meaningful comfort to investors.

Asset Management – Alternative Investment Funds

UK share of EU hedge fund assets



Source: Blackrock, 2016

Currently, AIFMs based in the UK are authorised under the AIFMD and can act as AIFMs to AIFs that are domiciled anywhere in the EU. The main advantage of this is that where both the AIFM and the AIF are based in the EEA, the AIF can be marketed in all EEA jurisdictions under the EEA marketing passport, although this necessitates compliance with the requirements of AIFMD.

With the proposed extension of the marketing passport, it has also been hoped that the marketing of non-EEA AIFs from certain jurisdictions, but with an EEA AIFM, would also be permitted under the AIFMD passport. However, post-withdrawal, even if the AIF remains in an EEA country, by virtue of the UK AIFM now being outside of the EEA, an EEA-AIF with a non-EEA AIFM would currently not be permitted to be marketed under the passport.

In order to continue to access the passport, it will be necessary to redomicile the AIFM to the EEA. If the UK asset manager was to continue to provide portfolio management to the AIF, the AIFM would have to delegate such a role.

An alternative would be that such funds are marketed as AIFs under the AIFMD's Article 42 private placement regime. This would require the AIFM to register the AIF in each EEA country into which it wished to market the AIF. European jurisdictions have implemented the AIFMD private placement rules differently, and in some countries it is not permitted at all. Further, it is intended that in due course, the private placement regime may be closed throughout Europe entirely.

Once registered, the non-EEA AIFM must comply with various of the AIFMD obligations during the life of the AIF, including the disclosure and reporting rules, restrictions on asset stripping and additional requirements on portfolio company disclosure. Futhermore, there must be co-operation agreements in place between the relevant regulators (between the home regulator in which the marketing will take place and the relevant third country regulator of the AIFM (i.e. the FCA)) and, where relevant, the non-EEA AIF must not be established in a country designated as noncooperative by FATF.

If the passport is extended to the UK such that UK-AIFMs of AIFs can be marketed across Europe under the AIFMD passport then there may be no need to establish such an AIFM. However it is likely that the extension of the passport to AIFs managed by UK-AIFMs will be conditional upon the UK-AIFMs complying with AIFMD in full (including any future iterations of the Directive).

The UK is an important source of investors for European asset managers distributing AIFs. Such asset managers presumably would be keen to ensure they can continue to distribute AIFs without any additional impediments (such as having instead to comply with the UK's private placement rules that apply to the distribution of funds to retail investors). As AIFMD has been directly transposed into national law, the UK's marketing regime should still support the marketing of AIFs in the UK.

Impact 1: It will no longer be possible to market domiciled Alternative Investment Funds ('AIFs') which have a UK authorised Alternative Investment Fund Manager ('AIFM') into the European Union or EEA under the Article 32 Passport

Impact 2: UK-based alternative investment fund managers will no longer be recognised as an 'EEA AIFM' under AIFMD

Mitigant

As with the proposals for the UCITS regime, the UK should explore the possibility of an agreement with the EU to the effect that managers who are subject to equivalent regulation in the EU and in the UK should be recognised in each others' systems as able to perform the same functions that they performed pre-withdrawal. Since AIFs are not generally distributed on the basis of a passport, the issue here is less the creation of an equivalence or mutual recognition regime than an agreement not to disrupt existing creation and distribution channels. Thus, what is required is a bilateral declaration on this point, by both the UK and the EU27, in a form which can provide meaningful comfort to investors.

Asset Management – Master Feeder Structures

A UCITS may not invest more than 30% of its assets in non-UCITS collective investment schemes. Post-withdrawal, UK UCITS would be treated as non-UCITS collective investment schemes. It will no longer be possible for UCITS funds to invest more than 30% in such UK funds. In order to continue operating in this manner, the UK fund would have to be redomiciled, although this may undermine the original rationale for putting in place the master-feeder structure.

Impact: It will no longer be possible to operate UCITS master feeders where the UK UCITS acts as a master fund to UCITS in other EEA jurisdictions. There may also be an impact on UCITS investment policies

Mitigant

This issue would be addressed if it were possible to create a mutual recognition regime. In this context, explicit recognition would be required in both the UK and the EU27 legal regimes that a UK equivalent scheme would not be subject to the non-UCITS investment cap in the UCITS regime, and that the UK would continue to apply these rules within the UK to permit investment by UK funds in UCITS schemes.

Asset Management – Fund Unit Distribution

Fund unit distribution may be undertaken either by the manager of the fund itself under its UCITS/AIFMD passport, or by a third party distributor under its MiFID passport. The UK has hitherto been a popular location for the establishment of private placement agents and other fund distributors. Once such authorisations are no longer recognised as 'passportable' into the EEA, UK-based placement agents will no longer be permitted to carry out their business in this way.

Impact: UK fund distributors can no longer distribute funds in the EEA by passporting their MiFID permissions under their existing FCA licences

Mitigant

The mitigant here as regards MiFID authorisation is broadly as set out in the earlier chapters on investment banking sales and trading. In particular, MiFID II/MiFIR will introduce a 'third country entity framework' which would in principle be available to UK-established placement agents, and which would permit them to continue to provide cross-border investment services to wholesale clients and counterparties across the EEA. However, this framework does not apply to retail distribution, and therefore would not assist the distribution of fund units to retail investors. In this regard, the modifications to the MiFID third country entity passport discussed above would be necessary before these firms could operate as they do today.

There does not appear to be any reason why a UK management company or portfolio manager should not apply for and obtain the MiFID passport, and if this were to be the case then no mitigating action by the UK government would be required. If this is not possible, however, a further step may be required to establish the rights of UK management companies of former UCITS and AIFs to continue to market in the EU, subject to euqivalence and reciprocity.

Asset Management – Portfolio Management

The most effective mitigant would be a public accord between the UK and the EU27 setting out the circumstances in which portfolio management and associated marketing did and did not require regulation

In addition to managing funds, investment managers also provide portfolio management services in respect of pools of assets owned by third parties. The characteristic of portfolio management services is that, rather than the assets being transferred to a fund managed by the manager, the assets remain owned by the client (usually in the hands of the client's custodian), and the portfolio manager is given authority to administer them. Portfolio Management is a MiFID service, although UCITS and AIFMD managers are also authorised to provide it. Portfolio management is typically provided in respect of pension funds, sovereign wealth funds, insurance company portfolios and ultra-high-net-worth individuals.

The issue which arises with portfolio management is that it is not always entirely clear where the service is being provided. Since there is no clearly identifiable authorised fund vehicle in a designated place, the question of where a portfolio management service is provided (and consequently which authorisation is required) is unclear. Equally, the marketing of portfolio management services is generally done by mobile managers, and the question of which marketing activities require authorisation where is also sometimes unclear.

Impact: A relative lack of clarity about regulatory requirements applicable to both the marketing and the performance of portfolio management services may inhibit business both in the UK and the EU27

Mitigant

Here again, the most effective mitigant in respect of this issue would be a public accord between the UK and the EU27 setting out the circumstances in which portfolio management and associated marketing did and did not require regulation.

Market Infrastructure

Market Infrastructure – CCP Clearing

'Clearing' can mean various different things, in difference contexts within the financial markets. In this context, we are referring to central counterparty ('CCP') clearing, whereby an entity, known as a CCP or clearing house interposes itself between two parties to a transaction.

While CCP clearing has been an important function of the financial markets for many decades, it has acquired particular significance since the previous global financial crisis. In particular, the G20 resolved in 2009 that, where appropriate, all standardised OTC derivatives contracts should be cleared through CCPs. In the EU, this resolution was implemented by the 2012 EU regulation on OTC derivatives, central counterparties and trade repositories, known as 'EMIR'. Among other things, EMIR requires EU firms to clear certain derivative contracts through a CCP.

EMIR also provides the framework for an authorisation and recognition regime for CCPs based both within and outside the EU. More specifically, it provides:

- that any entity established in the EU may only provide CCP clearing services where it is authorised by the relevant EU Member State's regulator (or 'competent authority'); and
- that a CCP established in a 'third country' (i.e. a state outside the EU) may only provide clearing services to firms, exchanges and other 'trading venues' that are established in the EU where such CCP is recognised by the ESMA.

In each case, such authorisation and recognition requirements apply to the clearing not only of derivatives, but to all other asset classes (bonds, shares, repos and many others).

of OTC derivative activity is cross-border

Source: Bank of England, BIS

A non-EU CCP may apply to ESMA for recognition pursuant to Article 25 of EMIR. The core requirements for recognition are, among others, that:

- ESMA must have consulted various authorities across the EU, including competent authorities in all the Member States in which the clearing members or trading venues to which the CCP intends to provide clearing services are based;
- the European Commission must have determined that the third country's arrangements for CCPs and their jurisdiction are equivalent to those of the EU (the third country must also have equivalent AML and anti-terrorist financing regulations);
- the CCP must be authorised and supervised in the relevant third country; and
- cooperation arrangements must have been established between ESMA and the relevant third country regulators. The following CCPs ('UK CCPs') are established in the EU and currently authorised by the Bank of England (being the UK competent authority):
- LCH Limited;
- CME Clearing Europe Limited; and
- LME Clear Limited.

The exit of the UK from the EU means that such UK CCPs will cease to be authorised for the purposes of the EMIR and will no longer be able to provide clearing services to clearing members and trading venues established in the EU.

EMIR itself provides a partial solution to this problem, in that these UK CCPs would be able to continue to provide clearing services in the EU if they were recognised by ESMA.

There are two particular challenges for such recognition: first, the current absence of any transitional regime from authorisation as an EU CCP to recognition as a third country CCP; secondly, the need for the UK regulatory regime to be recognised by the European Commission as equivalent, especially in light of the practical challenges that have been faced by other third countries in achieving such recognition of equivalence.

Currently under EMIR, only third country CCPs may apply for ESMA recognition. Immediately before withdrawal, the UK CCPs will be EU CCPs and will not therefore be able, technically, to apply for ESMA recognition. Unless UK CCPs are able to achieve ESMA recognition immediately on withdrawal, they may have to suspend, potentially for months or years, the provision of clearing services in the EU.

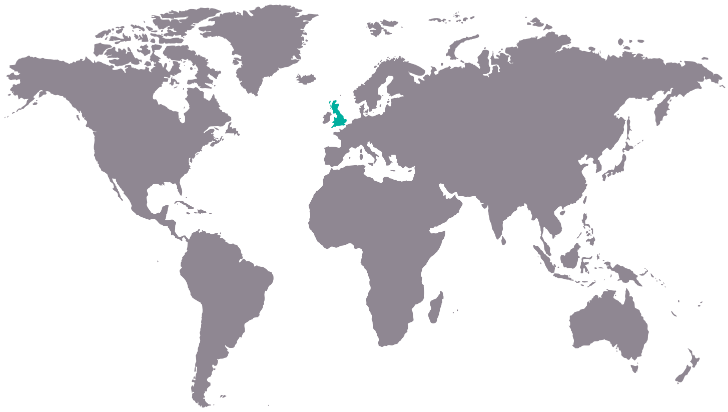
A fundamental requirement for ESMA recognition is that the home state of the CCP is held by the European Commission to have an equivalent CCP regulatory regime.

On the face of it, the recognition of the UK's regulatory regime for CCPs may seem like an easy goal to achieve, given that – at the present time – the UK regulatory regime is the EU regulatory regime. However, the practical and political challenges of achieving recognition (both at the level of the equivalence of third country regulations, and at the level of recognition of individual CCPs) pursuant to Article 25 of EMIR should not be underestimated.

These challenges have been starkly illustrated by the length of time and difficulties faced by current third country CCPs in achieving ESMA recognition since the introduction of the EMIR regime. Despite EMIR entering into force in 2012, ESMA did not recognise any third country CCPs until October 2014 (Australia, Hong Kong, Japan and Singapore).

The UK is a major global hub for investment banking

49% of global OTC interest rate derivative trading takes place in London



40% of global FX derivative trading takes place in London

Source: Bank of England, BIS

Impact 1: The current structure of EMIR seems to force a hiatus period on clearing systems generally, in that recognition of UK CCPs under the EU27 regime (and possibly recognition of EU27 CCPs under the UK regime) can only be commenced after exit and completed after a potentially significant delay

Mitigant

This is another area where it would be wise to include in any transitional agreement provisions which have the effect of preserving the provision of services between the EU27 and the UK until the final state is agreed. It should also be the case that, if an equivalence determination is required, work to determine equivalence should proceed during the period in which the transitional agreement is in place, so that on the day of commencement of the bilateral agreement, a finding of equivalence may be pronounced.

ESMA recognition of UK CCPs and UK equivalence pursuant to EMIR would be key to any argument that UK CCPs should not be prevented from carrying out euro clearing

Impact 2: UK CCPs may no longer be able to carry on euro clearing (or be prevented from carrying on such activities above a threshold)

A key function of UK CCPs that has come under close scrutiny in recent years is their role in 'euro clearing'. This is a loosely defined concept, but is perhaps most commonly understood to refer to the clearing of derivatives (especially credit derivatives), which may be settled in euros. On 5 July 2011, the ECB published its Eurosystem Oversight Policy Framework, which provided that the infrastructure for the clearing over-the-counter euro settled credit derivatives should be located within the Eurozone. This policy was successfully challenged (by the UK and Sweden) in the ECJ in 2015, meaning that the clearing of such derivatives remains an important function of UK CCPs.

At face value, the exit of the UK from the EU would not impact this decision or of itself prevent UK CCPs from carrying on euro clearing. In particular, it should be noted that the ECJ's judgment was based on the first of five pleas relied on by the UK; namely that the ECB lacked the competence to lay down a location requirement in respect of CCPs. The UK's membership of the EU is not directly relevant to this plea.

The UK will need to conclude negotiations with as many jurisdictions as possible during the withdrawal recognition period so that firms in those jurisdictions are not prohibited by their national laws from clearing derivatives in London

However, it is possible that, post-withdrawal, this matter might be reopened and UK CCPs (and other CCPs outside either the Eurozone or EU) may be prevented from carrying on euro clearing either absolutely or above certain volume (or other) thresholds. These might be imposed through a number of routes; for example, legislative or other changes may be introduced granting the ECB competence to lay down such prohibitions. If this were to be the case, it is not clear that the UK would be able successfully to challenge any such prohibitions or restrictions.

Mitigants

The risk that Eurozone (or EU) location requirements may be imposed for Euro clearing by CCPs is essentially a political risk that must primarily be addressed through political, rather than formal legal, means.

It is likely ESMA recognition of UK CCPs and UK equivalence pursuant to EMIR would be key to any argument that UK CCPs should not be prevented from carrying out euro clearing (not least because Eurozone and other EU clearing members could not, in any event, directly access such CCPs without such recognition).

Impact 3: UK CCPs will no longer be recognised as equivalent by other countries

EMIR provides a mechanism by which the EU as a whole can agree with other countries that their derivative clearing regimes are equivalent. This means that EU firms who clear derivatives on CCPs in those other jurisdictions will be regarded as having satisfied their EU obligation to clear, and vice versa. The EU has implemented such an agreement with the United States, and also with Australia, Hong Kong, Canada, Japan, Mexico, South Korea, Singapore, South Africa and Switzerland.

When the UK leaves the EU, US firms will, in principle, be unable to regard clearing on a UK CCP as discharging their clearing obligation under Dodd-Frank unless the relevant UK CCPs can be regarded as coming within the existing agreement between the EU and the US. The same will also be true in respect of the nine other countries with which the EU has concluded similar agreements.

Mitigants

In principle the UK should be able to enter into mutual recognition agreements with these jurisdictions on identical terms, since its rules will be equivalent to rules which those jurisdictions have already recognised as equivalent. The UK will need to conclude negotiations with as many jurisdictions as possible during the withdrawal negotiation period so that firms in those jurisdictions are not prohibited by their national laws from clearing derivatives in London.

Market Infrastructure – Central Securities Depositaries ('CSDs')

CSDs are the entities which record ownership in dematerialised/book entry securities. Their functions can be summarised as safeguarding ownership rights in securities and playing a key role in the settlement, clearing, trades and other transfers of such securities.

This role has been formalised and harmonised across the EU through the 2014 EU regulation on improving securities settlement and on central securities depositaries ('CSDR').

The CSDR sets out an authorisation/recognition regime which is similar to the EMIR CCP regime referred to in the previous chapter. Under the CSDR, EU CSDs must be authorised by the relevant 'competent' authority in their Member State and third country CSDs (i.e. non-EU CSDs) may be recognised by ESMA.

The process by which a third country CSD may obtain ESMA recognition pursuant to the CSDR is closely analogous to the process by which third country CCPs may obtain EMSA recognition pursuant to EMIR. Like the EMIR CCP recognition regime, central to this is the equivalence of the third country's regulatory regime.

There is a significant timing issue arising from the inability to apply for recognition under CSDR whilst the UK remains within the EU

More specifically, under Article 25 a third country CSD may provide CSD services in the EU, including through setting up a branch, provided it is recognised by ESMA. ESMA will only recognise a CSD where certain conditions have been met, including:

- ESMA must have consulted the competent authorities of the Member State where the CSD intends to provide services, the relevant authorities and the responsible third country authorities entrusted with the authorisation, supervision and oversight of CSDs (Bank of England in the UK);
- the European Commission must have adopted a decision determining that the legal and supervisory arrangements of that third county mean that the CSD is subject to equivalent requirements to those under the CSDR; and
- cooperation agreements must have been established between the competent authorities of the third country and ESMA.

For recognition a CSD must apply within six months of the entry into force of the relevant technical standards or from the European Commission's equivalence decision, whichever is the latter. Whenever any shares, bonds or other transferable securities of an EU incorporated company are traded on an exchange (or through certain similar venues collectively known as 'trading venues'), it is necessary that these securities (and transactions in such securities) are registered with a CSD in bookentry form.

A third country CSD must be recognised by ESMA if it operates a service similar to a securities settlement system (known as a 'settlement service') and at least one other core service as defined under the CSDR. This is the case whether the third country CSD provides such services through a branch in the EU, or even where it provides such service from outside the EU.

Impact: UK CSDs will cease to be authorised for the purposes of the CSDR and will no longer be able to provide 'core services' in respect of the traded securities of EU companies

Euroclear UK & Ireland Limited (which is established in the UK and owns and operates CREST) is authorised as a CSD.

The exit of the UK from the EU means that this UK CSD will cease to be authorised for the purposes of the CSDR and will no longer be able to provide the core notary and settlement services in respect of traded securities and other financial instruments issued by EU entities that are traded on trading venues. This could create significant difficulties for EU firms seeking to list on the London Stock Exchange.

Mitigants

Euroclear UK & Ireland Limited/CREST would be able to provide the core notary and settlement services in respect of traded securities and other financial instruments issued by EU entities that are traded on trading venues if it is recognised by ESMA.

Here again, there is a significant timing issue arising from the inability to apply for recognition under CSDR whilst the UK remains within the EU coupled with the lack of a current transitional or grandfathering regime.

This is another area where it would be wise to include in any transitional agreement provisions which have the effect of preserving the provision of services between the EU27 and the UK until the final state is agreed. It should also be the case that, if an equivalence determination is required, work to determine equivalence should proceed during the period in which any transitional agreement is in place, so that on the day of commencement of the bilateral agreement, a finding of equivalence may be pronounced.

Market Infrastructure – Securities Settlement Systems (Settlement Finality)

In this chapter we consider the position of securities settlement systems, as defined under the settlement finality directive ('SFD'). In practice, many or most CCPs and CSDs are securities settlement systems.

To understand the regulatory purpose for classification as a securities settlement system, it is important first to consider what is meant by 'settlement finality'.

Under the insolvency, or similar laws, of many jurisdictions, transactions entered into by companies and other entities around or after the time such entities become insolvent may be void, or vulnerable to challenge. This raises uncertainty and other risks for counterparties that transact with entities that subsequently enter into insolvency proceedings (and therefore for the market as a whole).

The SFD has the effect of ensuring that security transfers and netting rights remain effective and enforceable. The exit of the UK from the EU is likely to mean that UK securities settlement systems will cease to be treated as SFD systems

Settlement finality, in broad terms, is where modifications are made to relevant insolvency laws (or similar), with the effect of protecting, in specified situations, a counterparty's rights relating to transactions entered into with entities that subsequently enter into insolvency or similar proceedings.

More specifically, the SFD has the effect of ensuring that security transfers and netting rights remain effective and enforceable, where the relevant transactions have been entered into a system (including securities settlement systems and payment systems) prior to the formal onset of insolvency proceedings relating to an EU counterparty.

The SFD does not set out a licensing regime for SFD systems as such. However, Article 10 of the SFD requires Member States to specify arrangements as SFD systems and to inform ESMA of the identities of such SFD systems.

Impact: UK securities settlement systems may lose market share of securities transactions involving EU counterparties, as the benefits of settlement finality conferred under the SFD may be diminished

The exit of the UK from the EU is likely to mean that UK securities settlement systems will cease to be treated as SFD systems. There are several reasons for this outcome:

- SFD systems must be governed by the law of an EU Member State – UK based systems would invariably be governed by English law; and
- Article 10 provides for the specification of a SFD system by a regulator in the Member State – the UK's regulators will no longer be competent to do this, and it is likely that systems already specified by them (and notified to ESMA) will cease to be treated as SFD systems across the EU.

Such loss of designation will not of itself prevent UK settlement systems from recording transactions of, and interacting with, EU firms. Its key impact is that such loss of designation will increase the settlement/ insolvency risk faced by counterparties where transactions with EU firms are recorded through a UK securities settlement system.

This increased risk may have the effect of pushing business away from UK securities settlement systems, onto EU settlement systems. However, the risk should not be overstated; although the protections introduced by the SFD were significant at the time, their importance has somewhat been diluted by regulatory change over the last 20 years. Loss of status under the SFD itself is therefore not likely to be a significant factor in itself (although it may have a cumulative effect).

Mitigants

SFD status is important to market users, and a potential disappearance of this status for an important infrastructure provider before a pathway to exit or an appropriate substitute regime had been agreed would be potentially immensely disruptive to the financial markets as a whole.

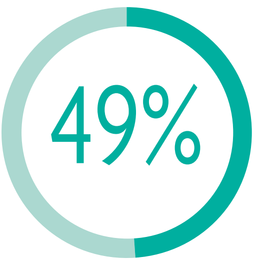
Consequently, it is important that there should be no risk of sudden loss of this status, and in particular that there should be no hiatus in the legal certainty position as regards key Financial Markets Infrastructures ('FMIs'). In this regard, any transitional agreement should explicitly preserve SFD rights of all parties pending agreement of the final state.

It should also be the case that, if an equivalence determination is required, work to determine equivalence should proceed during the period in which any transitional agreement is in place, so that on the day of commencement of the bilateral agreement, a finding of equivalence may be pronounced.

Whilst there is no third country recognition regime for systems, securities settlement systems and payment systems based in third countries are not precluded from being classed as SFD systems.

Market Infrastructure – Trading Venues

The UK accounts for



of all the EU's MTFs

Source: HMT, 2015

The term 'trading venue' is used throughout EU regulation to include a range of markets/exchanges and the like – namely 'regulated markets' (including the LSE main market and AIM markets), multilateral trading facilities ('MTFs') and, in the near future, when the relevant regulations come into effect, organised trading facilities ('OTFs').

At present, a very large proportion of the EU's securities and derivatives (and other financial instruments) are traded on regulated markets and MTFs in the UK. There are many trading venues in the UK. UK regulated markets include the LSE main market and AIM markets and, according to UK HM Treasury's 2015 MiFID II Consultation Impact Assessment, 49% of the total 152 MTFs in Europe were UK MTFs.

MiFIR and MiFID II, which come into effect in January 2018 will require certain financial instruments to be traded on EU trading venues or equivalent third country trading venues.

More specifically:

- Article 23 of MiFIR will require EU investment firms to ensure that equities trades are carried out on various EU trading venues (or by an EU investment firm acting as systemic internaliser) or on an equivalent third country trading venue; and
- Article 28 of MiFIR will require certain derivative trades to be carried out on EU trading venues or on equivalent third country trading venues.

The above introduce various permutations of an equivalence test in respect of third country trading venues, and the countries in which they are established.

More specifically:

- under Article 23 of MiFIR an equities trade can be carried out on an equivalent third country trading venue where, on the request of a Member State's competent authority, the European Commission has adopted an equivalence decision in respect of the third country market. The competent authority shall indicate why it considers the legal and supervisory framework of the third country to be considered equivalent; and
- under Article 28 of MiFIR a third country trading venue can be used where the European Commission has adopted a decision determining that the legal and supervisory framework in that third country has the same effect as supervision, enforcement and legally binding requirements that apply to EU trading venues. Such decisions may be limited to a category or categories of trading venues. The third country must also have an effective equivalent system for recognition of EU trading venues to admit/trade derivatives declared subject to a trading obligation in that third country on a non-exclusive basis.

Impact: UK trading venues will lose market share, will not be able to partake in the expected increase in on-exchange trading

Although EU firms will not be prohibited from trading on these venues, and these venues will not be prohibited from trading the securities of EU issuers and derivatives to which EU firms are party, absent the relevant equivalence decisions, the UK trading venues will likely lose market share or otherwise not be able to benefit from the expected increase in onexchange trading activity resulting from the introduction of the trading obligations per Articles 23 and 28 of MiFIR.

Mitigants

Where the UK and its trading venues are assessed as equivalent pursuant to Articles 23 and 28 MiFIR, then EU firms that are subject to the equities or derivative trading obligations will be able to trade such instruments thereon.

The UK's trading venues will face similar challenges as faced by UK CCPs and CSDs in seeking recognition – namely the practical and timing difficulties in achieving recognition of the UK's regulatory regime (if the difficulties faced by third countries in the context of CCP regime equivalence pursuant to EMIR are anything to go by) and the inability to apply for recognition whilst the UK remains within the EU coupled with the lack of a current transitional or grandfathering regime. As is the case for CCPs, appropriate provision in any transitional agreement will be essential to avoid market disturbance.

In the case of equivalence under Article 23 (i.e. specifically in the context of the equities trading obligation), it may also be necessary to address the issue specifically in the bilateral agreement. Article 23 requires a Member State and its regulator to initiate the recognition process. If no EU27 regulator is prepared to initiate this process, it may be necessary to deal with the point by treaty.

Market Infrastructure – Trade Repositories and Data Service Providers

A trade repository is a form of market infrastructure that maintains electronic records of transaction data, which it usually collects from market participants that directly report details of their transactions to it.

Where at least one counterparty is registered in the EU, Article 9 of EMIR introduced a requirement for certain derivative transactions to be reported to a recognised trade repository, in the case of an entity established in the EU, registered with ESMA or, in the case of a third country entity, recognised by ESMA.

The process by which a third country trade repository may obtain ESMA recognition pursuant to EMIR is not too dissimilar from the process by which third country CCPs may obtain EMSA recognition. Like the CCP recognition regime, equivalence of the third country's regulatory regime is the central concept.

More specifically under Articles 75 and 77 of EMIR, a third country trade repository may be recognised by ESMA where the trade repository is authorised and subject to effective supervision in a third country which:

- has been recognised by the European Commission as having an equivalent and enforceable regulatory and supervisory framework;
- has entered into an international agreement with the EU; and
- has entered into cooperation arrangements to ensure that EU authorities, including ESMA have immediate and continuous access to all the necessary information.

An almost identical regime has been established for the reporting of securities financing transactions pursuant to the SFTR

It should also be noted that an almost identical regime has been established for the reporting of securities financing transactions pursuant to the EU Securities Financing Transaction Regulation ('SFTR'). The SFTR provides that such transactions must be reported to a trade repository that in the case of an entity established in the EU is registered with ESMA or in the case of a third country entity is recognised by ESMA. This reporting obligation is currently expected to not come into effect until 2018. We expect that many of the existing EMIR trade repositories intend to apply to perform this role and as such, future aspirations would be impacted in the same way.

MiFID II will create demands for the services of various data reporting services providers. It can be expected that existing trade repositories and the like may intend to expand their business activities by providing such functions to meet such demands. More specifically, pursuant to MiFID II:

- EU investment firms must publish information about certain equities and fixed income (including derivatives) transactions through an approved publication arrangement ('APA');
- firms, trading venues and APAs must ensure that a consolidated tape provider ('CTP') consolidates certain trading data into a continuous live data stream; and
- an approved reporting mechanism ('ARM') may be appointed by EU investment firms to report transaction details to ESMA and other regulators.

Pursuant to Article 59 of the MiFID II, such data reporting service providers will need to be authorised by the relevant competent authority in a Member State.

Although the position of non EU entities as data reporting service providers is somewhat ambiguous, a reading of the relevant provisions of MiFID II implies that only such authorised firms may provide such services (or rather that trading venues and investment firms will not comply with their MiFID II obligations where they rely upon providers that are not so authorised).

Impact 1: UK trade repositories will cease to be registered for the purposes of EMIR and EU counterparties/CCPs will no longer be able to satisfy their EMIR reporting requirements by reporting to them

The following UK trade repositories are currently registered with ESMA (the 'UK trade repositories'):

- DTCC Derivatives Repository Ltd;
- UnaVista Limited;
- CME Trade Repository Limited; and
- ICE Trade Vault Europe Limited.

The exit of the UK from the EU means that such UK trade repositories will cease to be treated as registered pursuant to Article 55 of EMIR. As a consequence, although this would not prohibit EU counterparties and CCPs from reporting derivative transactions to such trade repositories, such reports would be redundant and would not discharge their reporting obligations pursuant to Article 9 of EMIR. The natural consequence would be that such parties would instead report to an EU-based trade repository, and not the UK trade repositories. This could have the difficult consequence of depriving the UK regulatory authorities, as regulators of the main global securities market, of reporting data in respect of that market.

Likewise, although no entity has yet achieved authorisation as an SFTR repository, and the SFTR reporting obligation has not yet taken effect, the exit of the UK from the EU would mean that UK Trade Repositories would not be able to benefit from the business arising from SFTR reporting obligations.

Mitigants

If the UK trade repositories achieve ESMA recognition pursuant to Article 77 of EMIR, then EU counterparties and CCPs would be able to discharge their EMIR Article 9 reporting obligations by reporting to such UK trade repositories, meaning that they should be able to maintain or defend their market share for such reporting services. The same will apply, in the case of reporting under the SFTRs, where they achieve ESMA recognition pursuant to Article 19 SFTR. However, this again gives rise to a significant risk of a hiatus between the state immediately upon exit and the end state which is desired by both the UK and the EU27. This is therefore another area in which it is important for any transitional agreement to ensure a period of stability by continuing mutual access and recognition until the terms of the bilateral agreement are finalised and implemented.

Impact 2: UK trade repositories (and other UK persons) will not be in a position to capitalise on the demand for data reporting services under MiFID II

It should be possible to create an agreement between the UK and the EU27 governing reporting obligations, access to information and sharing of data

As discussed above, MiFID II will create a demand for the services of various data reporting service providers (namely providers of APAs, CTPs and ARMs), but the providers of such persons need to be authorised by a EU Member State. The position of third country entities in somewhat unclear, but it seems likely that UK trade repositories (or equivalent) will not be able to perform such functions, unless they seek authorisation by a specific EU Member State regulator. This in effect may close off the opportunity to expand their business into this new market.

Mitigants

There is no equivalence regime for third countries data reporting services providers. However, the relevant MiFID II provisions are somewhat vague in respect of the position of third country entities (and subject to national implementing requirements).

Given the common interest of firms, governments and regulators in avoiding the fragmentation of trade reporting data, and ensuring that market regulators and others have effective access to data which is accurate, non-duplicative and comprehensive, it should be possible in this area to create an agreement between the UK and the EU27 governing reporting obligations, access to information and sharing of data, whose effect would be avoid such fragmentation. Unlike many of the other areas under discussion, this is not an area in which there is likely to be any competitive advantage accruing to any state, and the scope for international agreement seems to be very great.

If this cannot be achieved, it may be possible for UK trade tepositories and other UK persons to seek authorisation from individual Member States within the EU, although it is not entirely clear whether, to do so, they would need to establish a local place of business within the EU.

Payment systems

A payment system has been described simply by the Bank of England as 'an organised set of arrangements for transferring monetary value between participants. The transfer can be effected physically (for example, paper cheques) or electronically...*The corresponding set of arrangements can include technical infrastructure and networks, payments messages, and rules and agreements between the agents participating in the arrangements'*[6].

The EU wide regime relating to the regulation of payment systems derives primarily from the SFD and the Payment Services Directive ('PSD').

Whilst there is no EU wide requirement for payment systems to be licensed, authorised or established in the EU in order to carry out their core functions, payment systems in the EU may be designated as SFD systems (as discussed above).

[6]Bank of England, Payment Systems Oversight Report 2010, p3

There are two key consequences where a payment system is an SFD system:

- pursuant to Article 3 of the SFD, payment instructions that are recorded through it are given the same settlement finality protection as transfer orders in respect of securities trades (for which please see above); and
- such a payment system is exempt from certain access requirements pursuant to the PSD, meaning that it can exercise greater control over which institutions may transact through it.

Impact 1: UK payment systems may lose market share of payment transactions involving EU payers, as the benefits of settlement finality conferred under the SFD may be diminished

UK payment systems designated under the SFD include:

- CHAPS Sterling (operated by CHAPS Clearing Company Limited);
- Continuous Linked Settlement ('CLS') System (operated by CLS Bank International);
- BACS (operated by BACS Payment Schemes Limited);
- Cheque Clearing System and Credit Clearing System (operated by The Cheque and Credit Clearing Company); and
- Faster Payments Service (operated by Faster Payments Scheme Limited).

As discussed, in the context of securities settlement systems, the exit of the UK from the EU is likely to mean that UK payment systems will cease to be treated as SFD systems.

More than 1,700 banks use TARGET2 to initiate transactions in euro

This would mean that payments processed through such systems involving at least one EU participant would not have the benefit of settlement finality protections under the SFD. Such loss of settlement finality is likely to be of greater impact than the loss of such settlement finality protections in the context of securities transactions (discussed in the previous chapter), for the reason that the SFD remains, across the EU, the principal source of such protection against insolvency law challenges in respect of payment transactions. The loss of such settlement finality protections may therefore have the effect of pushing business away from UK payment systems, onto EU payment systems.

Mitigants

As discussed above, whilst there is no third country recognition regime for systems, securities settlement systems and payment systems based in third countries are not precluded from being classed as SFD systems.

It likely to be important for UK payment systems to retain their SFD system status (or equivalent), in order for EU27 firms to be confident of their legal robustness. Since SFD protections enhance the stability of systemically important infrastructure providers, it is very unlikely that any government would wish to see this damaged. Indeed, the UK has a strong interest in the stability of systematically important financial market infrastructures based in the EU27, and the EU 27 have an equally strong interest in the systemic stability of systemically important infrastructures in the UK. Thus, this is another area where it should be possible to create an agreement between the UK and the EU27 governing the applicability of SFD protections whose effect would be avoid the creation of such instability.

Impact 2: Access to euro payment and clearing services such as TARGET2 and EURO1

EU central banks and their national communities of commercial banks can use TARGET2. More than 1,700 banks use TARGET2 to initiate transactions in euro, either on their own behalf or on behalf of their customers, with the system settling a daily average value of €1.9 trillion. Technical connectivity to TARGET2 is typically used for the final settlement of claims originating from interbank operations and so-called ancillary systems, i.e. retail payment systems, large-value payment systems, foreign exchange systems, money market systems, clearing houses, central counterparties and securities settlement systems, could become more complicated.

There is no harmonised EU regime for the treatment of EU branches of non-EU banks and investment firms

The use of TARGET2 is mandatory for the settlement of any euro operations involving the Eurosystem. Direct participants must be supervised credit institutions from an EU or EEA country. Currently, many UK banks may use Eurozone branches as a means of sourcing euro liquidity via market operations with the respective national central banks that participate (the Bank of England does not). UK banks will maintain an account in the name of their London/UK office with a participant national central bank and secure direct access to TARGET2 via the UK branch as a credit institution in an EU or EEA country.

Indirect participants are registered by and are under the responsibility of the direct participants which act on their behalf, and are listed in the TARGET2 directory. Only supervised credit institutions established within the EEA can become indirect participants.

Another category of access is that of TARGET2 addressable Bank Identification Code ('BICs'). Any direct participant's correspondent or branch that holds a BIC is eligible to be listed in the TARGET2 directory, irrespective of its place of establishment. Additionally, the Eurosystem has not established any financial or administrative criteria for such addressable BICs, meaning that it is up to the relevant direct participant to define a marketing strategy for offering such a status. It is the responsibility of the direct participant to forward the relevant information to the appropriate central bank for inclusion in the TARGET2 directory. Addressable BICs always send and receive payment orders to/from the system via a direct participant, and their payments are settled in the account of that direct participant.

Although there is no difference between an indirect participant and an addressable BIC in functional terms, only indirect participants are recognised by the TARGET2 system and, as such, benefit from the protection of the Settlement Finality Directive (in the countries where such protection is granted). The system of addressable BICs is simply just a flavour of correspondent banking.

EURO1 is the only private sector large-value payment system for single, same-day euro transactions at a pan-European level. The EURO1 system processes transactions of high priority and urgency, and primarily of large amount, both at a domestic and at a cross-border level. In terms of access, a banking group may only connect via a single member and in order to qualify as a Direct Participant in EURO1, a bank must participate via a branch established in an EU member state, with sub-participants, they must be a branch located in an EU or EEA Member State. Overall, the technicality of connectivity could become more complicated and whilst access could possibly be retained, the assurances for this will be incredibly important. In this context, becoming a third country could have a substantial impact on connectivity to important euro clearing and settlement mechanisms.

Cross-cutting issues

In addition to the direct impacts discussed above, the exit of the UK from the EU will have other cross-cutting impacts that will need to be addressed in the negotiations. These issues will affect the business areas of banks discussed above as well as other business areas of banks. In addition, some of these issues are relevant to corporates, and so will also be of concern for the many other industries in the UK affected by the UK's withdrawal from the EU.

Branches – licensing and prudential issues

Cross-cutting impact 1: UK-based banks and investment firms with branches in the EU27 lose passport right to continue to provide services from those branches

Many UK-based banks and investment firms have established branches in the EU27 using their passport rights under CRD and MiFID. There is no harmonised EU regime for the treatment of EU branches of non-EU banks and investment firms. Member States may choose to authorise these branches, but must not treat them more favourably than branches of EU firms. Therefore, the exit of the UK from the EU could, unless legislative action is taken, lead to banks being required to cease business in those branches unless and until they can be relicensed under the domestic regime in the Member State where the branch is located.

In some cases, existing Member State law may not allow for branches of third country firms (in particular non-EU investment firms), but even where they are allowed it is likely to be necessary to satisfy the host state regulators as to the equivalence of UK supervision and the existence of appropriate regulatory cooperation arrangements.

The regulators of the branches will be the relevant national competent authority, as national competent authorities remain responsible for supervising local branches of third country banks and investment firms (even within the Single Supervisory Mechanism, where the ECB is the direct or indirect host supervisor of branches of banks from other EU Member States not participating in the mechanism but not of branches of third country banks).

Mitigants

The withdrawal agreement should contain a transitional period within which these firms can continue to conduct the same business from the branch before they become subject to the same rules as other third country firms with branches in the EU27.

The UK government could seek to extend the proposed new market access arrangements in the bilateral agreement so as to replicate the passport rights of UK-based firms under the CRD and MiFID (and MiFID II) to establish branches in the EU27 for the provision of CRD and MiFID services. These arrangements would need to be conditioned on the continued equivalence of regulation and appropriate regulatory cooperation arrangements and would need to be reciprocal. However, the UK and the EU27 may not wish to replicate the existing mutual recognition regime in relation to branches, particularly where the branches are systemically significant or deal with retail customers. In particular, the Prudential Regulation Authority ('PRA') may wish to apply its policy on the supervision of branches of third country banks to the branches of EU banks in the UK. For example, under this policy, the PRA restricts the retail deposit taking activities of some UK branches of third country firms.

Since an essential precondition for any such arrangement would be mutuality between the UK regulators and the EU27 regulators, it would be appropriate for the UK regulators to clarify their position on this issue as early in the negotiation process as possible. The extent to which the PRA is or is not prepared to be flexible in this regard is very likely to determine the position of the EU.

Cross-cutting impact 2: UK-based banks and investment firms with branches in the EU27 may have to join local deposit or investor protection schemes

Customers dealing with a branch of an EU bank or investment firm in another Member State are currently protected by the depositor or investor protection scheme in the home state. In contrast, where a non-EU bank or investment firm establishes a branch in a Member State, it may be required to participate in the local depositor or investor protection scheme in that Member State, at least unless its home state scheme offers equivalent cover. Therefore, the exit of the UK from the EU may mean that UK- based banks and investment firms with branches in the EU27 may have to join local deposit or investor protection schemes in relation to business conducted from the branch.

Mitigants

The withdrawal agreement should provide a transitional period under which the current arrangements continue to apply. The bilateral agreement could then create a framework under which customers would continue to rely on the home state schemes or, alternatively, the arrangements could revert to those that usually apply to all third country firms that maintain local branches.

Cross-cutting impact 3: UK-based banks and investment firms with branches or subsidiaries in the EU27 may need to revisit resolution planning arrangements

UK and other regulators will in any event have to revise their resolution plans for entities and groups bearing in mind the different scope of resolution powers in relation to third country entities operating through a branch. Under the Bank Recovery and Resolution Directive ('BRRD'), local law in the branch Member State would be required to give effect to the resolution decisions of the UK. In contrast, under the BRRD, the host state of a branch of a third country entity has discretion as to whether to recognise and give effect to resolution action by a third country resolution authority.

This may have a particular impact on UK-based banks that will be treated as ring-fenced banks under the UK banking reforms. UK legislation will allow these banks to have branches in other EEA Member States (but not elsewhere) because within the EU the single market legislation ensures that local law will give effect to the resolution actions of the UK authorities. The UK legislation also restricts the ability of these banks (in this instance, the ring-fenced bank itself but not the parent or another member of wider group outside the ring-fence) to have subsidiaries or other participations in undertakings outside the EEA.

Similarly, rules applicable to UK-based banks and their affiliates requiring them to include contractual provisions recognising the bail-in powers of the UK resolution authorities or the stays imposed in resolution on termination of contracts currently do not apply where the contract is governed by the law of an EU Member State on the assumption that within the EU the BRRD will require that local law in other EU Member States will give effect to UK resolution actions.

Mitigants

UK law and regulation will need to provide appropriate transitional relief for ring-fenced banks and other UK-based banks and their affiliates to address the change in circumstances. The Bank of England will need to seek understandings with its counterpart resolution authorities so that it can rely on their cooperation with respect to exercise of resolution powers. For example, the Bank of England should recognise that, where an EU27 Member State has fully implemented BRRD, liabilities of a UK bank governed by the law of that Member State can be subject to writedown and conversion powers by the Bank of England pursuant to the law of that Member State. This should obviate the need for UK-based banks to include contractual provisions recognising the bail-in powers of the Bank of England where a liability is governed by the law of that Member State.

The UK and the EU27 might consider including in the bilateral agreement binding provisions on cooperation on resolution in line with the arrangements contemplated by the BRRD on agreements with third countries.

Other prudential issues

Cross-cutting impact 4: EU27 banks and investment firms may be required to apply higher risk weightings and additional restrictions to exposures to UK-based banks

The Capital Requirements Regulation ('CRR') includes provisions allowing the European Commission to adopt an implementing act designating third countries as applying prudential, supervisory and regulatory requirements at least equivalent to those applied in the EU. Where they are so designated, EU institutions can treat exposures to those entities in the same way as exposures to EU banks and investment firms (e.g. for the purposes of risk weighting). A Commission implementing act already designates a large number of third countries as equivalent for this purpose.

In the absence of such a designation with respect to the UK, EU banks and investment firms would be required, for example, to apply higher risk weightings to their exposures to UK-based banks, which could adversely affect their willingness to deal with UK-based banks.

Mitigants

Even in the absence of provisions in the agreements between the UK and the EU27, the UK could seek such a designation for the UK from the Commission.

In any event, the withdrawal agreement should activate the provisions of the CRR which provide for this designation. The bilateral agreement should protect these arrangements from unilateral amendment or withdrawal without prior notice and consultation.

Cross-cutting impact 5: EU27 regulators may consider that UK regulators do not apply equivalent consolidated supervision to UK institutions and holding companies

The CRD may require EU regulators to take certain additional prudential measures where EU-based banks or investment firms have a parent institution or holding company in a third country if the third country does not apply consolidated supervision equivalent to the provisions of the CRR and CRD. The determination as to what is and what is not equivalent is made by the EBA for the EU27. Similar issues arise under the Financial Conglomerates Directive. Where there is no equivalent consolidated supervision, EU regulators might have to determine whether to apply consolidated supervision to the whole group or to apply alternative, more burdensome prudential measures to the EU institutions in the group.

Mitigants

Even in the absence of provisions in the agreements between the UK and the EU27, the UK could seek recognition from the EBA that the UK does apply equivalent consolidated supervision. The withdrawal agreement should also confirm that the UK regulators should be considered to apply consolidated supervision equivalent to the principles set out in the CRR and the CRD for the purposes of the provisions of the CRD and the Financial Conglomerates Directive relating to the consolidated supervision of EU27 institutions with a parent institution or holding company in the UK. The bilateral agreement should protect these arrangements from unilateral amendment or withdrawal without prior notice and consultation.

Data protection

Cross-cutting impact 6: Additional safeguards may be imposed on data flows from the EU27 to the UK

EU data protection legislation provides for the imposition of additional safeguards where transferring personal data to third countries unless the European Commission has determined that the third country provides adequate protection for that data. Therefore, unless there is such a determination, the exit of the UK from the EU would mean that there would be requirements to apply additional safeguards on data flows from the EU27 to the UK, which could significantly affect the ability of UK-based firms to operate in the EU27. This issue will affect all business sectors, not just the banking sector. Examples of the requirements would be the need for organisations who want to receive personal data from EU27 to seek consent from customers/employees or sign up to European Commission approved model contracts with the relevant EU entities. (There are practical implementation issues with this for those organisations with a branch structure as a branch/local office cannot technically sign up to a contract with the same legal entity based in another jurisdiction).

This does not just impact transfers from the EU27 as some other jurisdictions with data protection laws restricting cross-border transfers have confirmed the EU to be adequate and the UK would need to be granted a separate adequacy finding (although, in the majority of these cases, that is likely to be simpler than obtaining an adequacy finding from the European Commission).

An additional point to note is that the UK had stated it would exercise its right of opt-out in respect of what has been referred to as the 'anti- FISA' clause in the GDPR. Post-withdrawal having a data protection law without that provision would reduce the likelihood of the UK being deemed adequate. The anti-FISA clause would mean banks in the UK could only disclose personal data to courts, tribunals and regulators etc outside the EU where the relevant court order/regulatory request had been made under a formal international agreement like a mutual legal assistance treaty.

Mitigants

Even in the absence of provisions in the agreements between the UK and the EU27, the UK could seek recognition from the European Commission that the UK does have an adequate data protection regime. However, it would need to implement a law closely aligned to the General Data Protection Regulation, or seek to exploit the fact that specific sectors can be deemed adequate; even if the UK has no appetite to seek an adequacy finding across the board (however unlikely that may be) the financial services sector could implement requirements to meet EU levels of data protection compliance and be deemed adequate.

The withdrawal agreement should include a provision to seek a data protection adequacy finding from the European Commission so that personal data can flow from the EU to the UK without unnecessary duplicative requirements. Again, the bilateral agreement should contain provisions protecting these third country provisions from unilateral amendment or withdrawal without prior notice and consultation.

Employees

Cross-cutting impact 7: UK and EU27 nationals may not be able to continue in their current employment in the EU27 and the UK respectively

The UK exit from the EU could affect the rights of UK and EU27 nationals to continue in their current employment in the EU27 and the UK respectively. This issue will affect all business sectors, not just the banking sector.

Mitigants

The withdrawal agreement will need to address the employment and residence rights of UK nationals working for banking sector businesses in the EU27 and EU27 nationals working in the UK. UK banking firms employ significant numbers of EU27 nationals in the UK and their operations in the EU27 also employ significant numbers of UK nationals.

It will be important that the withdrawal arrangements create stable and secure arrangements that allow existing employees to continue to work and live where they are today, including provisions grandfathering the recognition of their qualifications. The most effective mitigant for this impact would be a robust and inclusive grandfathering regime applying to all EU27 nationals. In order to be effective, such a measure should be announced.

Cross-cutting impact 8: UK and EU27 businesses may not be able to continue to attract new employees from the EU27 and the UK respectively

It will be important to the banking industry (along with other sectors) in the UK and the EU27 that it continues to be able to attract talented new employees from the EU27 and the UK respectively. The banking industry will only be able to serve its customers if it able to recruit highly skilled employees with experience in the markets that it serves. There is a risk that new immigration controls, or new restrictions on the recognition of qualifications, in the UK and the EU27 may unduly restrict the ability to make critical hiring decisions.

Mitigants

The UK and the EU27 should ensure that new immigration controls between them do not unduly restrict the ability of businesses to hire appropriate staff. The withdrawal agreement should include transitional provisions relating to the recognition of qualifications.

Cross-cutting impact 9: Staff of UK and EU27 businesses may be subject to new restrictions on business travel between the UK and the EU27

The introduction of new visa requirements or other travel restrictions between the UK and the EU27 could affect the ability of businesses to market their services and travel for client meetings and to provide client service.

Mitigants

It will be important that there are appropriate arrangements for visafree travel between the UK and the EU27 after the UK exit from the EU. It is possible that business travel in relation to business covered by a bilateral agreement could be covered by a 'business visa' scheme granting the possibility for the holder to make multiple journeys over an extended period to the country/countries concerned with an accelerated application process (possibly where the applicant is sponsored by an appropriately authorised firm).

Anti-money laundering

Cross-cutting impact 10: The UK could be subjected to additional restrictions if its anti-money laundering regime is not considered equivalent to the EU

EU law provides for a number of adverse consequences for third countries if their anti-money laundering regime is not considered equivalent to EU standards.

Mitigants

Even in the absence of provisions in the agreements between the UK and the EU27, the UK could seek recognition from the European Commission that the UK does have an equivalent anti-money laundering regime.

The withdrawal agreement should provide for the UK to be added to the EU list of countries considered to have equivalent systems for anti-money laundering and combating the financing of terrorism in accordance with the criteria set out in the common understanding between Member States on third country equivalence under the 2005 directive on money laundering. For example, it is a condition of recognition of non-EU CCPs that the relevant non-EU country is on this list.

It should also be agreed that the UK should be regarded as having equivalent rules and supervisory arrangements for anti-money laundering for the purposes of the Anti-money Laundering Directives, e.g. so that EU27 firms can continue to rely on UK-based firms when carrying out customer due diligence.

Again, the bilateral agreement should contain provisions protecting these third country provisions from unilateral amendment or withdrawal without prior notice and consultation.

Choice of jurisdiction clauses and judgments

Cross-cutting impact 11: EU27 courts may no longer recognise and enforce judgments of UK courts even if the parties have agreed that UK courts have jurisdiction

The exit of the UK from the EU will mean that the EU Regulation will no longer regulate the allocation of jurisdiction and the mutual recognition and enforcement of judgments in civil and commercial proceedings as between the UK and the EU27.

Mitigants

In addition to including transitional provisions in the withdrawal agreement to deal with proceedings that are under way, the UK should seek to negotiate a separate replacement convention between the EU27 and the UK, possibly by seeking to accede to the Lugano Convention which includes the EFTA States (although this would require unanimous consent). Additionally, the UK should accede to the Hague Convention on exclusive jurisdiction clauses which requires its parties to give effect to these clauses (the EU is already a party to this convention).

Insolvency recognition issues

Cross-cutting impact 12: Changes to insolvency law may affect the ability of EU-based firms to participate in UK clearing and settlement systems (or UK-based firms to participate in EU27 clearing and settlement systems)

The EU SFD requires Member States to ensure that their law protects certain recognised clearing and settlement systems from the consequences of insolvency law affecting the participants in those systems. The Directive only applies to systems governed by the law of an EU Member State and designated by that Member State.

The exit of the UK from the EU means that the law of EU27 Member States will no longer necessarily protect UK designated systems from the consequences of insolvency law affecting the participants in those systems. This may affect the ability of UK systems to continue to admit EU participants. Similarly, UK law may no longer protect EU27 designated systems from the consequences of UK insolvency law. This may affect the ability of EU27 systems to continue to admit UK participants.

Mitigants

The UK could seek a transitional provision in the withdrawal agreement to preserve the current position for a specified period. The bilateral agreement could include provisions extending the arrangement on a reciprocal basis.

UK law could provide a mechanism under which it could continue to extend protection to EU27 systems (e.g. where they have been designated in the UK for that purpose).

Tax

Cross-cutting impact 13: EU27 subsidiaries may be required to withhold tax from dividend payments to UK parent companies

The exit of the UK from the EU will mean that the Parent-Subsidiary Directive will cease to apply as between the UK and the EU27. As a result, subsidiaries in a number of EU27 countries will be required to withhold tax on dividend payments to a UK parent company (this would apply in Austria, Czech Republic, Estonia, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Portugal, Romania and Slovakia). The Interest and Royalties Directive will also cease to apply, which means that in some circumstances subsidiaries in a few EU27 countries (most significantly, Italy, Greece and Portugal) will be required to withhold tax from interest and royalty payments.

Mitigants

The withdrawal agreement could provide for transitional provisions to delay the application of these withholding requirements.

The UK government should seek to renegotiate its bilateral tax treaties with these countries to address this issue, focusing initially on the more significant countries (although a practical obstacle will be that the UK does not itself impose a dividend withholding tax which will reduce the benefit to the negotiating partners of an agreement).

Cross-cutting impact 14: Business reorganisations required for regulatory purposes may have tax consequences

Where assets are required to be transferred for regulatory reasons, it is undesirable that such transfers should trigger tax charges, either deemed disposals or in any other way.

Mitigants

The withdrawal agreement could provide for transitional provisions to delay or absolve transfers entered into as a direct result of supervening illegality arising from Brexit.

Cross-cutting impact 15: The application of VAT in the UK and in the EU may diverge, creating inefficiencies and costs

There are likely to be a number of practical issues which need to be addressed during the exit process to ensure the continuing functioning of the VAT system for supplies to and from Europe. However, these issues are likely to be administrative and compliance focused and should not need significant changes to either UK or EU law to accommodate.

If the UK and EU27 tax authorities do not ensure the two VAT systems continue to work consistently, there will be potential double taxation and double non-taxation. However, the body of VAT law in the EU is largely driven by an ECJ approach to law which differs significantly in some respects from the common law approach. It is likely that the English courts would not accept the existence of certain concepts, such as the French civil law concept of 'abuse of law', which underpin the ECJ's jurisprudence in this area. It is likely that UK courts will not be bound by decisions of the ECJ post-withdrawal. Because of these discrepancies, it is likely that UK and EU VAT practice will diverge even if the legislation is maintained in identical terms.

Mitigants

There will likely be areas of VAT, and tax more generally, where the UK may wish to diverge from current EU policy. However, it may be undesirable for both the EU27 and the UK for VAT in the two jurisdictions to diverge significantly. A co-ordination arrangement could be put in place between HMRC and the EU27 with the aim of ensuring that revenue authorities in practice operate on a relatively common basis whilst allowing scope to recognise that some differences may be desirable.

6. Resetting UK domestic regulation of financial services

EU legislation on financial services is deeply embedded in the UK legislative and regulatory framework. The exit of the UK from the EU will require the UK government and UK regulators to evaluate the extent to which the UK should retain, revise or revoke provisions of the existing financial services legislative and regulatory framework that are based on EU legislation in the light of the UK's new status.

The UK Parliament will also need to repeal the provisions of the European Communities Act 1972 ('ECA') which provide the framework and powers for implementing EU legislation into UK law and to determine the extent of the resulting impact on existing provisions of UK law based on EU legislation.

Reviewing the body of UK law and regulation on financial services

The UK government and regulators will want to maintain many of the existing provisions of the legislative and regulatory framework to minimise the extent of disruption around the time of exit

As already noted, it will be important to the negotiations with the EU27 that the UK government signals a willingness to maintain legislative stability at least to the extent necessary to facilitate equivalence or mutual recognition discussions with the EU27 in key areas. In any case, many provisions of the existing regulatory framework based on EU law implement international or other standards that the UK would wish to maintain in force. In addition, the UK government and regulators will want to maintain many of the existing provisions of the legislative and regulatory framework to minimise the extent of disruption around the time of exit, leaving decisions on further change to future government and regulatory action after the UK has left the EU. Where the UK government or UK regulators consider that more immediate changes to rules may be warranted, they should carry out appropriate consultations and cost-benefit or impact analyses before deciding on those changes.

In any event, the UK government and UK regulators will need to review the whole body of UK law and regulation on financial services to determine the impact of the UK exit from the EU and how to address that impact having regard to the UK's new status. This is a major and complex task even if the objective is to maintain legislative stability.

The UK government and regulators will need to dedicate significant resources to this task to ensure that the transition does not give rise to additional disruption or other unintended consequences. The UK government should also carry out appropriate consultations on the conduct of this review and its policy objectives and choices, as well as on any changes proposed to be made to the body of UK law and regulation, to ensure that stakeholders and affected parties have an opportunity to comment on the likely impact. The legislation which takes the UK out of the EU will need to include provisions and powers to give effect to the outcome of this review, including provisions to amend primary and secondary legislation and making appropriate transitional provisions.

There are three main routes by which the UK legislative and regulatory framework implements the UK's obligations under the EU Treaties to give effect to EU legislation on financial services as part of UK law.

Amendments or secondary legislation interwoven with EU law would need to be reviewed and checked to ensure that there are no unintended consequences

In some cases, the UK has implemented EU directives through UK primary legislation, such as the Financial Services and Markets Act 2000 ('FSMA'), or by using powers under UK primary legislation to adopt statutory instruments or make rules. For example, the Prudential Regulation Authority ('PRA') and the Financial Conduct Authority ('FCA') have used their general rulemaking powers under FSMA to implement various EU directives. The repeal of the ECA would not affect the status of these provisions or rules. However, even so, many of the provisions are interwoven with EU law. For example, FSMA alone includes hundreds of references to the EU, the EEA and EU and EEA Member States, their institutions, regulators and firms and EU legislation and processes required under that legislation. Some of these references may simply become redundant on the UK leaving the EU but all would need to be reviewed and checked to ensure that there were no unintended consequences and appropriate changes would need to be made to adapt the legislation and rules to the UK's new status.

In other cases, the UK government has implemented EU directives using the powers under the ECA to amend existing provisions of UK statutes or secondary legislation or to create stand-alone secondary legislation, such as the UK Money Laundering Regulations implementing the EU Anti-Money Laundering Directives (which themselves implement standards set by the international Financial Action Task Force). Unless the legislation stated otherwise, the repeal of the ECA should not affect the status of amendments already made under these powers to existing legislation and the repealing legislation could specify that the repeal of the Act does not affect regulations made under it, which could remain in force. However, again, those amendments or secondary legislation will be interwoven with other EU law in many ways and would need to be reviewed and checked to ensure that there are no unintended consequences and appropriate changes would need to be made to adapt the legislation and rules to the UK's new status.

In addition, the ECA implements the UK obligations under the EU Treaties to give effect to directly effective EU regulations by providing that they have the force of the law in the UK without further UK legislative or regulatory action. The repeal of the Act would mean that these regulations would cease to have effect in the UK unless the repealing legislation provides for a different result. For example, the repealing legislation would have to address whether and how to maintain in effect (with or without amendments) a number of EU regulations that currently regulate important parts of the financial services sector, such as:

- the CRR which sets the regulatory capital framework for UK-based banks and investment firms and implements the global Basel Capital Accord in the EU;
- EMIR which implements the G20 commitments on OTC derivatives clearing, reporting and margining and sets the regulatory framework under which the Bank of England regulates CCPs and for the supervision of trade repositories by ESMA in accordance with international standards;
- the Market Abuse Regulation ('MAR') which from July 2016 replaces the UK domestic rules on insider dealing, market manipulation and issuer disclosure (which themselves are based in part on an earlier EU directive);
- the Prospectus Regulation which sets rules on the form and content of prospectuses; and
- the Credit Rating Agencies Regulation which provides for the regulation of credit rating agencies and their supervision by ESMA (and provides for the implementation of the international standards for credit rating agencies).

There are also many secondary regulations adopted by the European Commission under powers conferred by EU directives or regulations adopted by the European Parliament and the Council. These also have effect in the UK and would need to be addressed as part of the review.

The UK government will need to decide whether to incorporate the provisions of the relevant EU legislation into primary UK legislation, statutory instruments made under legislative powers or rules made by the UK regulators

These EU regulations are even more interwoven with other provisions in EU law and would need to be reviewed and checked to ensure that transforming them into wholly domestic UK enactments or rules does not give rise to unintended consequences. Appropriate changes would also need to be made to adapt the provisions to the UK's new status. Furthermore, maintaining the effect of these EU regulations will require a number of other choices. For example:

- The UK government will need to decide whether to incorporate the provisions of the relevant EU legislation into primary UK legislation, statutory instruments made under legislative powers or rules made by the UK regulators. This may be done either directly (copying out the relevant provisions) or by reference (adopting legislation, statutory instruments or rules which give continued effect to the provisions of the regulation), in each case with necessary modifications. In particular, it will be necessary to address which body or agency will have power to make future amendments to (or revoke) the adopted provisions. For example, it may be appropriate to replace large parts of the CRR with corresponding rules made by the PRA and FCA, so that they can amend or revoke those rules in the future in the same way as other rules relating to the prudential supervision of the firms they supervise. In contrast, it may be more appropriate to give many of the provisions of MAR the status of primary or secondary legislation, since they regulate firms that are not authorised persons under FSMA;
- In some cases, it will be necessary to re-allocate functions under the regulations. For example, ESMA supervises credit rating agencies under the Credit Rating Agencies Regulation and trade repositories under EMIR and it would be necessary to allocate these functions to a domestic regulator (most likely the FCA). Similarly, many regulations give further powers to the European Commission to adopt additional delegated and implementing acts under the regulations and it would be necessary to decide whether to keep corresponding powers and, if so, whether to confer these on domestic regulators or to give the relevant government department similar powers to act by statutory instrument; and
- Finally, EU law or regulation means, for the English courts, EU Law or regulation as interpreted by the ECJ. It is likely that decisions of the ECJ prior to Brexit will continue to have legal force in the UK. However, if this is not the case, then the UK courts could develop interpretations of EU laws which are at odds with the ECJs interpretations. This could threaten equivalence determinations.

Possible impact of changes to UK law on negotiations on the exit arrangements

The review of the existing body of UK legislation and regulation will also need to identify where changes may adversely affect the negotiations with the EU27 on the exit of the UK from the EU. In particular, in relation to the business areas discussed in the previous chapter of this report:

- Changes to the UK implementation of CRD/CRR, MiFID II/MiFIR and MAR may affect the ability of the UK to reach agreement with the EU27 on transitional arrangements, the activation of the MiFIR third country regime and new market access arrangements for UK-based banks and investment firms conducting business in the EU27;
- Changes to the UK implementation of EMIR may affect the ability of the UK to negotiate continued recognition of the equivalence of the UK regime in relation to the exemptions for intragroup transactions between UK entities and their EU27 affiliates, as well as the mutual recognition of CCPs and trade repositories; and
- Changes to the UK regime on short-selling, prospectuses, insolvency law, data protection, anti-money laundering and choice of law rules may also have an impact on the ability of the UK government to negotiate equivalence or transitional arrangements of the kind discussed in the previous chapter of this report. This does not mean that any changes

Equivalence assessments usually involve an evaluation of whether the relevant non-EU regime delivers equivalent regulatory outcomes to the EU regime, rather than a determination of whether each relevant provision of EU legislation is matched by a corresponding provision in the non-EU regime

This does not mean that any changes to the existing body of UK legislation or regulation giving effect to EU legislation would result in the UK regime not being regarded as equivalent to the EU regime. Equivalence assessments usually involve an evaluation of whether the relevant non-EU regime delivers equivalent regulatory outcomes to the EU regime, rather than a determination of whether each relevant provision of EU legislation is matched by a corresponding provision in the non-EU regime. There are also a significant number of areas where changes to UK implementation of EU legislation are unlikely to be directly relevant to an equivalence determination that the UK is seeking as part of the negotiations. However, significant changes to the existing body of UK law implementing or giving effect to EU legislation risk complicating the negotiations on mutual recognition or equivalence arrangements with the EU27. They would make it more difficult for the Commission and the EU27 to evaluate the UK regime (as well as complicating any reciprocal evaluation by the UK of the equivalence of the EU27 regime).

The UK government will have to address how the UK legislative and regulatory framework will address 'third country' issues when the UK is no longer part of the EU

In addition, when conducting its review, the UK government will have to address how the UK legislative and regulatory framework will address 'third country' issues when the UK is no longer part of the EU. In principle, after it ceases to be an EU Member State, the UK should apply its rules implementing EU regulations and legislation in a way that treats the EU27 and their firms in the same way as third countries and third country firms (as this will reflect the corresponding treatment in the EU27 of the UK and of UK-based firms). In addition, the UK should retain existing third country regimes under EU regulations and directives, which, in the UK context, should become regimes addressing the UK treatment of all foreign states, including the EU27.

This approach would provide a stronger basis for discussions on or mutual recognition or equivalence arrangements with the EU27, because it will provide the UK with a mechanism for reciprocal recognition of EU27 legislation and regulation. For example, EMIR gives ESMA the power to recognise third country CCPs in particular, so that EU firms subject to the obligations on mandatory clearing of OTC derivatives can satisfy those obligations by clearing their transactions on those CCPs instead of clearing them on EU incorporated and authorised CCPs.

In the exit negotiations, the UK would seek to ensure that its CCPs are recognised in the EU27 under EMIR. If EMIR is maintained as part of UK law, the UK law can provide the UK authorities with reciprocal powers to recognise CCPs that are incorporated and authorised in EU27 Member States as well as in third counties (so that UK-based firms subject to what will now be UK obligations on the mandatory clearing of OTC derivatives can satisfy those obligations by clearing their transactions on EU27 CCPs as well as UK CCPs). This would create a balanced framework which benefits both the UK and the EU27.

The law will also need to provide transitional provisions for EU27 CCPs and for third country CCPs that are already recognised by ESMA (or that have applied for recognition by ESMA and are currently benefiting from transitional provisions under EMIR) to enable these CCPs to be recognised in the UK as well. These arrangements will need to be underpinned by new regulatory cooperation agreements between the Bank of England and EU27 and third country regulators.

Under the GATS, the UK should only give preferential treatment to EU27-based firms (as compared with other third country firms) pursuant to the provisions of a comprehensive FTA meeting the standards of the GATS. This does not preclude the UK recognising the equivalence of EU27 regulation outside of such a comprehensive agreement. However, in that event, it must allow other GATS Members an adequate opportunity to negotiate comparable terms, in circumstances where there would be equivalent regulation, oversight, implementation of the relevant regulation, and, if appropriate, information sharing procedures.

The UK and the EU27 will also need to discuss how to address the impact of the UK exit from the EU on the transparency and reporting framework established under MiFID II/MiFIR. Under this framework, UK and EU27 firms are subject to transparency and regulatory reporting obligations with respect to securities and derivatives traded on any EU trading venue (and regulators share the data they receive from reports by firms). There could be a loss of market transparency and regulatory data after the UK exit from the EU if UK-based firms are only subject to transparency and reporting obligations with respect to securities and derivatives traded on UK trading venues and EU27 firms are only subject to transparency and reporting obligations with respect to securities and derivatives traded on EU27 trading venues (and if there are no arrangements to share reporting data).

UK law can provide the UK authorities with reciprocal powers to recognise CCPs that are incorporated in EU27 Member States as well as in third counties

The UK and the EU27 will need to consider whether to address this by extending their transparency and reporting regimes and creating mechanisms to share regulatory data and to cooperate on market supervision and enforcement. Similar issues arise in relation to the scope of the market abuse regime under MAR which also regulates behaviour in relation to securities and derivatives traded on EU trading venues.

These issues will also be relevant to discussions on market access as cooperative arrangements on transparency, reporting and enforcement could build confidence between the parties that continued market access will not adversely affect the functioning and supervision of the parties' respective markets.

Impact of the continuing EU legislative agenda

The parties to the negotiations will need to take account of the continuing EU legislative agenda on financial services. The UK remains an EU Member State with full voting rights until the date the withdrawal agreement under Article 50 enters into force. The EU Treaties will require the UK to implement new EU legislation that is required to be brought into effect before that date. In addition, new EU legislation may have implications for the regulatory relationship between the UK and the EU27 even if it is brought into effect after the UK withdrawal from the EU has taken effect. Therefore, the UK and the EU27 should seek to ensure that new EU legislation does not create additional disruption that might adversely affect firms and their customers and counterparties.

The European Commission is also developing other initiatives which may lead to new legislation which may have cross-border impact on third countries, including:

- An overall review of the cumulative impact of EU financial sector legislation, as well as reviews of individual regulations, such as EMIR;
- Proposals to introduce amendments to the CRD and the BRRD, including changes to implement the Financial Stability Board recommendations on total loss absorbing capacity for banks; and
- Other initiatives in the context of the proposed capital markets union, including on insolvency law and funds.

The UK government will need to consider the approach to be taken for EU laws in the course of implementation or negotiation both during and after the withdrawal period

There are a number of legislative initiatives currently under negotiation where the UK and the EU27 will need to take stock of their position in the light of the results of the UK referendum, in particular where proposals may affect cross-border business between the EU27 and third countries, including the UK. For example, the EU institutions are currently negotiating:

- A proposed regulation on the structural reform of credit institutions that could adversely affect UK-based banks operating through branches or subsidiaries in the EU27; and
- Legislative proposals on securitisation that may affect the cross-border origination and sale of securitisations.

In addition, there is other recently agreed legislation where the secondary rule-making process is not yet complete. For example, the final rules that are made under MiFID II/MiFIR, the Securities Financing Transactions Regulation and the Benchmarks Regulation may have significant impacts on cross-border business.

The UK should continue to engage with these and other initiatives to seek to influence the outcome in a way that enables financial markets to function efficiently for the benefit of their users and that does not curtail cross-border business. In particular, the UK will be interested to see that new EU legislative initiatives contain appropriate third country regimes, if the EU legislation is capable of curtailing cross-border business between the EU27 and the UK.

In addition, the UK will retain a strong interest in the evolution of EU legislation to the extent that the UK is seeking to maintain equivalence with EU regulation or for mutual recognition purposes with a view to maintaining market access.

Annex 1: Summary of impacts by business line

Corporate and business banking

- Impact 1: UK-based banks lose passport for cross-border provision of CRD services from UK into EU27
- Impact 2: UK-based banks with branches in EU27 lose passport for cross-border provision of CRD services from those branches into other EU27 Member States
- Impact 3: EU27 banks with branches in the UK lose passport for crossborder provision of CRD services from those branches into other EU27 Member States

Investment banking: equities and fixed income sales and trading

- Impact 1: UK-based firms lose passport for cross-border provision of MiFID services from UK into the EU27
- Impact 2: UK-based firms with branches in the EU27 lose passport for cross-border provision of MiFID services from those branches into other EU27 Member States
- Impact 3: UK-based firms lose rights of access under MiFID to market infrastructure in the EU27
- Impact 4: EU27 firms with branches in the UK lose passport for crossborder provision of MiFID services from those branches into other EU27 Member States
- Impact 5: UK-based firms lose benefit of intragroup exemptions under EMIR for transactions with affiliates in the EU27
- Impact 6: UK-based firms lose benefit of market making exemption under the Short Selling Regulation in reliance on membership of a UK trading venue

Investment banking: mergers and acquisitions advisory, capital markets

- Impact 1: UK-based firms lose passport for cross-border provision of MiFID services from UK into the EU27
- Impact 2: UK-based firms with branches in the EU27 lose passport for cross-border provision of MiFID services from those branches into other EU27 Member States
- Impact 3: EU27 firms with branches in the UK lose passport for crossborder provision of MiFID services from those branches into other EU27 Member States

Retail Banking

Retail Banking – Retail Payment Services

- Impact 1: UK-based institutions lose the passport for the provision of payments services from the UK into the EU27
- Impact 2: UK banks may face increased obstacles to providing euro payment services for their customers

Retail Banking – Mortgage Lending

- Impact 1: Given that CRD IV does not contain a third country equivalence regime, UK banks will lose the ability to originate mortgages directly in EU countries
- Impact 2: Mortgage intermediaries in the EU may be unable to offer mortgages offered by banks which are not subject to CRD or MCD
- Impact 3: UK mortgage originators will lose the right to passport into the EU27 under the MCD

Retail Banking – Payment Accounts

- Impact: The position of UK payment accounts as regards equivalence might be impaired (or rendered nugatory) if the provisions of the PAD are not applied in the UK

Retail Banking – Consumer Credit

- Impact: The position of UK credit products as regards equivalence might be impaired (or rendered nugatory) if the provisions of the CCD are not applied in the UK

Retail Banking – Distance Marketing

- Impact: The position of financial products offered or sold from the UK as regards any putative equivalence might be impaired (or rendered nugatory) if the provisions of the DMD are not applied in the UK

Retail Banking – Credit card issuance

- Impact: UK card service providers may find it difficult to maintain their existing position in the UK, as they provide a range of services to companies in the EU27 which will be concerned that UK institutions, not being subject to the IFR, may change their terms of business. UK issued cards may be less accepted in the EU27 since they will incur higher costs for retailers

Retail Banking – Deposit taking

- Impact: Uncertainty about the regulatory position as regards the provision of banking services involving elements in more than one country could inhibit both UK banks' ability to provide deposit taking services to customers, and non-UK banks' ability or willingness to engage with UK banks in multi-jurisdictional transactions

Retail Banking – Deposit Guarantee Directive

- Impact: Any disruption in respect of depositor protection arrangements could have a negative effect on depositor and consumer confidence in the UK

Retail Banking – Money Laundering

- Impact: UK banks dealing with EU intermediaries, and EU banks dealing with UK intermediaries, may be prohibited from relying on customer due diligence on individual customers performed by that intermediary,thus significantly increasing the regulatory burden on customers and disincentivising cross-border busines.

Private Wealth Management

- Impact 1: Private Banks may not be able to provide the MiFID services of portfolio management, arranging transactions in securities, entering into derivatives and giving investment advice to the majority of their clients in the territory of other Member States post-withdrawal, since the MiFID branch equivalence regime will not cover any of these services when provided to retail investors
- Impact 2: Private Banks will not be able to accept deposits from investors in the EU, since the CRD does not contain a third country equivalence regime
- Impact 3: Any such equivalence-based regime would only operate in practice if the UK maintained product governance, regulation and other measures as set out in the range of EU product and service directives
- Impact 4: Private bankers are much more likely to travel to their clients than retail bankers or traders. The uncertainty of different national regimes as to what is permitted in which jurisdiction could have a chilling effect on the provision of these services

Asset Management

Asset Management – UCITS

- Impact: UK UCITS-equivalent retail funds would not be classified as UCITS in the EU27, despite being identically regulated. This could result in significant investor transfers between UK and EU27 funds

Asset Management – Management Companies

- Impact: The current permissive structure for EU27 UCITS may change

Asset Management – Alternative Investment Funds

- Impact 1: It will no longer be possible to market domiciled Alternative Investment Funds (‹AIFs›) which have a UK authorised Alternative Investment Fund Manager ('AIFM') into the European Union or EEA under the Article 32 Passport
- Impact 2: UK-based alternative investment fund managers will no longer be recognised as an 'EEA AIFM' under AIFMD

Asset Management – Master Feeder Structures

- Impact: It will no longer be possible to operate UCITS master feeders where the UK UCITS acts as a master fund to UCITS in other EEA jurisdictions. There may also be an impact on UCITS investment policies

Asset Management – Fund Unit Distribution

- Impact: UK fund distributors can no longer distribute funds in the EEA by passporting their MiFID permissions under their existing FCA licences

Asset Management – Portfolio Management

- Impact: A relative lack of clarity about regulatory requirements applicable to both the marketing and the performance of portfolio management services may inhibit business both in the UK and the EU27

Market Infrastructure

Market Infrastructure – CCP Clearing

- Impact 1: The current structure of EMIR seems to force a hiatus period on clearing systems generally, in that recognition of UK CCPs under the EU27 regime (and possibly recognition of EU27 CCPs under the UK regime) can only be commenced after exit and completed after a potentially significant delay
- Impact 2: UK CCPs may no longer be able to carry on euro clearing (or be prevented from carrying on such activities above a threshold)
- Impact 3: UK CCPs will no longer be recognised as equivalent by other countries

Market Infrastructure – Central Securities Depositaries ('CSDs')	• Impact: UK CSDs will cease to be authorised for the purposes of the CSDR and will no longer be able to provide 'core services' in respect of the traded securities of EU companies	
Market Infrastructure – Securities Settlement Systems (Settlement Finality)	• Impact: UK securities settlement systems may lose market share of securities transactions involving EU counterparties, as the benefits of settlement finality conferred under the SFD may be diminished	
Market Infrastructure – Trading Venues	• Impact: UK trading venues will lose market share, will not be able to partake in the expected increase in on-exchange trading	
Market Infrastructure – Trade Repositories and Data Service Providers	• Impact 1: UK trade repositories will cease to be registered for the purposes of EMIR and EU counterparties/CCPs will no longer be able to satisfy their EMIR reporting requirements by reporting to them	• Impact 2: UK trade repositories (and other UK persons) will not be in a position to capitalise on the demand for data reporting services under MiFID II

Payment systems

	• Impact 1: UK payment systems may lose market share of payment transactions involving EU payers, as the benefits of settlement finality conferred under the SFD may be diminished	• Impact 2: Access to euro payment and clearing services such as TARGET2 and EURO1

Cross-cutting issues

Branches – licensing and prudential issues	• Cross-cutting impact 1: UK-based banks and investment firms with branches in the EU27 lose passport right to continue to provide services from those branches • Cross-cutting impact 2: UK-based banks and investment firms with branches in the EU27 may have to join local deposit or investor protection schemes	• Cross-cutting impact 3: UK-based banks and investment firms with branches or subsidiaries in the EU27 may need to revisit resolution planning arrangements

Other prudential issues	• Cross-cutting impact 4: EU27 banks and investment firms may be required to apply higher risk weightings and additional restrictions to exposures to UK-based banks	• Cross-cutting impact 5: EU27 regulators may consider that UK regulators do not apply equivalent consolidated supervision to UK institutions and holding companies
Data protection	• Cross-cutting impact 6: Additional safeguards may be imposed on data flows from the EU27 to the UK	
Employees	• Cross-cutting impact 7: UK and EU27 nationals may not be able to continue in their current employment in the EU27 and the UK respectively • Cross-cutting impact 8: UK and EU27 businesses may not be able to continue to attract new employees from the EU27 and the UK respectively	• Cross-cutting impact 9: Staff of UK and EU27 businesses may be subject to new restrictions on business travel between the UK and the EU27
Anti-money laundering	• Cross-cutting impact 10: The UK could be subjected to additional restrictions if its anti-money laundering regime is not considered equivalent to the EU	
Choice of jurisdiction clauses and judgments	• Cross-cutting impact 11: EU27 courts may no longer recognise and enforce judgments of UK courts even if the parties have agreed that UK courts have jurisdiction	
Insolvency recognition issues	• Cross-cutting impact 12: Changes to insolvency law may affect the ability of EU-based firms to participate in UK clearing and settlement systems (or UK-based firms to participate in EU27 clearing and settlement systems)	
Insolvency recognition issues	• Cross-cutting impact 13: EU27 subsidiaries may be required to withhold tax from dividend payments to UK parent companies • Cross-cutting impact 14: Business reorganisations required for regulatory purposes may have tax consequences	• Cross-cutting impact 15: The application of VAT in the UK and in the EU may diverge, creating inefficiencies and costs

Annex 2: Explanation of frequently used terms

Bilateral Agreement	In this context, an agreement between the EU27 and the UK, covering market access or other areas. A bilateral agreement between the EU and the UK could be the vehicle for commitments on regulatory convergence and mutual recognition allowing reciprocal rights to provide certain financial services into each others' markets.
Equivalence	In EU law, a judgement by the EU authorities that the regulatory system of a third country is equivalent in its intent and outcomes to EU rules. This can then be the basis for reciprocal preferential market access rights or operational treatment in the EU for firms whose home regulator is in that market or for EU firms operating in those markets. These can be lost if the two regimes subsequently diverge for any reason.
European Economic Area ('EEA')	The EEA is the association of Norway, Lichenstein, Iceland and the EU which creates uniquely open access to the EU single market for these states, although they remain outside of the EU customs union. EEA states in principle can access the EU passporting regime for financial services, provided that they continue to incorporate EU financial services rules directly into their own – a process over which they have only limited influence.
European Free Trade Association ('EFTA')	The European Free Trade Association is the intergovernmental arrangement established to promote the economic integration of the economies of Norway, Lichenstein, Iceland and Switzerland. Three EFTA members (Norway, Lichenstein and Iceland) are also signatories to the EEA Agreement.
Free Trade Agreement ('FTA')	A bilateral or plurilateral agreement between states providing for a higher level of reciprocal liberalisation of trade between them than they provide to most other countries through their WTO commitments. Potentially covers both goods and services, although in general FTAs have focused on trade in manufactured goods and agricultural products. The EU27 and the UK would be likely to sign an FTA as the basis for their future relationship, although it could be augmented with other bilateral agreements.

General Agreement of Trade in Services ('GATS')	The WTO agreement that covers trade in services, including trade in financial services. Each WTO member has a GATS 'Schedule' in which they guarantee certain forms of non-discriminatory access and treatment for foreign services companies alongside domestic ones.	However, in general, cross border financial services trade is carved out from this commitment to equal treatment on the grounds of protecting the prerogatives of prudential regulators.
Mutual recognition	States will often use systems of mutual recognition to ease trade or operation between their markets. This will generally take the form of countries	stating that a product licensed or authorised in one market can have expedited treatment for the same in the other.
Passporting	The EU/EEA passporting system allows firms to sell and provide financial services across the EU single market irrespective of where they are authorised in the EU or EEA. It reflects the rights to operate across border guaranteed by the EU treaties and the application of the EU single rulebook for	financial services across the EU and EEA, which in principle guarantees that regulatory standards in all of these states are virtually identical. The passporting regime is not available to states outside of the EU and EEA.
Third Country	In this context, any state that is not a member of the EU or EEA and therefore outside of the jurisdiction of the EU single rulebook for financial services. Third countries trade with the EU on the basis of the market access rights created by the EU's international commitments.	In some cases such as banking they are also covered by the individual licensing systems of national member states, although these do not confer rights to the wider single market.
World Trade Organisation ('WTO')	The multilateral organisation that oversees the commitments made by states in the 1947 General Agreement on Tariffs and Trade (GATT) and subsequent agreements.	WTO members are obliged to trade with all other WTO members in a non-discriminatory way, although they may sign preferential agreements with each other deepening the liberalisation of their trade as long as these meet certain WTO standards of depth and comprehensive coverage.

Glossary

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive
BRRD	Bank Recovery and Resolution Directive
CCP	Central counterparty
CRD/CRD IV	Capital Requirements Directive
CRR	Capital Requirements Regulation
CSD	Central Securities Depositaries
CSDR	Central Securities Depositaries Regulation
DMD	Distance Marketing Directive
EBA	European Banking Authority
EEA	European Economic Area
EFTA	European Free Trade Association
EMIR	European Market Infrastructure Regulation
ESA	European Supervisory Authority, i.e. EBA, ESMA
ESMA	European Securities and Markets Authority
EU	European Union
EU27	The continuing EU and its 27 Member States after the UK exit from the EU
IFR	Interchange Fees Regulation
FATF	Financial Action Task Force
FSMA	UK Financial Services and Markets Act 2000
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
MAR	EU Market Abuse Regulation
MiFID	Current EU Markets in Financial Instruments Directive
MiFID II/MiFIR	New EU Markets in Financial Instruments Directive andRegulation replacing MiFID
4MLD/AMLD	Forth Money Laundering Directive
PAD	Payment Account Directive
PSD	Payment Services Directive
PSD II	Second Payment Services Directive
PSP	Payment Service Providers

SEPA	Single Euro Payments Area
SFD	Settlement Finality Directive
UCITS	Undertakings for Collective Investment in Transferable Securities
WTO	World Trade Organisation