Time to adapt:

Achieving an orderly transitionfor banking – an EU customer perspective

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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Executive summary

A formal exit of theUK from the EU ispotentially as littleas two years away.This may result in adramatic overnightrevision of marketframeworks thathave developedover threedecades.

In November 2016, UK Finance published its report Time to Adapt: achieving an orderly transition for banking. The UK Finance Report assessed the risks posed to EU financial services customers by a disorderly exit of the UK from the EU. It contained a detailed analysis of why a transitional framework for financial services is needed for banks and their EU customers, and how such a framework might be designed. This paper does not repeat that analysis, but looks in greater detail at the nature of the financial services supply chains that exist between the UK and the rest of the EU. It assesses the practical implications for EU-based businesses of changes to their ability to source financial services from the UK – especially if these changes are not carefully managed.

A formal exit of the UK from the EU is potentially as little as two years away, and with it the possibility for a dramatic overnight revision of market frameworks that have developed over three decades. A sudden and significant change in current rights to obtain financial services from UKbased providers poses the risk of serious disruption for EU-based businesses, giving rise to a damaging cliff edge effect. If banks and businesses attempt to avoid such disruption by preemptively restructuring operations and existing transactions that straddle the cliff edge date, this may involve costly, inefficient and potentially unnecessary change. While some providers may seek to move some operations into the EU, and other providers inside the EU may emerge, such significant changes in business mean that these will not in any reasonable timeframe be able to replicate the current depth and breadth of financial services provision.

Certainly, it is unlikely that such change can be soundly, prudently and transparently undertaken in the two-year period provided for in Article 50. This carries material risk for the large number of EU businesses that currently obtain financial services from providers based in the UK. The damaging cliff edge effect is not unique to financial services. Other economic sectors, such as automotive, pharmaceutical, engineering and telecoms are likely to experience new tariff and non-tariff barriers to trade in goods or services that disrupt commercial and economic structures built on the basis of the single market in goods and services.

The EU market in financial services today

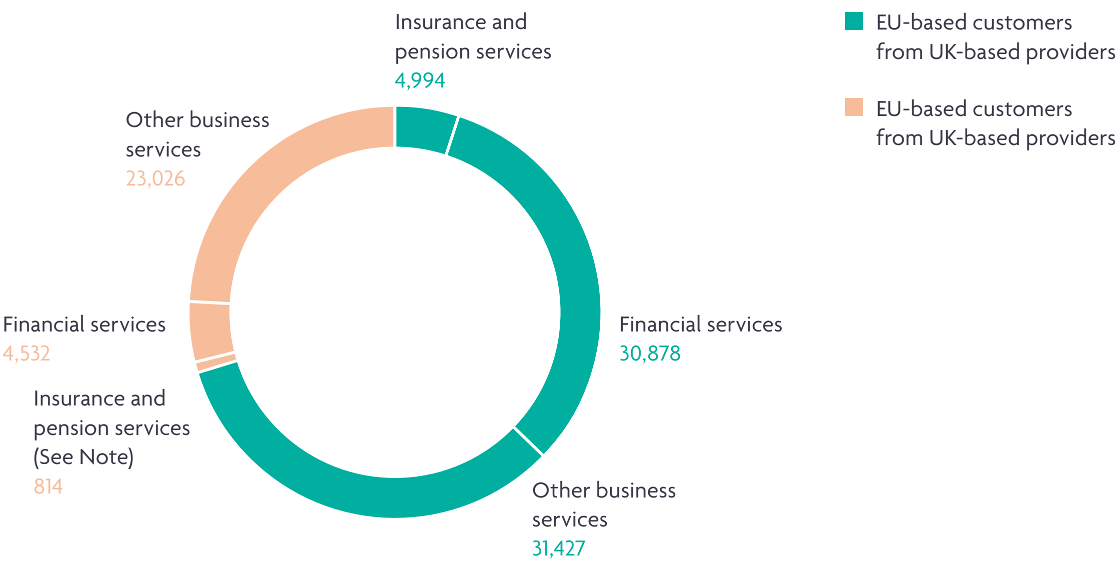
As with any other supply chain affected in this way, managing the consequent transition means understanding the ways in which the EU market currently operates.

The UK and the EU currently make up a single marketplace for many financial and related services. That marketplace is dynamic and very substantial. Customers based in the UK purchase financial services from firms based in the EU and vice versa. In 2015 the UK government's estimate of this flow between the EU and the UK indicates around €41 billion of financial and insurance-related services[1] were bought and sold between firms in the two markets. The largest part of this commercial activity represents services sold by British, European, US and other international businesses located in the UK to customers across the rest of the EU. Indeed, for every one euro spent by a UK buyers with an EUbased financial services company, EU buyers spend more than six euros purchasing financial services from UK-based financial services companies.

Each of these purchases represents a business need met by a provider of a service in the other market. These services cover the full range of banking and other financial services and represent by far the largest segment of the current EU market for such services.

This commercial activity will inevitably be reshaped by the UK decision to leave the EU, not least because much of this activity is dependent on EU frameworks. As with any other supply chain affected in this way, managing the consequent transition means understanding the ways in which the EU market currently operates, and where services provided from the UK fit in that wider European economic picture.

Figure 1: The EU27 – UK cross-border marketplace for financial and related services 2015 (€ in millions)



Source: UK ONS, converted to euros at 2015 average spot price of €1.377/£.

Note: 2014 data for sales of EU-based insurance and pension services in the UK.

[1] Services classified as financial, insurance or pension-related in UK ONS classifications. It should be noted that many services classified as business services in these classifications are closely integrated with the supply of financial, pension and insurance services. Businesses based in the UK and in the rest of the EU traded almost €55bn of such business services in 2015.

A UK exit from the EU will inevitably impact in some way on how financial services are bought and sold between the UK and the rest of the EU. These changes could range from moderate disruption to a significant reduction in current rights and freedoms.

The wider EU single market procures a significant part of its financial services from the UK, one of the largest financial centres in Europe. More than a third of the EU's wholesale banking activity takes place in the UK; half of its asset management activity; sixty percent of its capital markets activity and almost seventy percent of its foreign exchange trading in euros. These services range from core banking services such as lending and deposit taking to complex risk management services such as the writing and clearing of derivatives contracts. Every major euro area bank has a commercial presence in the UK, in many cases helping their domestic customers engage in the global financial markets served by London. UK-based banks account for around a fifth of all banking activity in the EU – extending more than €1.6 trillion in credit to EU-based banks, governments, businesses and households as at Q3 2016.[2]

This cross-border marketplace for financial services between providers and customers in the EU and UK is underpinned by the frameworks of the EU single market for financial services. These include the EU Treaties themselves, the EU passporting regime for financial services and a wide range of EU directives and regulations that facilitate cross border trade in financial services across the EU. Many of the rights created by this framework are not available to businesses based outside of the EU, even for the trading partners currently granted highly preferential terms of access to the EU market. For this reason, a UK exit from the EU will inevitably impact in some way on how financial services are bought and sold between the UK and the continuing Member States of the EU (EU27).

Figure 2: Selected services to EU-based customers potentially impacted by revised UK market access

Class of service	UK share as % of EU28	Key services purchased by EU-based customers potentially impacted by changed UK rights
Wholesale financial services	c35%[3]	• The provision of financial services by financial institutions to corporate clients, investors, institutions and public sector bodies, as well as to other financial institutions.
Capital markets services	c60%[4]	• Issuance of debt and equity securities in international capital markets. • Issuance of EU sovereign debt in international capital markets.
Foreign exchange trading	c69%[5]	• Sale and purchase of foreign exchange instruments, including spot transactions, outright forwards, foreign exchange swaps, currency swaps, options and other products.

[2] Bank of England

[3] City of London and London Economics: The Importance of Wholesale Financial Services to the EU Economy 2014. Measured as share of GVA generated by wholesale financial services. Based on data from Eurostat.

[4] Estimated at March 2016 in Global Capital – UK in the Global Marketplace, March 2016 http://cdn.globalcapital.com/Media/documents/euroweek/pdfs/2013/UK%20report%202016.pdf.

[5] Triennial Central Bank Survey, 11 September 2016, Foreign exchange turnover in April 2016. BIS http://www.bis.org/ publ/rpfx16.htm. Represents UK share as a % of EU28 in euro denominated foreign exchange instruments.

For EU-based customers, their primary concern will rightly be the consistent and reliable availability of important services throughout the period of a UK exit negotiation with the EU and at and after point of a formal UK exit.

These changes could range from moderate disruption to a significant reduction in current rights and freedoms for banks and their customers. In addition, the operational burden and financial costs involved in implementing the reorganisation of business supply chains and restructuring existing transactions are likely to be substantial for both banks and customers; the extent of such operational burdens and financial costs will be materially influenced by whether the transformation from the existing framework to a new framework is implemented in a timely, transparent and orderly manner.

The risks of a cliff edge for EU-based customers

A high level of current integration combined with a material risk of major revision in the rights of EU-based customers to source financial services from UK-based providers makes an orderly transition important for the stable provision of financial services to EU-based customers and the EU economy.

What is preserved of the status quo in terms of cross border trading rights is ultimately a political question for the UK and the other EU Member States. However, irrespective of the precise detail of that future framework, the transition to new arrangements raises important risks of service disruption for EU-based customers of services provided from the UK. In particular, a cliff edge effect in the right of EU-based businesses to procure financial services from UK-based suppliers would have profound and disruptive implications for businesses currently dependent on those services. With the Article 50 process of negotiating a UK exit from the EU expected to take just two years, such a cliff edge could be as close as 24 months away.

Among other impacts, such a cliff edge could entail:

- The overnight loss of access to UK based financial service providers for EU customers due to the loss of legal authorisation for UK-based firms (including EU firms' operations in the UK) to provide services such as commercial lending, corporate and business deposit taking, investment management services and derivative writing and trading services;
- The creation of legal uncertainty for pre-existing contracts between EUbased customers and their UK-based providers where these depend on EU authorisations and whose performance continues beyond the date(s) of the cliff edge, with the potential for contracts being terminated or service withdrawn;
- The financial and operational costs of restructuring such pre-existing contracts to protect legal certainty;
- Additional cost and complexity for EU businesses using payment services to or from the UK;
- Insufficient time for alternative service provision to be established or to develop capacity inside the EU;
- Financial and operational costs and burdens of replacing or rebalancing prior service and product provision, or the risk that a satisfactory substitute may not be available.

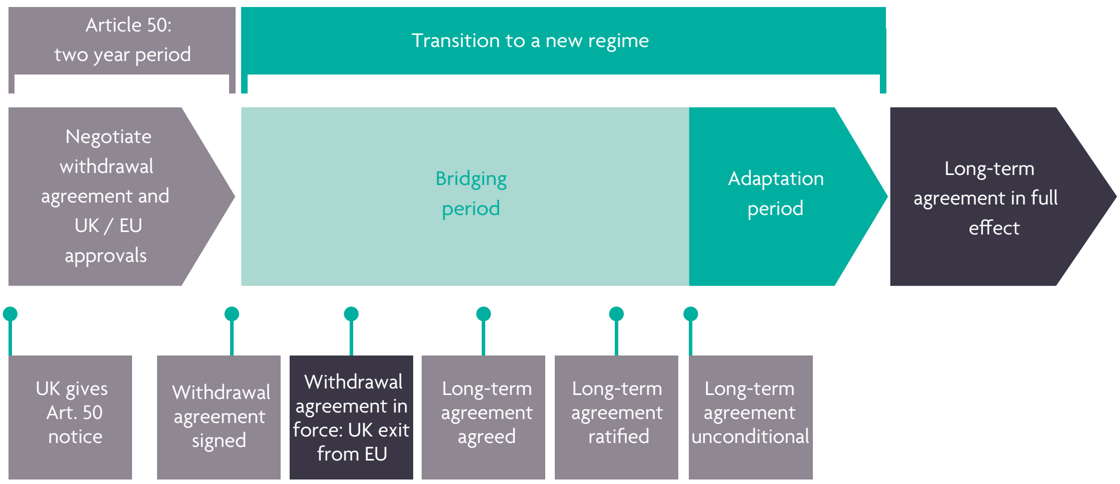
Transitional arrangements are key to ensuring an orderly and non-disruptive mechanism for dealing with these unknowns and will help avoid damaging cliff edge effects.

For EU-based customers, their primary concern will focus on the consistent provision of services throughout the period of UK exit negotiation with the EU27 at and after the point of a formal UK exit. A cliff edge carries the risk of both banks and customers restructuring supply chains in a way that is costly, inefficient and potentially premature, given the prospect of the EU and the UK agreeing a new framework for market access. Where this causes unnecessary disruption, it is not in the interest of EU businesses or the wider EU economy.

The need for transitional arrangements

Brexit will inevitably bring with it changes to the way goods and services are traded between the UK and the EU27. If these changes happen suddenly, there is a serious risk of disruption to businesses and their customers. Transitional arrangements are key to ensuring an orderly and nondisruptive exit from the EU and will help avoid damaging cliff edge effects at the point of exit when existing rights and obligations may disappear overnight. Both the UK and the EU27 have an interest in this transition being orderly.

Figure 3: Transitional arrangements – Illustrative timeline



Transitional arrangements should address the requirements of both the UK and the EU. They should act neither as a delay on fulfilling the commitment of the UK Government to exit the EU nor should they be seen as a mechanism for 'cherry picking' by the UK in relation to the EU.

Transitional arrangements should have two phases:

- A bridging period: The first phase is needed to bridge the gap between the UK exit from the EU and a potential long term framework. Models for transitional arrangements that do not include such a bridging period, or which suggest different periods for different sectors have the basic weakness that they do not ensure that all sectors can bridge the gap between the point of UK exit from the EU and confirmation of the nature of the future EU-UK relationship in the same way. A bridging period that covers all impacted activity avoids this risk.
- An adaptation or implementation period: The second phase is needed to create the time required by users, providers and market infrastructure to adapt to this new framework once it is determined – or, in a conservative scenario, a decision to proceed without such a framework. This is an adaptation or implementation period. Such a period could in principle vary in length across sectors.

The timely agreement of suitable transitional arrangements by the EU and the UK would minimise unnecessary disruption and reduce the risk of businesses making precipitous, costly – and potentially premature – decisions about the structure of their operations and their dealings with customers, suppliers or other cross-border relationships.

Transitional arrangements should address the requirements of both the UK and the EU. They should not act as a delay on fulfilling the commitment of the UK Government to exit the EU. Nor should they act as an unnecessary check on moving to a new long term framework or be seen as a mechanism for 'cherry picking' by the UK in relation to the EU. Their purpose is to facilitate orderly change and to provide businesses with the time to adapt to the new partnership. Transitional arrangements should be comprehensive, non-disruptive – and temporary.

How such a framework might be structured is set out in detail in the UK Finance Report.

Transitional arrangements – summary recommendations

Transitional arrangements should be comprehensive, non-disruptive – and temporary.

The UK Finance Report contains a detailed analysis of why a transitional framework for financial services is needed to cover the UK's exit from the EU and offers five recommendations on transitional arrangements to EU and UK policymakers.

Agree transitional arrangements	*The withdrawal agreement under Article 50 must include realistic and practical transitional arrangements. These should include both a bridging period between exit of the UK from the EU and the point that the terms of the new partnership between the UK and the EU27 becomes certain, and a follow-on adaptation period.*
Commit to transition at outset	*The UK and the EU27 should commit in principle to include realistic and practical transitional arrangements in the withdrawal agreement, at or around the point that notice under Article 50 is delivered.*
Indicate objectives at outset	*The UK and the EU27 should indicate the broad parameters of the wider relationship they will seek to establish with one another, at or around the point that notice under Article 50 is delivered, in order to minimise uncertainty.*
Ensure a separate workstream	*The UK and the EU27 should, from the outset, fully resource a workstream dedicated to structuring and agreeing the transitional arrangements.*
Apply transition to all activities and businesses	*The transitional arrangements should apply to all activities of existing and new businesses, subject only to specified exceptions.*

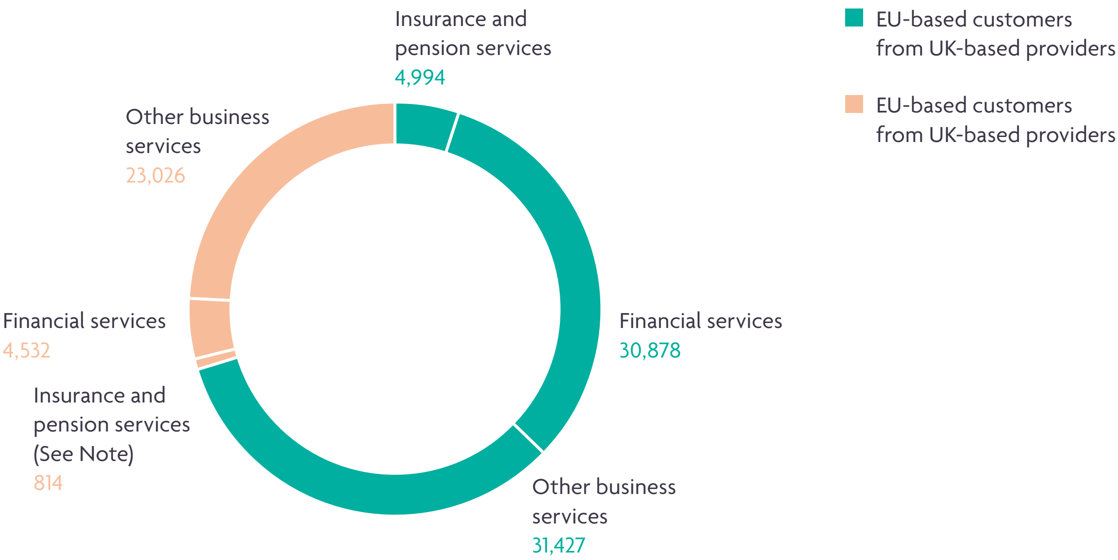
1. The EU single market for financial services

For every one euro spent by a UK buyers with an EU-based financial services company, EU buyers spend more than six euros purchasing financial services from UK-based financial services companies.

The EU – UK marketplace for cross-border provision of financial services is large and active, reflecting over three decades of integration and the implementation of a single rulebook. In 2015, non-UK based businesses from the EU single market purchased services worth more than €35 billion from UK-based providers of financial and insurancerelated services. The sellers of these services include domestic UK firms, businesses from elsewhere in the EU located in the UK and non-EU firms operating in or from the UK market.

Businesses based in the UK also imported large volumes of financial services from the rest of the EU: they purchased around €5.3 billion in financial and financial related services from providers based in the rest of the EU in 2015. Many of these services in both directions are provided by businesses relying on EU financial services passports or other EU frameworks (See Box 1: How does passporting underpin the ability of EU-based businesses to source financial services from UK-based suppliers?). When the wider business services that support many parts of this activity are included, the true scale of the cross-channel market place is even more marked (See Figure 4, below).

Figure 4: The EU27 – UK cross-border marketplace for financial and related services 2015 (€ millions)



Source: UK ONS, converted to euros at 2015 average spot price of €1.377/£.

Note: 2014 data for sales of EU-based insurance and pension services in the UK.

The role of UK-based banks in the EU single market for financial services

Financial services are an integral part of almost all business supply chains. From a basic business bank account to the most complex corporate financing, the services provided by banks and financial services businesses are an important part of everyday life for most EU businesses. In the same way that the single market has enabled a factory in one EU Member State to source inputs from across the EU with relative ease, the EU single market for financial services has made it increasingly easy for a business to source their financial services from centres in any part of the EU, irrespective of where the business itself is based. London and the UK are an important provider of financial services and are closely integrated into this wider EU market for these services.

Box 1: How does passporting underpin the ability of EU-based businesses to source financial services from UK-based suppliers?

The EU passporting regime for financial services firms is one of the basic foundations of the modern EU market for financial services. There are several separate passporting regimes, each for a different class of financial services activity, although they overlap in some areas such as banking and investment services and banking and payments services.

Once adequately established and authorised in one EU Member State, financial services firms in the EU have a 'passport' to open branches across the EU and sell services across EU borders with minimal additional authorisation requirements and with the requirement that they be treated no differently than domestic firms. The passporting regime reflects the fact that all EU Member States have adopted a common body of financial services regulation and supervisory practice. The passporting regime is not available to businesses based outside of the EU.

The passporting regime has been important because it has created a framework for businesses based in the UK or in the rest of the EU to serve customers in the other market directly, without having to establish a separate authorised business there. Once the UK is outside of the EU, and in the absence of a new long term partnership agreement to maintain elements of the status quo, it will no longer generally be possible for UK based firms to provide cross-border services to EU-based customers in the same way. It is this loss of passporting rights that creates the greatest risk of disruption.

Financial services accessed by EU customers through the UK

As at Q3 2016, UK-based banks had extended more than €1.6 trillion in credit to EU-based banks, governments, businesses and households.

Among the most important services provided to customers across the EU by UK-based banks are:

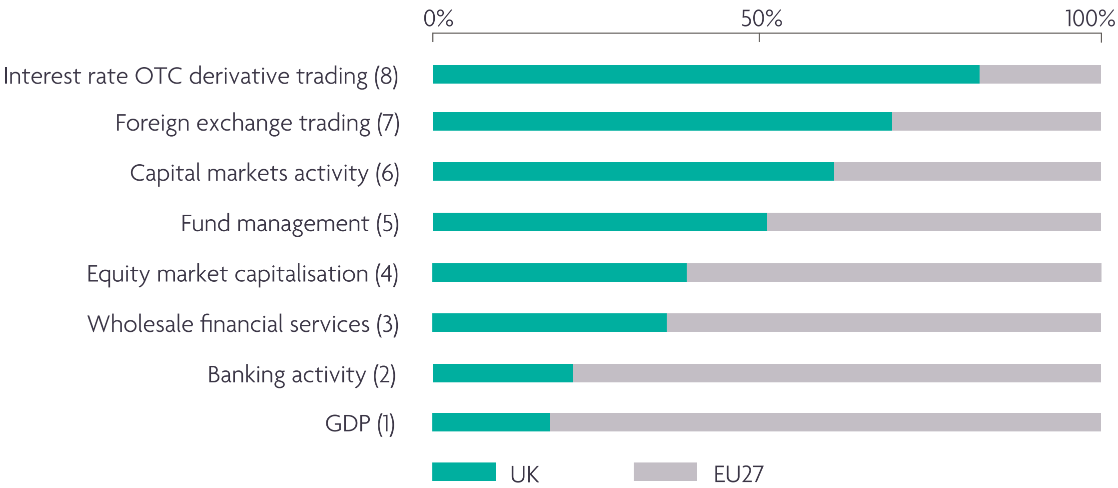
- Corporate lending and deposit taking. The UK is an important provider of financing through the provision of cross-border lending and trade finance to EU-based customers. As at Q3 2016, UK-based banks had extended more than €1.6 trillion in credit to EU-based banks, governments, businesses and households[6], and UK-based financial services businesses had provided billions more in other forms of credit or investment. UK-based banks also provide a range of business banking services, including holding deposits in a wide range of global currencies, including euros.
- Corporate and capital markets services. The UK is an important provider for capital markets services to EU companies, often linked to the specialist debt and equity capital raising, investment and risk management services provided in London, but also on many global aspects of the operation of EU-based businesses, including financing international investment and trade. Approximately 60% of EU capital markets activity is conducted in the UK.[7]
- Securities services and trading. The UK is the largest EU provider for the sales and trading of securities, covering every market, from equity and debt securities from companies listed in the UK and EU27 markets and across the world, to structured securities, sovereign debt and physical commodities. The UK is also a major EU provider of securities services to the owners of securities, providing asset custodial and other asset services to large holders of securities such as pension funds.
- Foreign exchange services. The UK is the EU's largest and most liquid marketplace for trading in foreign exchange instruments (spot transactions, outright forwards, foreign exchange swaps, currency swaps, options and other products). The UK accounted for 69% of the total EU turnover in foreign exchange instruments denominated in euros and 78% of the total EU turnover in foreign exchange instruments across all currencies.
- Derivatives and other specialist risk management products. The UK is the largest EU provider for 'derivatives' – tradeable contracts between market participants used to anticipate and insure against changes in interest rates, exchange rates or a very wide range of other market values. The UK is also a major European centre for the clearing of many such derivatives on central counterparties (CCPs) – these are the organisations that stand between the buyers and sellers of derivative contracts to minimise the impact of defaults, and their use has been made mandatory for many categories of derivative contract since 2008.
- Retail banking services. Alongside a large domestic banking market, UK-based banks provide retail banking services including deposit taking and consumer credit to consumers across the EU. The UK is also an important EU centre for financial planning and private wealth advice and banking services to individuals across the EU.
- Asset management. The UK is one of the largest EU providers for asset management services, including providing many middle and back office services to asset managers in other EU locations such as Ireland, Luxembourg and the Netherlands.

[6] Bank of England

[7] Estimated at March 2016 in Global Capital – UK in the Global Marketplace, March 2016 http://cdn. globalcapital.com/Media/documents/euroweek/pdfs/2013/UK%20 report%202016.pdf.

Many EU and Eurozone institutions use London both as an important entry point for international capital into the EU and a gateway to international markets for capital and services.

Figure 5: UK share as a % of EU28 total



Sources: (1) 2015. Eurostat; (2) 2016: ECB statistics; (3) City of London and London Economics: The Importance of Wholesale Financial Services to the EU Economy 2014; share measures GVA of wholesale financial services based on data from Eurostat; (4) World Federation of Exchanges, December 2016; (5) efama: Asset management in Europe, 8th Annual Review, April 2015; share represents discretionary mandates AuM; (6) Estimated at March 2016 in Global Capital – UK in the Global Marketplace, March 2016; (7) Triennial Central Bank Survey, 11 September 2016, Foreign exchange turnover in April 2016. BIS http://www.bis.org/publ/rpfx16.htm. Representing UK share as a % of EU28 in foreign exchange instruments denominated in euros: (8) Triennial Central Bank Survey, 11 September 2016, OTC interest rate derivatives turnover in April 2016. http://www.bis.org/ publ/rpfx16ir.pdf.

The role of the UK in the EU market is underpinned by the EU single market framework for financial services, but is also linked to a number of other key factors.

Depth and liquidity

For some of the activities of which the UK is a major provider in the EU market, a very high volume of trading and highly liquid markets are an important feature. The presence of many buyers and sellers on UK-based markets helps push down fees and establish efficient pricing for individual services.

Specialisation

As noted above, providers based in the UK offer services throughout the EU across the full spectrum of financial and banking services from payments and retail banking services to corporate advisory services. However, the UK is also a major European location for the specialist banking services for which UK-based providers have developed a global role. These include the writing of risk-hedging products such as interest rate or currency derivatives and the provision of foreign exchange services.

These services are almost exclusively provided to wholesale customers and sophisticated users, and they include many services that have become an integral part of managing a global European business trading and operating across the EU and around the world. Around a third of all such corporate banking and wholesale financial services activity in the EU is conducted from London. This has also made London a major EU centre of regulatory specialism in these areas, an important factor in thinking ahead about how to manage changes in the EU single market for financial services.

International networks

Many EU and Eurozone institutions use London both as an important entry point for international capital into the EU and a gateway to international markets for capital and other financial services. Every major euro-area bank has a commercial presence in London. Of the non-British deposit-taking institutions authorised in the UK, more than half are from elsewhere in the EU, and hundreds more EU financial services firms have licenses of some kind to operate in the UK. These include EU-based banks and financial services firms raising wholesale capital for lending and investment across the single market.

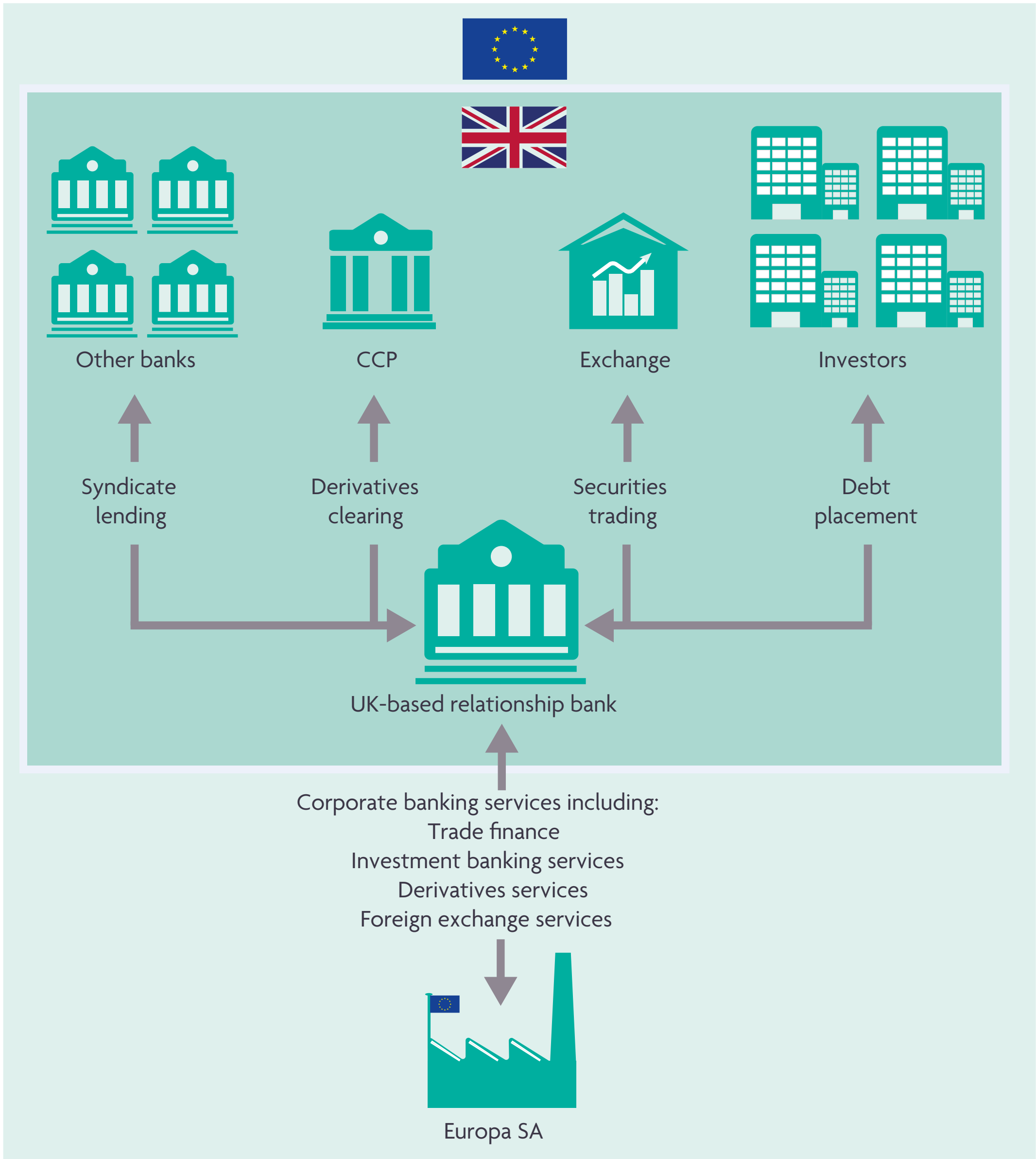
These three features of the UK's role in the EU single market for financial services are often taken as a given, but they are important in managing the transition of the UK out of the EU because they represent the key reasons why it may not be straightforward for UK-based supply chains simply to be restructured into the rest of the EU, or why restructuring UK-based financial services supply chains may mean higher costs and more limited availability in some areas for EU-based customers shifting to alternative suppliers in other EU markets.

This has also made London a major EU centre of regulatory specialisation in these areas, an important factor in thinking ahead about how to manage changes in the EU single market for financial services.

Case study 1: Europa SA – the status quo

Europa SA is a large manufacturing company based in an EU Member State. It has operations across the EU single market and around the world. It operates chiefly in euros, but routinely uses US dollars and other currencies to purchase goods from global suppliers and invest in new manufacturing sites around the world. Europa SA uses providers based in the UK, including the UK branch of its primary relationship bank in its home EU Member State to:

- Access corporate banking and advisory services. The UK-based bank operates multi-currency corporate deposit accounts and a range This has also made London a major EU centre of regulatory specialisation in these areas, an important factor in thinking ahead about how to manage changes in the EU single market for financial services. UK Finance Time to adapt: achieving an orderly transition for banking – An EU customer perspective of other corporate banking services for Europa SA. The global services team in its UK-based bank provide advice on its funding strategy and financing options and day-to-day banking options, including support from their own global branch network or correspondent banking relationships around the world.
- Access capital for its funding needs. As well as a potential source of direct lending, UK-based banks assist Europa SA in raising funds financing both through syndicated lending via a group of banks and through the design, underwriting and issuance of debt securities in the capital markets. The latter option is used by Europa SA to establish a profile with investors as it prepares for an eventual public listing.



- Access foreign exchange services. Europa SA uses UK-based banks and the deep and liquid UK-based foreign exchange markets to buy and sell large volumes of foreign currencies to finance operations outside of the EU, including paying its non-EU suppliers.
- Write and clear derivative contracts. Like many large EU companies exposed to changes in interest rates, foreign exchange rates or commodity prices, Europa SA routinely hedges its exposure to such changes by entering into derivative contracts that protect it against shifts in interest rates, foreign exchange rates or commodity prices. The UK-based relationship bank then clears its offsetting or hedging contracts on a UK or EU27 CCP, as required, enabling the UK-based relationship bank, as a clearing member, to benefit from the least onerous capital requirements, and resulting in better commercial terms for Europa SA.

At present, Europa SA can procure all of these services from providers based in the UK directly from the its home EU Member State. As long as the UK-based banks providing services to Europa SA hold the necessary EU passports, they do not need to have a legal presence in Europa SA's home EU Member State. Nor does Europa SA need a legal presence in the UK to transact with UK-based banks.

The importance of EU frameworks in financial services activity between the UK and the EU27

Many, if not most, of the rights created by these frameworks are not available to businesses based outside of the EU, even for the EU trading partners currently granted privileged terms of access.

This commercial activity in both directions is highly dependent on current EU frameworks. These establish the basic market access rights of businesses trading between the UK and the rest of the EU and therefore the choice of suppliers for customers. They also materially shape the operational freedom and regulatory treatment of businesses operating in both directions in ways both large and small. The most important of these EU frameworks are:

- EU Treaties. The basic commercial rights created by the Treaties underpin all operations between the UK and the rest of the EU. These create rights to establish and trade throughout the EU market, subject to authorisation requirements. These rights can be enforced via the EU courts system.
- EU passporting regime. The EU passporting regime grants important rights to financial services businesses that are appropriately authorised in the EU, including in the crucial area of permitting the sale of financial services in one EU market from another. As noted above (See Box 1: How does passporting underpin the ability of EU-based businesses to source financial services from UK-based suppliers?) this framework is central to the creation of a genuine pan-European market for financial services and is one of the key pillars of the role of the UK in the wider EU market. The passporting regime is itself underpinned by a very high level of cooperation and information-sharing between UK authorities and their counterparts in the rest of the EU (See also the UK Finance Brexit Quick Brief #3: What is 'passporting' and why does it matter? www.ukfinance.org.uk/brexit).
- EU payments system. The UK is currently part of the Single Euro Payments Area (SEPA), which facilitates payments in euros across this geographical area and making payments more efficient and cheaper for end users.

There are also a wide range of EU frameworks that harmonise regulatory treatment of financial and related services in the UK and the rest of the EU via EU directives and regulations.

By setting a single EU standard for all the national markets of the EU, this single rulebook facilitates or simplifies the sale of services between these markets, or creates operational rights for EU businesses in other EU markets outside their home jurisdiction. Two key examples of this are:

- The EU market infrastructure framework. The EU Market Infrastructure Regulation (EMIR) harmonises the regulation and supervision of market infrastructure across the EU, with a focus on the CCPs and linked infrastructure used for clearing derivatives contracts. EU regulatory reforms since 2008 have required that many types of such contracts be cleared on CCPs and the EU regime enables EU-based institutions to use CCPs anywhere in the EU to meet such requirements. As the major EU centre for the writing and clearing of derivatives, UK-based CCPs are also used by institutions from across the EU to meet their EMIR clearing obligations. The EU does recognise CCPs outside of the EU for this purpose, but only after an EU equivalence judgement that they are subject to the same standards as EU market infrastructure.
- The EU data protection framework. The EU Data Protection Directive8 harmonises standards across the EU for the protection of personal and sensitive data. The movement of personal data between locations is an integral part of modern banking operations. Banks and other financial services businesses store and process personal data digitally as a routine part of conducting business, including providing lending, securities operations, investments, client due diligence, operating retail and corporate accounts and as part of managing their workforce. Many banks and other companies in the EU have taken advantage of this framework to rationalise data storage or processing, or to provide customer service or back office functions, from a limited number of locations inside the EU. The EU applies significant safeguards and restrictions on personal data transferred out of the EU. These are to ensure that strong data protection standards are maintained, but can be complex to administer. The UK exit from the EU risks impeding the cross border data flows between the UK and the EU (See also the UK Finance Brexit Quick Brief #5: Data protection and transfer www.ukfinance.org.uk/ brexit).

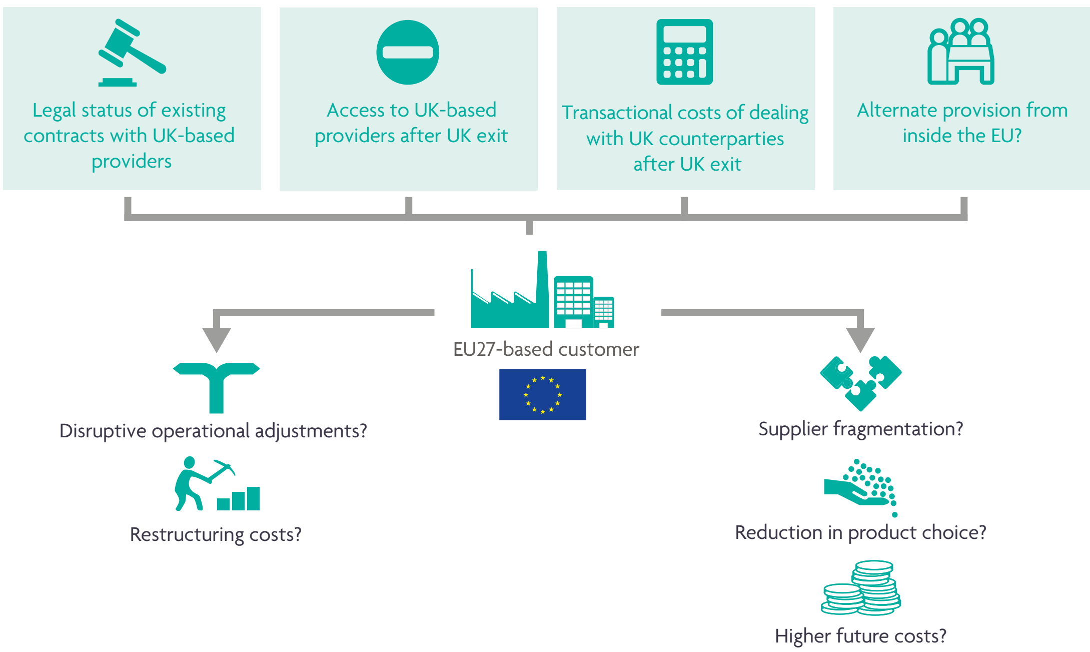
2. Brexit and the provision of financial services to EU-based customers from the UK

What is preserved of the status quo is ultimately a political question for the UK and the other states of the EU. However, irrespective of the precise detail of that future long term framework, the transition to new arrangements raises cliff edge effects for EUbased customers.

The previous section has described a high level of integration between financial services businesses based in the UK and EU-based customers. The UK is also a large importer of financial services from the rest of the EU, but these flows are smaller by comparison. Because provision of these services in both directions is primarily based on EU legal frameworks, they will inevitably be affected by a UK exit from the EU. The ability of UK-based customers to continue to access services from EU-based providers is potentially impacted by a UK exit from the EU. However, EU-based customers are likely to face a greater range of new potential restrictions on their access to services as compared to UK-based customers, because the licensing regimes in most other EU Member States is more restrictive of cross-border services than the licensing regime in the UK.

This raises important questions for the stable provision of financial services to EU-based customers and the EU economy. The absence of a new long term framework for financial services trade between the EU and the UK or a sharp change in the legal right to deliver services into the single market from the UK will inevitably require that at least some EU-based customers seek alternative providers inside the EU for some services, if such alternatives are available, and that a large number of existing transactions will need to be restructured.

Figure 6: Four key business continuity issues for EU-based customers of UK-based banks



This is not a problem unique to financial services. It can be especially acute for financial services customers as, unlike trade in goods, market access rights and legal authorisation for some crossborder activity in regulated financial services could cease completely and suddenly.

What is preserved of the status quo is ultimately a political question for the UK and the other states of the EU. However, irrespective of the precise detail of that future long term framework, the transition to new arrangements raises cliff edge effects for EU-based customers of UKbased banking and financial services. A cliff edge in the right of EU-based businesses to access financial services from UK-based suppliers would have profound implications for EU businesses currently dependent on those services.

This is not a problem unique to financial services. However, it can be especially acute for financial services customers as, unlike trade in goods, market access rights and legal authorisation for some cross-border activity in regulated financial services could in theory cease completely and suddenly at the point of a UK exit. The sanctions for providing unauthorised financial services are in many cases highly punitive and EUbased customers will find their UK-based providers rapidly restructuring their service offerings as the point of exit approaches if a cliff edge in legal rights is a material risk.

This is a much larger issue than many EU-based persons may appreciate. This is because it potentially affects both direct and indirect users of UK-based banking and financial services. Direct users are EUbased customers that themselves use UK-based banks and financial services. Indirect users are EU-based customers that use EU-based banks and financial services providers, where the EU based providers use a 'back-to-back' or similar arrangement with a UK-based provider to risk manage their own positions by accessing the broad and deep wholesale markets of the UK. For EU-based customers of UK-based banking and financial services, the key questions can be grouped in the following basic categories.

Will contracts with a UK-based entity remain legally valid and effective?

Where the legality of a contract with a UK-based service provider depends on the appropriate EU authorisation (e.g. a license in order to continue to lend) of that provider, a UK exit from the EU will inevitably be relevant for that contract. In many cases the current provision of a financial service from the UK may involve a contractual period that extends beyond the likely two-year timeframe of the UK's exit negotiations with the other states of the EU.

Such a contract might cover a long-term revolving loan arrangement providing committed access to future financing. A similar risk will attach to standing services such as deposit accounts, custody or depository services for investment funds which are provided on an ongoing contractual basis and may in many cases depend on a legal basis to provide a service to an EU-based customer from the UK.

If the legal ability to provide such services to EU-based customers is to lapse at the point of a UK-exit, then many such arrangements will need to be restructured. Where these contracts concern the delivery of services in the medium term, EU-based customers could find the terms being restructured or renegotiated, some contracts being terminated and other services withdrawn from fear of legal uncertainty. Depending on the particular situation of the EU customer and their national location this could give rise to a number of significant consequences affecting matters such as tax, market pricing adjustment, or accounting treatment. All of these factors could materially affect the availability and cost of financial services provided to EU customers by UK-based suppliers.

Will EU-based businesses be able to use UK-based providers after exit?

Even where they have no existing contractual arrangement with a UKbased provider that overlaps the formal point of a UK exit from the EU, many EU-based customers will be affected by the withdrawal of UK-based banking services from the EU single market. As noted above, UK-based providers offer a wide range of banking and investment services to EU businesses, from commercial lending and trade finance to writing and clearing derivatives. The continued right to access services directly from the UK for individual businesses will depend in many cases on the rules that govern the domestic EU market in which that business is based, but in most cases these are less open with respect to using providers outside of the EU. As one important example, corporate lending is a regulated activity that is currently not permitted to be conducted by non-EEA banks in many EU Member States.

> The impact of these restrictions on the ability to procure services from UK-based banks will not fall evenly on EU-based businesses. Midsized European businesses large enough to require wholesale financial services but without legal entities in the UK will be more exposed to change.

Aside from such corporate lending, the heaviest impact on EU-based customers in this area is likely to be in areas that combine a high level of current use of UK-based providers and a service model based on passporting and cross-border provision directly from the UK to EU-based customers. This is most acutely the case with respect to capital markets services such as the underwriting of debt and equity securities and risk management services such as derivatives contracts.

For example, UK-based banks (including branches of EU banks) are the largest provider of primary dealer services for the sovereign debt issuance of EU Member States. In many cases, EU Member States currently require that this role only be undertaken by EEA-licensed banks. This may restrict their access to capital markets via the UK once the UK no longer had this status.

> Most of these potential complications for EU-based consumers of banking services raise the same basic question: if provision from the UK is reduced or restricted, will an equivalent service be available in a timely manner from a provider inside the EEA?

A further potential impact may be restrictions on the ability of EUbased financial institutions to use UK-based CCPs to clear derivatives contracts. For example, EU financial institutions will be constrained in their ability to use UK-based CCPs for the purposes of meeting their EU legal requirements if UK CCPs have not been recognised as equivalent by the EU. Without such equivalent recognition, EU-based financial institutions buying risk management products such as foreign exchange or interest rate derivatives from UK-based banks will be required to clear them through CCPs inside the EU or in jurisdictions that have been recognised by the EU, such as the United States, Hong Kong or Singapore.

This will potentially add to costs and complexity, as spreading clearing across many CCPs can reduce the scope to net exposures and can significantly multiply collateral and other regulatory requirements. This limitation may become material for many EU businesses who buy their risk management products from EU-based banks or other financial institutions because the EU banks and financial institutions will frequently use a ‘back-to-back’ arrangement with a UK-based provider to risk manage their own position by accessing the broad and deep wholesale markets of the UK.

The impact of these restrictions on the ability to procure services from UK-based banks will not fall evenly on EU-based businesses. Large EUbased multinationals may find a ready-made solution to continue to use UK-based banks via their own subsidiaries or treasury operations in the UK. Mid-sized European businesses large enough to require wholesale financial services but without legal entities in the UK will be more exposed to change.

Will the costs of dealing with UK-based financial counterparties rise?

In some other areas, the impact will be chiefly in the cost or complexity of transacting with UK-based counterparties. For example, this problem will arise if the UK is no longer part of the SEPA, which facilitates low-cost euro transfers across its member banks. The result of this would be higher transfer fees to EU-based customers wishing to move funds to or from the UK, and slower transfers between the two jurisdictions.

Will the service currently procured from a UK-based provider be available from another provider inside the EU?

Most of these potential complications for EU-based consumers of banking services raise the same basic question: if provision from the UK is reduced or restricted, will an equivalent service be available from a provider inside the EEA at a similar cost and with a similar degree of choice and competitiveness?

As importantly, will that service be available before or at the point that commercial engagement with UK-based providers is impacted by a formal UK exit from the EU? The answers to these questions will depend on a range of factors.

Box 2: UK-based banks and service continuity to the EU after exit

A UK-based bank considering its response to the possible loss of rights to serve EU-based customers directly from the UK will assess a range of factors in determining how best to provide continuity of service to its customers. Once it is clear that such rights will lapse – or insufficiently clear that they will not – a bank will consider three factors.

How can service continuity to EU-based customers be guaranteed?

In general, the simplest way to guarantee service provision to EUbased customers will be to seek to establish authorised operations inside the EU. UK-based banks with established relationships with EU-based customers will inevitably consider this option as their primary means of preserving important service provision. In some cases this may be a case of expanding an existing presence inside the EU. In others, it might involve new authorisations or legal entities.

Is such relocation of functions into the EU economic?

It is possible such relocation and restructuring is not economic for UK-based banks. This may be especially the case for capital intensive or technology intensive capital markets or trading services where duplicating UK-based capacity in the EU is not determined to be cost effective. In these cases, services may be discontinued.

Is relocation or migration of services to other jurisdictions a viable alternative?

In some cases, an alternative approach will be to consider moving UKbased operations outside of both the EU and the UK into jurisdictions such as the United States where they already have some legal and practical capacity to serve EU-based multinationals in areas such as derivatives that is cost-effective to expand.

What these considerations emphasise is that it cannot be taken for granted that it will be practical or economic simply to migrate all the functions currently conducted from the UK into the EU single market, in the short or long term. For EU-based customers – especially EU businesses without a global footprint – this poses some risk of disruption in existing services.

It should also be recognised that the provision of equivalent services inside the EU cannot be assumed to mean equivalent cost or choice for the EUbased customers compared to the status quo.

It may depend on whether current UK providers choose to adapt their European operations to seek to continue serving EU-based customers from new authorised operations inside the EU (See Box 2: UK-based banks and service continuity to the EU after exit). This may involve the evolution or expansion of an existing licensed entity, or it may require a new branch or entity and new authorisations, especially for services currently provided directly from the UK. In both cases the provision of services locally will depend on the capacity of firms to restructure operations in good time before a UK exit and of local regulators to authorise – and in some cases, expand the capacity to supervise – them.

Second, and in parallel, it will depend if, and how quickly and effectively, EU-based banks and other financial services providers develop the capacity to replicate the services currently provided by UK-based banks to EU customers. This will in many cases raise similar questions to the relocation of services from the UK: internal capacity in existing providers, sufficient commercial rationale for investment in new services, regulatory capacity to authorise and supervise new activities or new volumes of activity and timeframes for authorisation.

It should also be recognised that the provision of equivalent services inside the EU cannot be assumed to mean equivalent cost or choice for the EU-based customers compared to the status quo. As noted above, hundreds of UK-based firms currently provide between a third and three quarters of key services in areas such as corporate banking, wholesale services, capital markets, OTC derivatives and foreign exchange, implying a potentially material reduction in the pool of providers available to EUbased customers if they can no longer source services from UK-based businesses. The volume of provision from UK-based services is also a source of considerable scale and liquidity benefits that may be impacted if provision is fragmented to multiple venues across the EU.

For EU-based customers, the primary concern in any circumstance will be the consistent and reliable availability of important services throughout the period of a UK exit negotiation with the EU at and after the point of a formal UK exit. As noted above, a lack of clarity about future rights may see UK-based providers withdrawing services to EU-based customers that are subject to legal uncertainty, once the formal process of exit has been commenced. It may also prompt EU-based customers to restructure their own supply chains in a way that is costly, less efficient and potentially premature, given the prospect of the EU and the UK agreeing a new long term framework for market access.

Where the market attempts to respond by restructuring services inside the EU, the two-year timeframe provided by the Article 50 process for developing, establishing and authorising new services is likely to prove challenging from the perspective of an orderly transition for EU-based customers. The final section of this paper addresses that problem.

Case Study 2: Europa SA – service impacts of UK exit for EU customers

Case study 1 introduced Europa SA, an EU-based corporate that currently sources a range of wholesale banking services from UK-based providers.

Case study 2 explores the possible disruptive consequences for Europa SA of a sudden lapsing in the capacity of Europa SA to source financial services from its UK-based providers and the steps Europa SA could take to address this if there were no transitional arrangements or other mechanisms in place to permit orderly service continuity when the UK departs from the EU.

Europa SA is a 'poster child' example of an export and growth oriented European business that is an important contributor to the European economy and which the UK international financial markets are ideally suited to serve.

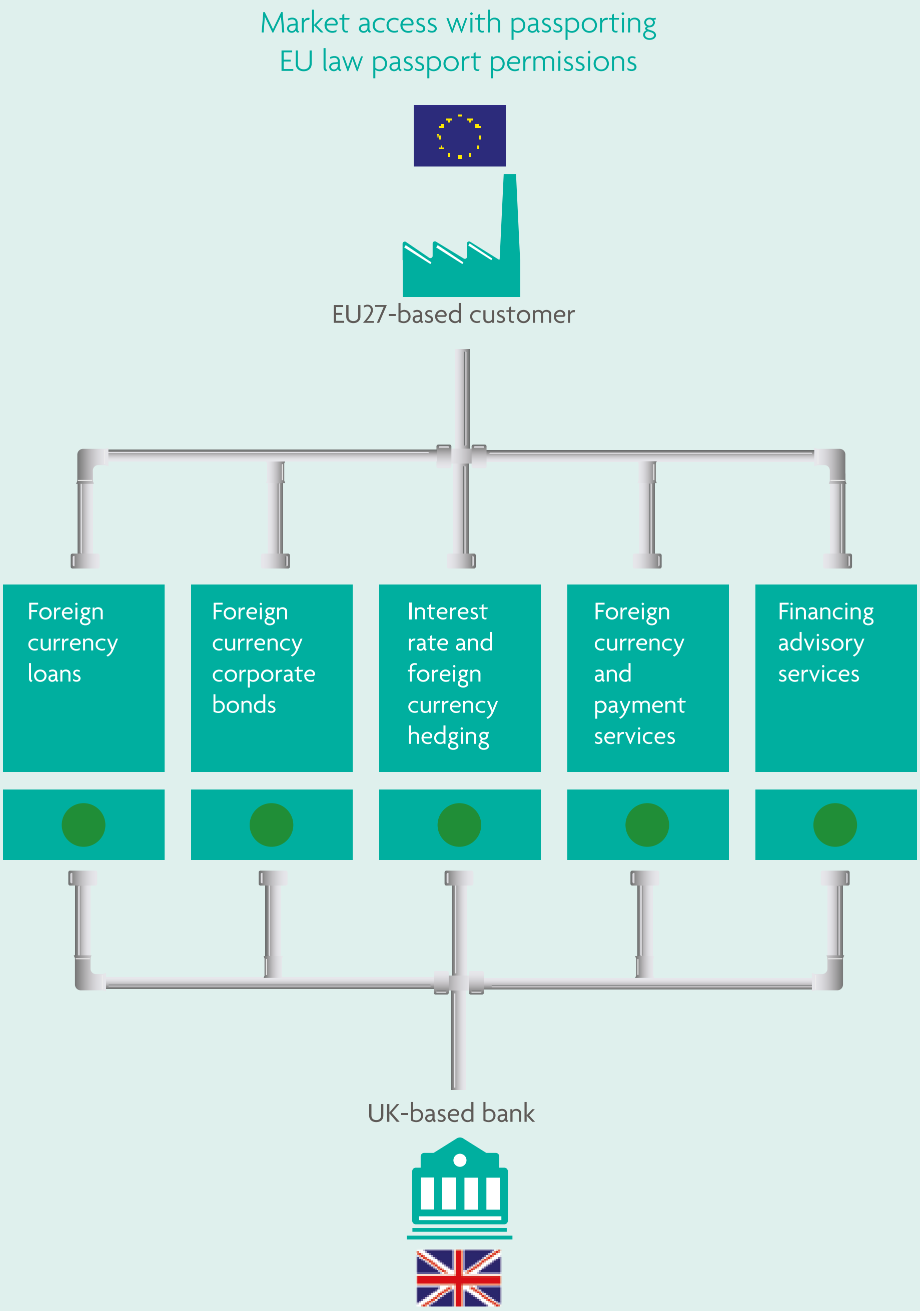
To support the growth of Europa SA's business exporting from the EU to its international markets it has obtained the following wholesale banking services from its UK-based relationship bank.

Banking products and services used by Europa SA include:

- Obtaining capital – foreign currency loans: In late 2015, Europa SA secured a large dollar-denominated revolving line of credit with a five year maturity from its UK-based bank to fund the development of its operations in the United States. Europa SA began drawing on the credit facility in 2016 and its strategic plan anticipates use of the facility to fund inventory for its new US factory from late 2018.
- Obtaining capital – foreign currency corporate bonds: In 2016 Europa SA asked its UK-based bank to lead a syndicate of banks in organising the sale of dollar-denominated corporate bonds with a ten year maturity to investors in London and the international capital markets. (Bonds with maturities of ten years or longer are often used by companies looking for stable long term funding for large capital investments because these offer considerably longer maturity and more flexible terms than available from a bank loan). Europa SA plans to use the proceeds from the bond sale to finance the construction of its new factory in the US.
- Risk management – Interest rate and foreign currency hedging: Alongside its revolving credit line and corporate bonds, Europa SA entered into interest rate swaps and hedged its foreign exchange risk with forward contracts with a five year maturity and ten year maturity to match its liabilities. These derivatives were agreed with its UK-based bank which hedged its own risk by purchasing derivative instruments cleared on a UK-based CCP.
- Foreign currency and payment services: Europa SA will continue to use foreign currency and payment services between its headquarter location in the EU and its business in the US (and in its other international markets) using the international branch and correspondent bank network of its UK-based bank.
- Financing advisory services: Europa SA will obtain continuing advice from its UK-based relationship bank for all these services, including when and how best to adjust the products that it uses as market conditions and its business needs change.

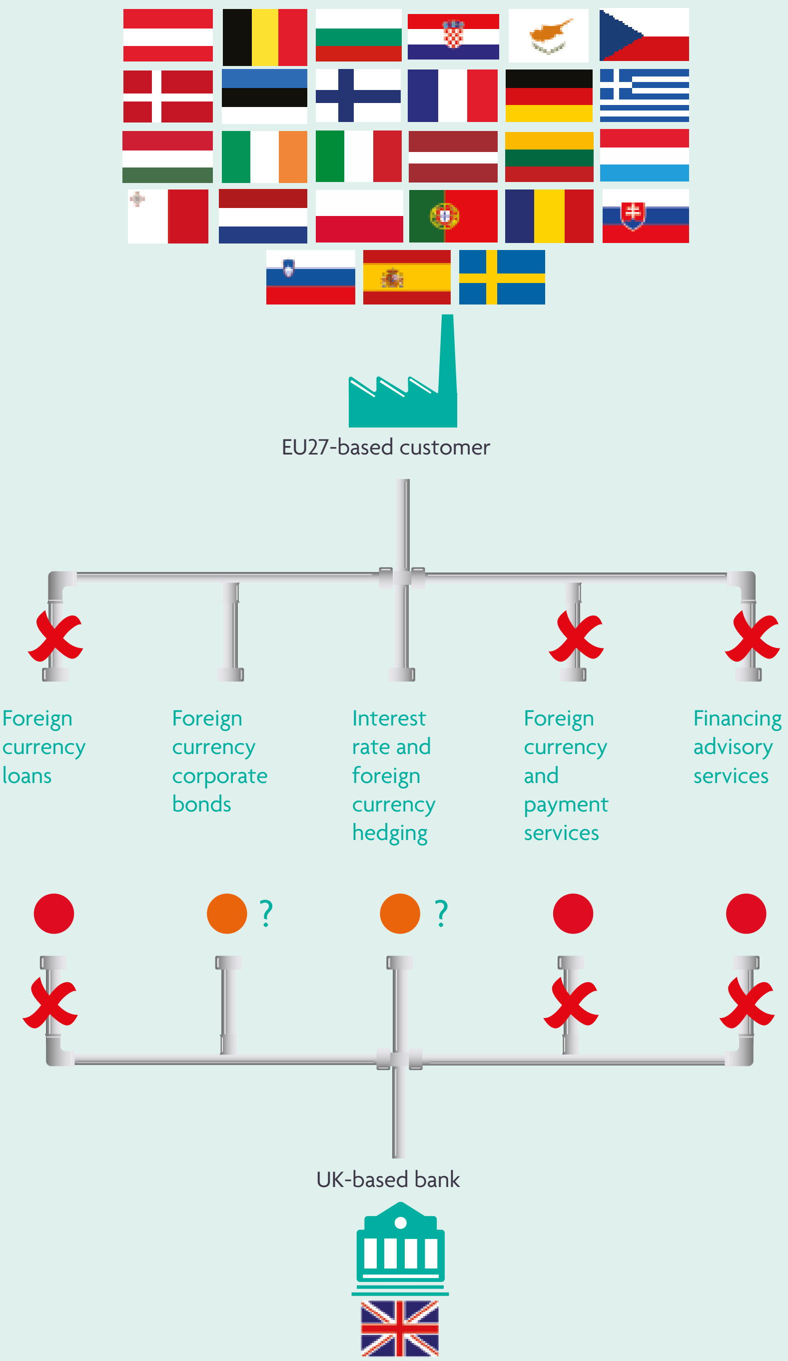
Possible consequences for Europa SA of disruption to sourcing of banking services

- If the UK departs from the EU without any transitional arrangements or other mechanisms in place to permit orderly service continuity the sudden lapsing in the capacity of Europa SA to source financial services from UKbased providers has some important implications for Europa SA. Most of the above products and services used by Europa SA would no longer be accessible by it. This is because of legal restrictions on the right of its UK-based bank to continue to provide these from the UK.



- Today these are provided to Europa SA by its UK-based bank with the benefit of its EU 'passport'. Following the departure of the UK from the EU, the UK-based bank would no longer benefit from the passport unless it had also established operations inside the EU. Other more limited EU law based rights of market access to serve customers in the EU (for example those based on a finding of 'equivalence') may not be available on a timely basis (See the UK Finance Brexit Quick Brief #4: What is 'equivalence' and how does it work? www.ukfinance.org.uk/brexit).
- Consequently, the rights of market access to serve customers in the EU would fall back upon the national laws of each individual EU27 country, and Europa SA's access to some (but not all) of these products and services would depend upon the national laws of the particular EU27 country(ies) in which Europa SA's businesses using the banking products and services are located. (This is because each of the EU27 has its own different national laws regarding the banking products and services that may and may not be provided from a non-EU location, which the UK would have become).

Market access with no passporting / Third country status
Reliance on 'equivalence' or national licencing regimes



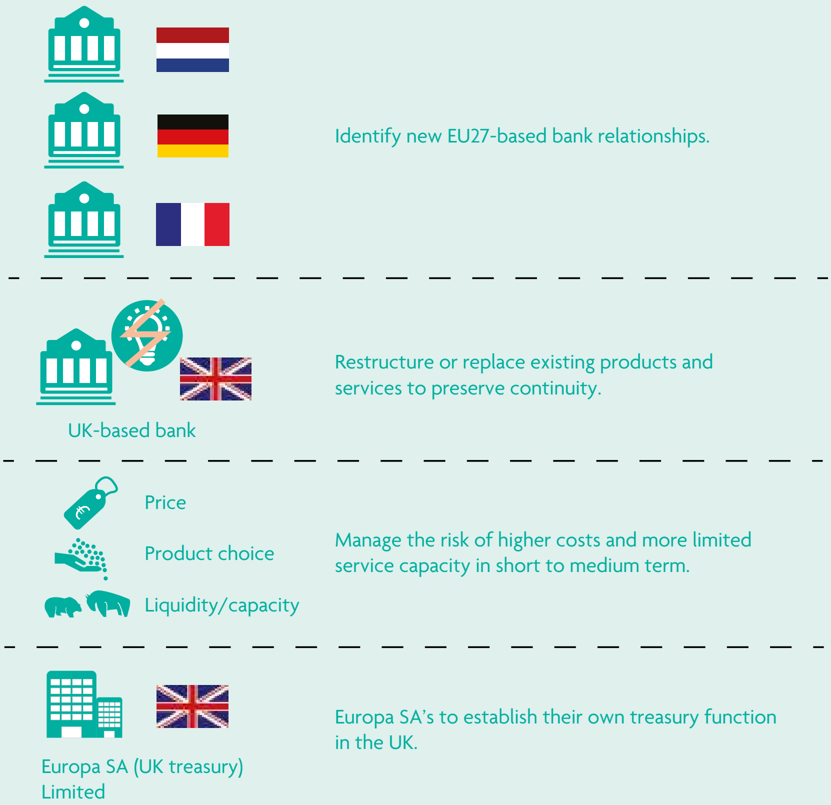
- For example, some EU27 countries' national laws permit simple foreign currency transactions; others do not. Most EU27 countries do not permit the provision of sophisticated risk management products such as interest rate or currency swaps. Many do not permit lending services.
The potential result for any European business that requires a variety of banking products and services is a 'balkanised' outcome with a patchwork of products and services accessible to it if it is located in an EU27 country with a more liberal national regime (for example, Ireland). If Europa SA is located in an EU country with a more restrictive national regime (for example, France) then it will have access to few if any. This result is not a viable position for any commercial enterprise.

Europa SA and Brexit: implications for banking services from the UK

So what are the solutions available to Europa SA, and how burdensome and/or costly could these be? The following example illustrates the steps Europa SA may need to take to protect its position:

- Identify new bank relationships: Europa SA will wish to identify a bank that can provide the same suite of products and services as its UKbased relationship bank. It will generally prefer not to have to replace this with multiple different service providers that require considerably more management time and effort to oversee, and that may not offer the same efficiencies of interconnected offerings and cost. The 'new bank relationship' could in some cases be the same UK-based bank used by Europa SA if it has an existing or newly established banking operation in an EU27 location with the capacity to continue to offer the full range of international services. In other cases, it may be a new EU based bank that can provide the same broad suite of international services. If one of these options is available Europa SA will incur administrative and operational costs and effort to reorient itself towards these new service providers (but also see "Implications for costs and full service capacity" further below).
- Restructure or replace existing products and services that can no longer continue to be provided: Europa SA has a number of products and services in place that only mature years in the future (for example its revolving loan, corporate bonds, and interest rate and currency swaps). Some of these (such as the revolving loan) will need to be transferred (if this is legally possible) or terminated and replaced. This is likely to involve transfer or termination and replacement costs, and these may be substantial, particularly if market pricing is less favourable than when the product was first purchased. There may also be tax costs if the transfer or termination results in a taxable gain, or accounting charges. Other products may be able to continue (for example, the corporate bonds or the swaps) but certain services associated with the product may need to be restructured at additional cost. For example, the bonds may not be affected for the remainder of their term, but Europa SA may need foreign exchange services to convert euros into dollars to pay the semi-annual interest on the bonds or the regular payments due on the swaps, and may need international payment and correspondent banking services to pay the interest payments to the international bondholders. Europa SA may need to use its new bank relationship for these ancillary services where these may no longer be provided from its UK-based relationship bank. Europa SA will wish to review the legal position of every product and service it has in place to determine whether this can continue or will need to be restructured. This will at a minimum involve considerable administrative and operational resource and may also result in significant restructuring expenses as described above.
- Implications for cost and full service capacity: Because the UK is a very significant provider for the EU of several of the products and services used by Europa SA there is a question regarding the capacity of EU based banks to immediately establish the necessary scale and capability quickly and soundly to provide the broad services offering that Europa SA requires. This risk will be exacerbated if there are many 'Europa SA's' all with similar requirements to service in a compressed timeframe. In addition to the risks around short term capacity, it is probable that the costs to Europa SA of obtaining some of the products and services will increase and that the selection of products and services available to it may not be as rich at least in the short to medium term. This is because of the shallower market for provision of certain of these inside the EU27 and, for those UK-based banks that implement an alternative solution for their customers inside the EU27, the additional delivery costs for such a solution compared to the deep and efficient market currently available in the UK access to which would have been disrupted.

Europa SA steps to protect its access to financial products and services may become burdensome and costly



- Establish Europa SA treasury operation in the UK: For some larger European businesses the operational inconvenience, costs and disruption resulting from the above protective measures may be significant enough to justify Europa SA setting up a treasury function in the UK. The cost savings and efficiencies from retaining direct and continuing access to the deep and efficient products and services available from the UK may be attractive enough to justify establishing such a function.

In summary, if Europa SA's access to the financial services provided from the UK is disrupted in circumstances where there are no transitional arrangements or other mechanisms to permit orderly service continuity when the UK departs from the EU, then Europa SA is likely to experience administrative and operational consequences, may be subject to restructuring and replacement costs, taxes and other charges that could be significant, and may experience a diminished product and services offering at higher cost.

3. An orderly transition for EUbased customers of UK-based banks

What is preserved of the status quo is ultimately a political question for the UK and the other states of the EU. However, irrespective of the precise detail of that future long term framework, the transition to new arrangements raises cliff edge effects for EUbased customers.

The UK's transition from being an EU Member State to a new partnership with the EU27 will inevitably bring with it changes to the way goods and services are traded between the UK and the EU27. While businesses on both sides are beginning to anticipate and plan for change, the scope and nature of these changes are as yet unclear. They could range from moderate disruption to a significant reduction in current rights and freedoms.

This means that businesses in the EU face three key elements of uncertainty:

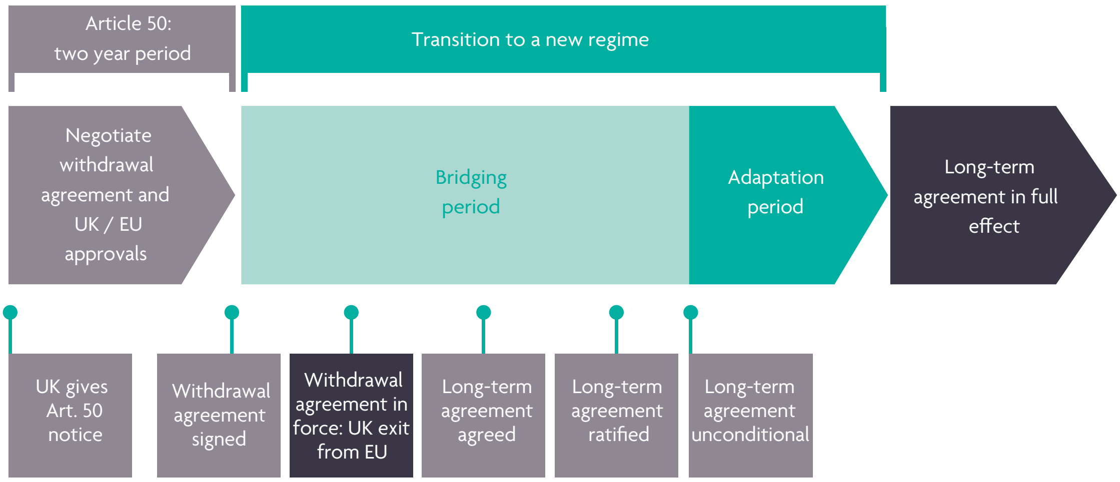
- What a future trading framework for financial services between the EU and the UK might look like;
- When such an arrangement might be in place given that the negotiation of a new future relationship is a separate process from the Article 50 negotiation and, notwithstanding that the UK government has recently indicated that their ambition is to have a new bilateral agreement on trade and cooperation in place at the point of exit, at present there is no mutual agreement from the EU to this effect. The complexities of negotiation, codification and ratification would in any case make agreeing such a framework in a short period extremely challenging; and
- What might happen in the period between the end of the current EU framework for the UK and a possible future framework.

A cliff edge affecting the right of EU customers to procure services from UK-based providers in the way they are provided today poses the risk of serious disruption. If banks and businesses attempt to avoid such disruption by pre-emptively restructuring operations, this may involve costly and potentially unnecessary change. While some providers might seek to move operations into the EU, and other providers inside the EU may emerge, neither can be guaranteed. Certainly, there is no prospect that such change can be soundly, prudently and transparently undertaken in the two-year period provided by Article 50.

For this reason, it is important for all sectors, including financial services, that transitional arrangements are in place to ensure that change is well-managed and disruption of services (irrespective of where they are provided from) is minimal. Such arrangements need to play two roles for EU-based customers of UK-based service providers. The first is the possible need to bridge the gap between the end of the UK's current status as an EU Member State and its new potential status as a preferential trading partner of the EU via a new bilateral agreement. The second is the time required by businesses, the banks that serve them and their regulators to adapt to this new framework – or, in a conservative scenario, a decision to proceed without such a framework.

This suggests approaching transitional arrangements in two phases:

Figure 7: Transitional arrangements – Illustrative timeline



This suggests transitional arrangements in two phases: a bridging period and an adaptation period. Collectively, these two phases would constitute a transitional period designed to make the journey of the UK out of the EU as orderly as possible for EUbased businesses currently buying services from UKbased providers.

- A bridging period. This period would cover the period from the date the UK exits the EU after the withdrawal agreement is reached to the agreement of a new partnership framework. This would minimise unnecessary disruption of services during the negotiation of a new partnership between the EU and the UK. Such a period would temporarily preserve existing trading conditions – perhaps subject to specified exceptions – until the point at which a future agreement is agreed. Ideally, the EU and the UK would be able to signal early in the negotiating process the kind of relationship they will seek to agree.
- An adaptation period or implementation period. This period would be designed specifically to allow businesses to adapt and, if required, to restructure to conform with a new framework agreed between the EU and the UK. The regulatory regime in force during the adaptation period would be identical to that of the bridging period. Alternatively, such a period could also provide a cushion for adjusting to the complete absence of such an agreement. Such a period would be designed chiefly to provide time for business and regulators to prepare and plan for a new regime, to anticipate the pressures of restructuring and to react to teething issues. While its duration would be subject to egotiation, to serve this purpose it would need to cover the multi-year process of soundly restructuring a banking service. Collectively, these two phases would constitute a transitional period designed to make the journey of the UK out of the EU as orderly as possible for EU-based businesses currently buying services from UKbased providers.

Transitional arrangements should be clearly temporary and their purpose is to facilitate orderly change, not delay it.

Case study 3: Europa SA – the value of transitional arrangements

Case study 1 introduced Europa SA, a large EU-based manufacturing company that currently sources a range of banking services from UKbased providers. Case study 2 set out the operational and restructuring challenges that Europa SA will face in the event of the UK's departure from the EU without transition or other mechanism to permit orderly service continuity in place and some of the risks of the cliff edge consequences. Europa SA faces a number of challenges when it considers the impact of a UK exit of the EU. Transitional arrangements on the model described above would materially mitigate some of the risks it faces.

In late 2015, Europa SA secured a large dollar-denominated revolving line of credit with a five year maturity from its UK-based bank to fund the development of its operations in the United States. Europa SA began drawing on the credit facility in 2016 and its strategic plan anticipates use of the facility to fund inventory for its new US factory from late 2018. In 2016 Europa SA appointed its UK-based bank to lead a syndicate of banks in organising the sale of dollar-denominated corporate bonds with a ten year maturity to investors in London and the international capital markets. A transitional period extends the right of its UK-based bank to provide this line of credit, and to continue to provide the ancillary payment and foreign currency services associated with the bonds, into 2020, avoiding short term disruption to Europa SA's existing strategic plans.

Alongside the revolving credit line and corporate bonds, Europa SA negotiated interest rate swaps and hedged its foreign exchange risk with forward contracts with a five-year maturity and ten year maturity to match its liabilities. Both these derivatives were agreed with its UK-based bank which hedged its own risk by purchasing derivative instruments cleared on a UK-based CCP. As with the credit line and corporate bonds, a transitional period ensures that these derivatives contracts do not need to be restructured and their existing clearing arrangements grandfathered. In both cases, the risk of a cliff edge is removed.

However, the question remains whether Europa SA's UK-based provider will be able to continue to provide services under the terms of a future EUUK framework, as its provider currently depends on a EU financial services passport and the bank currently has no additional banking licenses inside the EU.

A bridging period enables both Europa SA and its bank to plan for this potential change in a considered way and maintain their current relationship if mutually acceptable while they await clarity on future operational conditions. An adaptation period provides time for both bank and customer to adapt to the new framework as required. For example, it might be used by Europa SA's bank to establish a licensed presence inside the EU, or by Europa SA to find an alternative solution if its current service was ultimately withdrawn.

While these transitional arrangements will enable Europa SA to manage its procurement of financial services with minimal disruption, changes of provider or restructuring of existing services could still involve restructuring costs, changes of tax or accounting treatment, a more limited range of providers, additional administrative requirements and potentially higher future costs of products and services. These are likely to vary depending on the national regulations in the country where Europa SA is located.

Ideally, negotiations on such a future framework should run in parallel to exit negotiations to minimise any required bridging period.

Both transition frameworks should be comprehensive, non-disruptive – and temporary. To minimise impacts on the range of choice available to EU-based customers and maintain healthy competition, transitional arrangements should cover all new and existing businesses and activities, and extend current rights and obligations except where explicitly excluded. However, they should be clearly temporary and their purpose is to facilitate orderly change, not delay it. To assist EU-based customers in developing a new supply chain strategy for their financial services provision, the EU and the UK should aim to indicate the broad parameters of the wider relationship and market access framework that they will agree for UKbased providers at or around the time of the triggering of Article 50. Ideally, negotiations on such a future framework should run in parallel to exit negotiations to minimize any required bridging period.

Because of its importance for business planning, a transitional framework for all economic activity between the EU and the UK should be an integral part of the Article 50 negotiation. It is important that a transition workstream is established at the start of the Article 50 process, backed by clear political will and fully resourced. This is the most effective way to ensure that a UK exit from the EU is orderly and causes as little disruption as possible to the services that support the businesses that drive the EU economy.

Transitional arrangements – recommendations

The UK Finance Report contains a detailed analysis of why a transitional framework for financial services is needed to cover the UK's exit from the EU and offers five recommendations on transitional arrangements to EU and UK policymakers.

Agree transitional arrangements	*The withdrawal agreement under Article 50 must include realistic and practical transitional arrangements. These should include both a bridging period between exit of the UK from the EU and the point that the terms of the new partnership between the UK and the EU27 becomes certain, and a follow-on adaptation period.* The purpose of the bridging period is to avoid damaging cliff edge effects from sudden and significant changes at both the point of exit of the UK from the EU and the point of entry into the new partnership. The purpose of the adaptation period is to give banks, their customers and clients, regulators and providers of market infrastructure sufficient time to take steps to conform to the regime that will apply when the transitional period comes to an end. The length of the bridging period will therefore be dependent upon the time between the withdrawal agreement coming into force and the terms of the new partnership agreement becoming certain. The adaptation period should be sufficient in length to enable banks, customers, regulators and other stakeholders to assess, design and execute implementation plans, once the shape of the new partnership between the UK and the EU27 is clear.

Commit to transition at outset	*The UK and the EU27 should commit in principle to include realistic and practical transitional arrangements in the withdrawal agreement, at or around the point that notice under Article 50 is delivered.* If the UK and EU27 can commit at an early stage to transitional arrangements, then that should reduce the risk of businesses or banks feeling forced to act precipitously and conservatively during the Article 50 negotiation period. The UK should look to include transitional arrangements in their Article 50 notification. Equally, the Council should include transitional arrangements in the negotiation guidelines it provides to the Commission.
Indicate objectives at outset	*The UK and the EU27 should indicate the broad parameters of the wider relationship they will seek to establish with one another, at or around the point that notice under Article 50 is delivered, in order to minimise uncertainty.* This recommendation is made for similar reasons to those set out under the immediately preceding recommendation.
Ensure a separate workstream	*The UK and the EU27 should, from the outset, fully resource a workstream dedicated to structuring and agreeing the transitional arrangements.* The transitional arrangements will form a complex and demanding part of the negotiations between the UK and the EU27. They are not something to be addressed only when the main features of the overall agreement have been determined.
Apply transition to all activities and businesses	*The transitional arrangements should apply to all activities of existing and new businesses, subject only to specified exceptions.* In financial services, as in other sectors, the transitional arrangements should ensure minimal disruption of services to customers. This is best achieved b y permitting businesses to continue to conduct their existing activities during this time, subject only to specified exceptions. The transitional arrangements should apply to new as well as existing businesses, to avoid impeding business activity and distorting national economies in the UK and EU27. To avoid creating legal uncertainty, contracts entered into prior to the expiry of the transitional arrangements should not become invalid or unenforceable when the transitional arrangements end.