Time to adapt:

Achieving an orderly transition for banking

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Acknowledgements and contacts

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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 UK has voted to leave the European Union, and the UK Government intends to trigger Article 50 by March 2017. This will start a complex and potentially challenging two year process where the UK and EU27 must work together to establish a new partnership that works for customers, businesses and the economies of the UK and EU27.

The financial services sector is one of the success stories in the EU. With more than £1.1 trillion of cross-border lending from UK-based banks to European companies and governments the free trade in financial services contributes to the national economies of the UK and Europe. These activities are underpinned legally by the passporting regime which allows UK-based banks to provide services to customers in Europe and EU based banks to provide services to customers in the UK. It also allows banks in one EU Member State to set up branches in any other with minimal additional authorisation.

The UK's exit from the EU will require both parties to work together and construct a new partnership to enable customers and businesses to continue to receive the level of services they receive today.

While the nature of the new partnership between the UK and EU27 is still unclear, banks and their customers are faced with existing rights and obligations suddenly disappearing at the end of the two year Article 50 period. Without new arrangements in place enabling the provision of the financial services we have today, there will be significant commercial disruption to the services enjoyed by millions of businesses and customers across the UK and the EU27 and harm to their economies. Transitional arrangements are critical to help avoid this – they can help bridge the gap between the end of the two year Article 50 period and the putting in place of the new UK/EU partnership, giving policy makers the time to reach an agreement and ensure a smooth and orderly transition to a new partnership.

To inform this debate, UK FInance has worked with Clifford Chance and Global Counsel to help to clarify why transition is needed and how transition arrangements may be structured to avoid a disorderly exit and deliver the most positive outcome for UK and EU27 citizens. This report builds on the analysis in the UK FInance August 2016 report, UK exit from the EU: an orderly transition for banking, prepared with the support of Clifford Chance and Global Counsel.

Executive summary

The EU Treaties, EU legislation, and the rights which they confer, have had a profound impact on the structure of the financial services markets in the UK and Europe, and the way that retail and business customers access and use financial services. The exit of the UK from the European Union ('EU') will significantly change those markets. However, adapting to these changes will require a significant amount of time – if that time is compressed or truncated then risks to customers, the financial system and to national economies will be increased.

A sudden withdrawal of rights would create a damaging cliff edge effect for banks and their customers. EU27 businesses would suddenly be unable to receive services from UK-based banks, and vice versa, and existing legal agreements could suddenly become unenforceable. Without clarity and practical transitional arrangements, banks and their customers will have a disincentive to continue, extend or begin contracts for these types of services, particularly for the many banking products that have a reasonably long duration. The consequence of this will be that decisions to withdraw from the provision of these services will need to be taken in advance of the exit date itself.

Similar examples would play out across the full spectrum of financial services. Indeed, this issue goes beyond banking, and affects insurance, asset management and providers of market infrastructure and other sectors of the financial services industry, as well as the related professional services sector. The damaging cliff edge effect is not unique to financial services. Other economic sectors, such as automotive, pharmaceutical, engineering and telecoms, will experience both tariff and non-tariff barriers to trade in goods or services that disrupt commercial and economic structures that have been built on the premise of the single market in goods and services.

The extent and nature of this reshaping of financial services will depend upon whether there is to be a new partnership between the UK and EU27 which makes provision for financial services, and if so, what the terms of that partnership will be. The inevitability of change, coupled with uncertainty as to the terms of the new partnership, means that comprehensive, non-disruptive and temporary transition arrangements are needed.

These transition arrangements should be designed to avoid the damaging cliff edge effects described above, and provide businesses with time to assess the terms of the new partnership and then adapt to the changes it creates. Transitional arrangements for the banking sector will therefore need to be negotiated as a part of a wider negotiation on transitional arrangements for all economic sectors, as well as the transitional arrangements for EU/UK citizens that have relied on the freedom of movement of workers.

The key objective for banks will be to ensure that they can continue to serve their existing and future customers. At present, in the absence of a reasonable basis for a more positive conclusion, the most plausible conservative scenario is that the UK ceases to be an EU Member State in the first quarter of 2019, without any transitional arrangements or new partnership agreement in place. Because of the long lead times often involved, banks will soon face the decision to move from planning to implementation if they are to complete the execution of their adaptation plans by the first quarter of 2019.

This paper therefore recommends that transitional arrangements are included in the withdrawal agreement under Article 50 of the Treaty on European Union ('TEU'). The transitional arrangements should provide for a transitional period consisting of:

- A 'bridging period' between the date the UK exits the EU and the date the new partnership agreement is ratified and becomes unconditional (or, if there is to be no formal partnership, the date at which that becomes clear).

  The purpose of the bridging period is to avoid damaging cliff edge effects at both the point the UK exits the EU and the point of entry into the new partnership agreement.

  It is possible the bridging period could be very short; there might even be no bridging period if the withdrawal agreement itself provides for exit to take effect on the date the new partnership agreement is ratified and becomes unconditional.

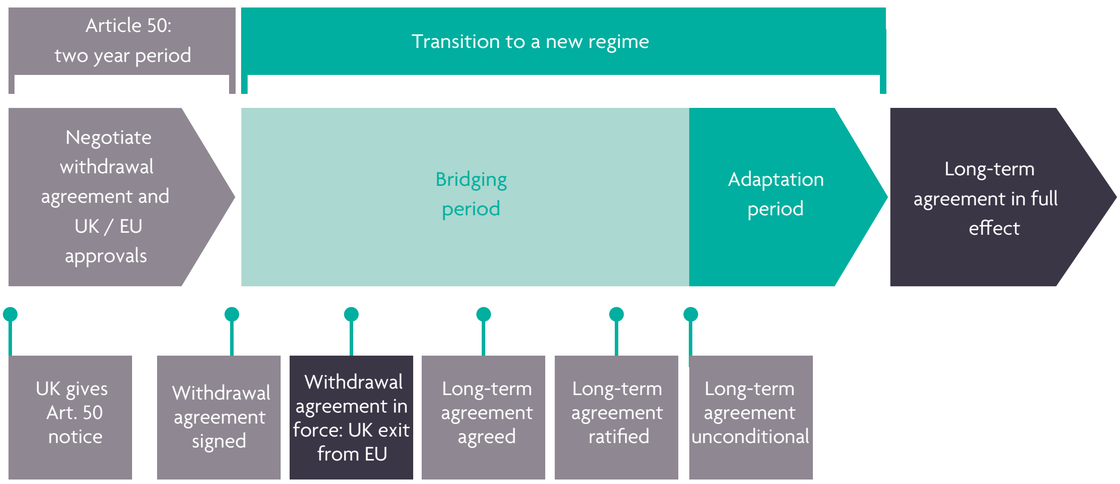
- An 'adaptation period' starting on the date the bridging period ends (or, if there is no bridging period, on the date of exit).

  There may be very little time between the terms of the new partnership between the UK and EU27 becoming certain (and the bridging period ending) and the new partnership coming into force.

The purpose of the adaptation period is to give banks, their customers, regulators and providers of market infrastructure 'breathing space' to consider the implications of the new partnership and take steps to adapt their businesses to the rules that will apply under it. The regulatory regime in force during the adaptation period would therefore be identical to that during the bridging period, save that the adaptation period would include 'settling-in' mechanisms permitting processes such as applications for licences and equivalence determinations to commence in advance of the point when they would be required.

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. How much time is required will depend on the nature of the new partnership between the UK and the EU27; the more closely it replicates the existing main features of the single market for banking services, the shorter it can be.

Figure 1: Transitional arrangements – Illustrative timeline



Transitional arrangements of this kind would be invaluable for the many other industries for which it will be important to avoid a similar disruption of services to customers to those highlighted above.

In the design of transitional arrangements there are a number of issues that require consideration. These include, among others, the legal framework of the arrangements, their scope and application, and how to address changes in the parties' laws during the transitional period.

This paper does not discuss the eventual nature of the relationship between the EU27 and the UK – that is a matter for political decision by the UK and EU27. Rather, it focuses on the issues involved in ensuring a comprehensive, non-disruptive and temporary transition from the current state of affairs to whatever the future state of affairs may be.

Conclusion

The challenge for policymakers is that, for transitional arrangements to be effective, they must be committed to as soon as possible, ideally at the point that notice under Article 50 is delivered. That is clearly not straightforward as a political matter. It also reverses the usual practice of agreeing transitional arrangements towards the end of the negotiation process. However the unique circumstance of the UK leaving the EU creates unique risks, and potentially very significant adverse consequences for the UK, the EU27 and their businesses and consumers.

Without an up-front commitment, many banks and their customers will proceed on the prudent assumption that there will be no transitional arrangements. UK-based banks may start to withdraw services from a wide range of EU27 customers and vice versa, and banks and/or their customers may take irrevocable steps to restructure or terminate contracts or lines of business. This will be a particularly unfortunate outcome if the eventual terms of the new partnership between the UK and EU27 are such that this kind of forced action was not in fact required.

This paper outlines what is at stake, and the case for committing to transition at the outset.

Recommendations

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 followon 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 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 by 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.

1. The need for transitional arrangements

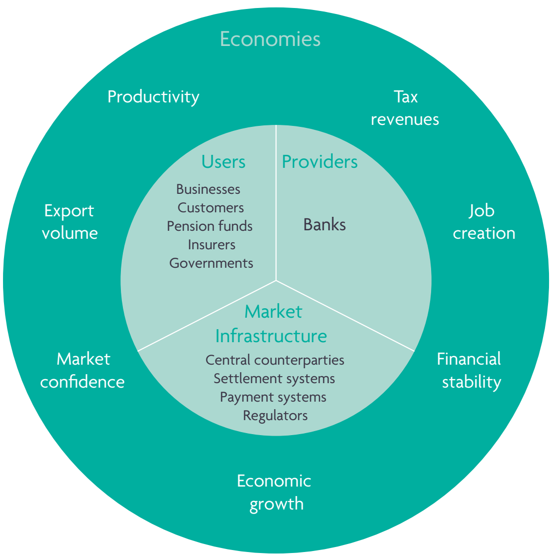
The exit of the UK from the EU will reshape the European financial markets. Both the UK and the continuing Member States of the EU ('EU27') have an interest in this transition being orderly. Hundreds of thousands of businesses and millions of individual customers currently benefit from the banking and financial services that flow between the EU and the UK. All are potentially affected by the UK's exit from the EU.

EU Treaties and EU legislation, and the rights which they confer, have had a profound impact on the structure of the financial services markets. Sudden withdrawal of these rights would potentially create a damaging cliff edge effect for banks[1] and their customers from sudden and significant changes in the services that are available or the terms of their availability. Similar issues will arise for insurance, asset management and providers of financial market infrastructure and other sectors of the financial services industry, as well as the related professional services sector.

The damaging cliff edge effect is not unique to financial services. The exit of the UK from the EU risks raising both tariff and non-tariff barriers to trade in goods or services that disrupt commercial and economic structures that have been built on the premise of the single market in goods and services. Even if the issues caused by such a step change are addressed after a period, it is likely that the disruption will have already occurred, and business will have been permanently diverted to less efficient channels (e.g. through the reconfiguration of supply chains).

Transitional arrangements for the banking sector will therefore need to be negotiated as a part of a wider negotiation on transitional arrangements for all economic sectors, as well as the transitional arrangements for EU/ UK citizens that have relied on the freedom of movement of workers.

Figure 2: Who and what is potentially affected?



[1] In this report, references to 'UK-based banks' include both banks established in the UK (including subsidiaries of EU27 and non-EU banks), as well as UK branches of EU27 banks; references to EU-27 based banks includes banks established in the EU27 including subsidiaries of UK and non-EU and branches of UK banks.

1.1. Assessment of impact on commerce and the wider economy

The following paragraphs set out a range of impacts for commerce and the wider economy – financial service customers, providers and market infrastructure providers – should no transitional arrangements be agreed and in place upon exit. These are non-exclusive – there are numerous other instances not described in this paper.

Many of the impacts and related risks identified below will inevitably crystallise if there is no formal partnership between the UK and EU27, or if the partnership is limited in scope.

The risk from the absence of transition is that these risks crystallise at a cliff edge where there is sudden and significant changes in the services that are available or the terms of their availability before businesses are able to adapt, and even if, in the medium-to-long term, the new partnership would have resolved matters. Hence the lack of transitional arrangements would, in the best case, bring forward the point of risk crystallisation, and in the worst case, create new risks that would not have otherwise arisen.

There are four main categories of risk: risk to customers, risks to providers, risks to providers of market infrastructure, and risks to the UK and EU27 economies.

In each case, the risks result from the potential loss of regulatory authorisation (or other EU rights) upon the UK exiting the EU. Where regulatory authorisation is withdrawn from a particular class of transaction, any providers continuing to transact will face severe consequences. These can include regulatory penalties, criminal sanctions and (in some cases) transactions becoming unenforceable.

It will sometimes be clear that authorisation is lost – for example a UK-based bank will no longer be permitted to lend to a German business without first obtaining a local license. However in many cases the result will not be so clear-cut, particularly when considering the impact of exit on preexisting arrangements (such as an existing line of credit). This will create significant legal uncertainty, and the potential for legal disputes, which is not in the interests of business, providers or the wider economy.

Risks to customers

Disruption of cross-border consumer banking

There are currently two ways in which cross-border consumer financial services operate across the EU. The first is formal, where a provider based in one jurisdiction offers its services (typically deposit accounts, but also credit cards and payment services) in the other. The second is informal, where a citizen of one jurisdiction is in another jurisdiction (temporarily or for the medium term) and seeks to access their home financial services by telephone or the internet.

Both of these forms of service provision could be disrupted if the UK exits the EU without transitional arrangements, as providers would in some cases now lack the required regulatory authorisation to be able to provide regulated services cross-border. Consumers could find themselves unable to access existing accounts and/or use existing services unless they or their service providers had taken mitigating actions in advance of the date of the cliff edge to put in place authorised alternatives.

Loss of UK-based banks as lenders to EU business

UK-based banks were providing EU businesses with more than £1.1 trillion in cross-border lending at the start of 2016[2]. However, commercial lending is a regulated activity in many EU Member States. As a result, non – EU-based banks without a national licence are prohibited from lending to customers in those Member States. Although the lender will be required to have a valid licence or passport at the time that it advances a loan (as UK-based banks will have today), if there are no transitional arrangements in place to take account for the continuation of service contracts upon the UK's exit from the EU, UK-based banks would begin to work on the basis that their ability to meet obligations to existing customers would be severely impeded upon exit – effectively rendering contracts, with long-dated obligations, ineffective. An example of the type of lending services that would be impacted includes a typical revolving credit loan. The 'revolving credit' element enables the borrower to repeatedly borrow and repay some or all of the loan over a number of years. This type of loan would in many cases need to be restructured after the cliff edge date to enable an EU27 customer to continue to access the loan.

An abrupt and disorderly UK exit could therefore severely impede or eliminate an important source of funding for EU business, and create legal uncertainty as to whether EU businesses can continue to access preexisting loan facilities.

Withdrawal of banking services

As well as lending, the banking industry encompasses a huge range of activities and plays a role in every part of the UK and EU economy. Alongside providing deposit services, offering corporate and commercial lending, providing trade finance and managing payments and settlement, banks operating in the UK play a range of roles from providing financing for investment to facilitating activity on the UK and EU's financial markets. In many cases these are also regulated activities, where banks would face the same issues discussed above (in the context of loans) if their rights to provide them are withdrawn. These issues will affect both UK-based banks currently providing services cross-border, and EU27 branches of UK-based banks.

In the absence of transitional arrangements, customers in the EU27 currently receiving financial services from the UK will face different rules in the different countries in which they operate if they wish to maintain the level of service they currently receive today. That may lead to inefficiencies, diseconomies of scale and increased consumer costs.

This is therefore likely to lead UK-based banks to withdraw services from a range of EU27 customers as a result of not being able to adapt their business in time. This will disrupt the ability of customers to access existing sources of finance and capital markets services. In addition to bank lending, the impact is likely to be most severe in relation to capital market services such as underwriting new issues of debt and equity securities, securities and derivatives trading and risk management services – given the substantial role of UK-based banks in relation to the provision of these services across the EU.

Without clarity and practical transitional arrangements, banks and their customers will have a disincentive to continue, extend or begin contracts for these types of services with customers, particularly for the many banking products that have a reasonably long duration. Parties will be concerned about legal uncertainty and, in particular, the potential for contracts to become unenforceable. The consequence of this will be that decisions to withdraw from the provision of these services will need to be taken in advance of the exit date itself.

EU27-based banks would have similar issues where they provide cross-border services to UK customers. However, for a significant range of products, UK national law is more accommodating to crossborder business by foreign entities, especially where they transact with professional or institutional customers and counterparties.

[2] Source: Bank of England

Disruption to savers

Recently introduced safeguards for retail savers have included the introduction of requirements for European investment funds (whether retail investment funds ('UCITS') or alternative investment funds ('AIFs')) to appoint third party banks to hold the funds' investments securely ('depositories'). These depositaries are required to be in the EU. At present, a significant percentage of the depository market is comprised of UK UK Finance Time to adapt: achieving an orderly transition for banking based banks.

Absent transitional rules, UK-based banks would no longer be able to act as depositories, meaning that the very large number of affected EU funds would need to appoint new depositories. It is highly questionable whether such a substantial restructuring of an integral part of the EU private savings market could be carried out in a short space of time without disruption for retail savers.

In addition, UCITS are limited as to the size of certain exposures they can have to non-EU-based banks unless they benefit from an equivalence determination. Exposures could result from deposits and derivatives. So, for example, an EU27 fund investing in US equities will often enter into hedging arrangements to reduce its investors' exposure to exchange rate volatility. If the UK exits the EU without transitional arrangements to achieve equivalence determinations, then such funds would potentially have to restructure their service provision at short notice (and at present such services are very significantly provided by UK-based banks). In a worstcase scenario this could leave a fund unable to find a replacement hedge counterparty, potentially leaving investors unhedged, or incurring significant costs to unwind and replace existing hedges.

Ability of UK-based banks to transact with EU27 business and banks

As noted above, since many banking products are of reasonably long duration, decisions to avoid or withdraw from these may be taken well before the date of the UK exit from the EU. If (for the reasons noted above) EU27 customers foresee that services provided by UK-based banks may be disrupted by a UK exit with no transitional arrangements, these customers may become increasingly unwilling to continue or enter into longer term arrangements with UK-based banks without sufficient assurances that the bank will be able to continue the arrangement after the UK exit. Customers in this position will need to expend costs and efforts to replace those relationships and the existing services at a time when the eventual UK/EU27 relationship is uncertain. There may be significant costs involved in unwinding and replacing many of the existing arrangements. And the new arrangements may be less competitive or more limited than those available today as a result of less competition and more limited access to the deep pool of services available from UK-based banks and the surrounding ecosystem. Such costs and efforts may be wasteful and unnecessary in whole or part if the eventual new UK/EU27 arrangements enable such services to continue.

Risk to providers

Regulatory capacity

Many UK-based banks maintain branches in EU27 Member States and many EU27-based banks have branches in the UK. Without transitional arrangements, the UK exit from the EU will disrupt their regulatory treatment. They will cease to benefit from the passport but may not be able to apply for a licence to replace the passport in advance of the UK exit from the EU, and even if they can apply, they will have no assurance that the authorisation will be in place in time for exit.

UK and EU27 regulators and resolution authorities will therefore have to handle applications for licences for these bank branches, as well as applications for licenses and the other regulatory approvals required if banks begin to implement their adaptation plans (see Annex 1 – Implementing bank adaptation plans). This will require support by regulators at the same time as they are managing the normal process of regulatory oversight and reforms in their home country (and, in the UK, during 2018 regulators will be supervising the completion of the bank ringfencing process).

While regulators should be able to expand their capacity to some extent by hiring new personnel, many decisions will involve the participation of senior staff, whose numbers cannot be easily or speedily increased.

In the case where multiple and/or complex regulatory approvals are required, then individual approvals are likely to take longer to achieve. For example, a new subsidiary bank that is increasing its activities may need regulators to approve their internal risk models, without which the subsidiary would face prohibitively high capital requirements for its business. Approval of these models is a complex and time-consuming process. This and other regulatory approval requirements would increase the risk of adaptation measures taking longer than the time available, creating potential disruption for customers.

This consideration may lead banks to conclude that the most effective way to avoid the risk of running out of time before a required new licence is obtained is to execute any adaptation plans sooner. The perverse result is that banks may feel that it is necessary to move first before others do. This is particularly the case for countries where historically the regulator has been able to handle only a modest number of licence applications. This risks creating a regulatory logjam and exacerbates the risk of a damaging cliff edge effect. The Great Repeal Bill, which the government currently intends to introduce in the 2017 Parliamentary session, will necessarily pass matters which are currently the responsibility of EU institutions to UK regulators. This will necessitate the significant task of reviewing and revising thousands of pages of UK regulatory rulebooks. For example, the UK regulators will be required to take over the regulation of rating agencies and trade repositaries (the bodies to whom certain derivative transactions are reported) currently undertaken by the European Securities and Markets Authority ('ESMA'). All this is likely to put resource pressures upon regulators in the UK.

Banks unable to adapt on time

The key objective for banks will be to ensure that they can continue to serve their existing and future customers. In this respect, banks confronting the uncertainties as to the outcome of the negotiations on the UK exit from the EU, and the risks identified above, must plan for a conservative outcome.

In the absence of a reasonable basis for a more positive conclusion, banks will have to assume that the UK will cease to be an EU Member State in the first quarter of 2019, without any transitional arrangements or new partnership agreement in place. There would then be an immediate impact on the business and customers of UK-based banks or of EU-based banks that had previously relied on single market rights and privileges to service their customers respectively in the EU27 or in the UK.

Banks will therefore soon face the decision to move from planning to implementation if they are to complete the execution of their adaptation plans by the first quarter of 2019. The time it will take to put adaptation plans in place means that banks will in many cases not be able to 'wait and see' what the terms of the eventual new partnership will be.

The most obvious adaptation plan in most cases is for a bank to migrate some or all affected business to a branch or entity in the EU27 (for a UK-based bank) or in the UK (for an EU27-based bank), in order to be able to continue to provide a similar range of services to customers respectively in the EU27 or the UK. However, in practice this may not be attractive or feasible. For example, in some cases a line of business may be insufficiently profitable to justify the additional costs and operational burdens of migration, in which case the business may simply be stopped. In other cases, it may be feasible to migrate some services to serve a large market but not a smaller one – this is an advantage that larger EU27 countries are likely to have over smaller ones. And in other cases (particularly for international banks not headquartered in the UK or the EU27) it may be preferable to move the service to a location outside the EU and the UK to preserve economies of scale. In all these instances, the depth and competitiveness in services available to customers in the EU27 and the UK are likely to be reduced compared to those available today. Annex 1 – Implementing bank adaptation plans sets out further details on the steps, timing considerations and options for bank adaptation plans.

For the reasons noted in Annex 1 – Implementing bank adaptation plans, in many cases these plans will take materially more than two years to put into effect. If there are no transitional arrangements, banks risk at least some elements of their adaptation plan failing to complete by the date that the UK exits the EU. That would potentially crystallise all the risks identified in the previous sections, for providers, customers, infrastructure and the wider economy. Banks faced with this risk may act precipitously, and put into effect plans to migrate or cease business. That will be an unfortunate outcome if the eventual terms of the new partnership between the UK and EU27 are such that this kind of forced action was not in fact required.

Data protection and information security

The Data Protection Directive regulation provides for a high degree of freedom in moving personal data between locations within the EU and the EEA, provided certain standards for the accessing, storing and processing and transferring are adhered too. It places restrictions on businesses from transferring personal information outside the EU, unless the EU has recognised the data protection standards of that country as adequate, or unless the business in question adheres to strict additional data protection protocols.

Moving customer data between locations is an integral part of modern banking, especially in an era of increasing digitalisation. Many financial services businesses in the EU centralise their processing of customer information in one, or a small number, of locations. For example, all the account opening administration for a pan-EU bank could be carried out on computer systems in the UK, by personnel based there.

Following the UK's exit from the EU, such a bank could be restricted in its current freedom to move EU customer information into the UK unless or until an appropriate adequacy determination has been made by the European Commission. While it could in principle adopt a number of strict additional security protocols to enable it to move data into the UK, these are burdensome, subject to legal uncertainty, and in some cases may not be feasible. While waiting to see if the EU will recognise the UK's post-Brexit data protection regime as adequate, banks face a difficult and expensive choice of whether to restructure and potentially duplicate their data processing capabilities in the two markets.

Other important systems of data protection and cybersecurity cooperation are also likely to be disrupted by a UK exit. The EU Network and Information Security Directive is due for full implementation before the UK leaves the EU and will establish new regulatory cooperation protocols for cybersecurity and new cybersecurity obligations for banks and financial services businesses. Maintaining both in some form may be an important part of a future adequacy determination for the UK.

Risk to market infrastructure: disruption of existing structures

Many of the financial services on which businesses depend are in turn dependent upon market infrastructure of various kinds (often described as the 'plumbing' of the financial system). A UK exit from the EU without transitional arrangements would disrupt much of the way market infrastructure is currently organised. Examples include:

- The UK may cease to be part of the Single Euro Payments Area ('SEPA') which facilitates low cost euro payments across the SEPA geographical region, encompassing the EEA together with Switzerland, Monaco, San Marino and the UK Crown Dependencies. The result would be increased fees to customers and slower payment transfers between these jurisdictions and the UK.

- In many cases, UK-based banks would no longer be able to act as primary dealers in government debt for the debt management offices of EU27 Member States either because of the rules of those arrangements or because local law requires a non-EEA firm to be locally licensed to act as a primary dealer. Because UK-based banks are a substantial proportion of the primary dealers in this market, the vacuum resulting from their disqualification would be likely to result in Member States facing higher interest rate costs, lower liquidity, a less deep secondary market, and in more extreme instances the risk of failed auctions. The consequential impact on government financing capacity and cost will flow through to fiscal expenditure and taxpayers.

- One of the important new regulatory requirements introduced by the European Market Infrastructure Regulation ('EMIR') is 'OTC derivative clearing' – a requirement to clear certain hedging contracts via central counterparties ('CCPs') (with the intention of reducing counterparty exposure and systemic risk). However, these contracts must be cleared with CCPs which are recognised in the EU under EMIR. The three major CCPs for the EU OTC derivatives markets are currently all located in the UK.

If the UK exits the EU without transitional arrangements then EU27 – based banks and businesses would no longer be able to clear these derivatives on UK CCPs unless and until these CCPs are recognised by ESMA. This recognition would depend on other conditions, including a determination by the European Commission that the UK's regulatory regime is 'equivalent' to that in the EU. The process could be expected to take many months. EU businesses seeking to hedge against interest rate or currency risk in the meantime may be able to clear some of these contracts through EU27 or non-EU CCPs in the interim. That is likely to increase costs for business. The reason is that businesses usually seek to reduce cost and exposure by using a single CCP, because it enables their rights and obligations to be set against one another, thus reducing their margin requirements and therefore the cost of hedging. If a business with existing contracts cleared on UK CCPs is required to clear new contracts on EU27 CCPs then that reduces this benefit, and may therefore increase margin requirements and overall cost. There will be many other cases where the exit of the UK from the EU will potentially disrupt important market infrastructure.

Risk to the UK and EU27 economies

The banking industry is a crucial part of the UK and EU27 economies and a significant export sector for the UK in particular. It is a major enabler through the very wide range of services it provides, and a material contributor to tax revenues. The potential disruption of services provided by banks for their customers has wider implications, including for market confidence, business stability, productivity, jobs, investment and growth in the UK and across the EU.

1.2. 'Sudden Stop' case studies

The following two case studies illustrate the risk of substantial disruptive impact for customers and economic activity that will result from a sudden cliff edge prohibition or significant forced change in the flow of goods or services in both the banking sector and another significant industrial sector (in this case study, automotive) in the UK and EU27 following the UK's departure from the EU.

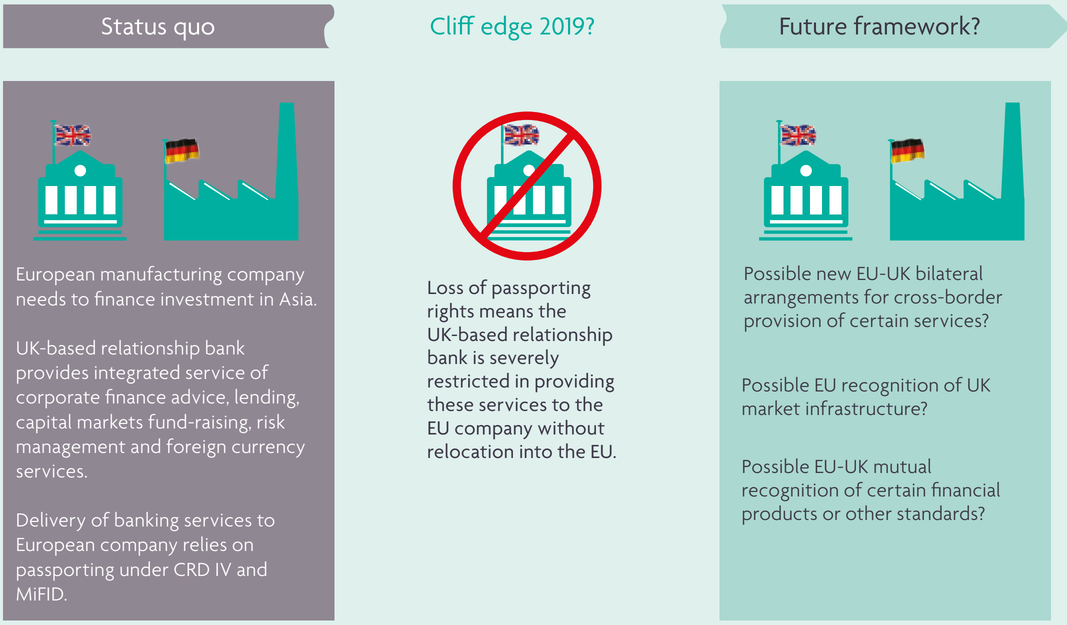
Sudden stop case study 1 – Financial services: A manufacturing company looking to finance an investment

A rapidly-growing European manufacturing company plans to grow its business in in Asia and wishes to build a new factory in Asia. It needs to raise money to finance the building of the factory, and the early years of production until the factory is doing enough business to be profitable. While growing its business in Asia is a single strategic objective for the European manufacturing company, the financing arrangements required to support this are sophisticated and complex, and require a variety of different financial services to be combined and delivered in an efficient package. The European manufacturing company therefore turns to its relationship bank in the UK as a single and efficient source for its needs.

The UK-based relationship bank puts together the following services to meet its customer's needs:

- Syndicated loan: A large loan which is set up as a 'revolving credit facility'. This is to give the company the flexibility to repay parts of the loan and redraw parts of the loan from year-to-year as its cash needs change once the Asian factory is built and begins to produce and sell goods. Because of the size of the loan it is 'syndicated' or provided by the relationship bank, which acts as the lead arranger, and a group of UK-based banks (some of which are EU banks and some of which are international banks).
- Bond issue via capital markets: A large bond issue on the London capital markets, accessing the many international investors with investment operations in London as well as investors in the European manufacturing company's home country and other investors in other EU countries. The bond issue is intended to serve an additional strategic objective by raising the profile of the European manufacturing company with international investors in anticipation of a future need for capital as the company continues to grow.
- Risk management of currency and interest rate exposures: A derivatives contract to manage the risk of significant changes in interest rates or in exchange rates between the Euro and the Asian currency required to build the factory during the life of the loan and the bonds. By EU regulation, the derivative is required to be cleared through an approved clearing house, and it is therefore cleared via a London-based clearing house, which offers the largest clearing service in the world for these types of derivative.
- Foreign currency and payments services: Foreign exchange conversion and payments for a variety of services, including conversion of the Euro funds received from the loan and the bond issue to the Asian currency needed for the factory and transmission of these to Asia, arranging for interest payments on the loan and bonds, and arranging for margin and other collateral payments required for the derivative.

Figure 3



In addition to the services mentioned above, the relationship bank will have provided a variety of other banking services to 'package' the solution for the European manufacturing company's needs. These include the overall advice on the financing strategy and the individual elements to be combined; the capability to put together a suitable syndicate of banks for the large loan; the design and sale of the bonds to the right international investors; the expertise to risk manage a multi-year derivative for Asian currencies at the most competitive price for the company; and the international branch network and correspondent and other relationships to connect the European and Asian components of the offering. Underpinning all these services are the UK-based bank's current rights to serve clients in the EU from the UK – its so-called 'passporting rights'. Although the services appear as an integrated and efficient 'one-stop solution' to the European manufacturing company, the bank draws on at least two different EU financial services 'passports', and a range of other current EU frameworks.

Some of the consequences of a sudden stop to these rights and frameworks would include:

- The bank syndicate may not be able to advance further loans to the company if the company wished to use the revolving credit feature after the factory is built. This is because the bank would lose its passport under the EU Capital Requirements Directive ('CRD'). This may preclude it from providing corporate advice, lending or deposit taking services to a business or individual in the EU27. The UK-based bank may be able to rely on local national regulation to provide the advice and the lending facility, but this will vary from country to country, may be subject to legal uncertainty, and may entail applying for a local licence or permission – a process which is likely to be lengthy and possibly expensive. The bank may also be unable to provide foreign currency management and exchange services, since this activity requires authorisation in many EU countries.

- The bank and the company may have to trigger early termination of the derivative contract, and the bank may not be able to offer the company its bond raising services to finance future growth. This is because the bank will no longer have the EU Markets in Financial Instruments Directive ('MiFID') passport which entitles it to provide these services. Although there are current potential provisions in MiFID for many of these services to be provided from countries outside the EU in the future, these provisions have not yet been activated, and even if they were activated it would take some time for the UK to be able to benefit from them and that is not certain – this is because this would require the UK to be judged 'equivalent' to the EU in its regulatory approach. This is a time consuming process, and uncertain in its outcome. If the company needed to replace the derivative contract to continue to manage its risk for the remaining duration of the financing this could be expensive and complex – first, the forced early termination of the derivative contract may result in unexpected tax and other costs; second, if currency and interest rate changes mean that pricing had changed, the replacement derivative contract may be more expensive; and third, if the company is not able to access the UK market, which is the deepest and most liquid European market for these kinds of derivative services, it may find the more limited competition in the EU27 market affects the price and other terms available to it.
- The services provided by the bank are likely to require payment transactions on the EU's SEPA network. If the UK were to cease to be part of this system, these payments are still possible, but only at greater complexity and cost.

For the European manufacturing company the benefit of access via a single relationship bank to both the bundled services required to meet its needs and to the deepest pools of capital in Europe is considerable. The disruption to its financing arrangements and the additional cost and effort required to replace these if lost overnight or with little warning is significant. Such services might be preserved by the UK-based bank relocating the relevant parts of its business into the EU – although this would take time and may not happen. An alternative for the company may be to turn to more fragmented and costly provision by a range of different correspondent and specialist banks around the EU, although this would not avoid the risk of disruption and expense around the initial restructuring of its existing financing arrangements at the time of the sudden stop.

Transitional arrangements would ensure that unnecessary disruption to the current service did not take place. They would also mean that where disruption was unavoidable, banks would have time to restructure to continue serving clients as they do now, or clients have time to make reliable alternative arrangements.

Sudden Stop case study 2 – Industrial services: the EU automotive sector[3]

The EU is not just a large market for cars – it is a single factory floor for automotive production. A European carmaker will routinely use components sourced in one EU country to build engines in another before moving them to another to be placed in a finished vehicle. That vehicle is then sold across the EU single market or exported around the world.

The UK automotive industry is tightly embedded in this supply chain: depending on the UK manufacturer, between 20% and 50% of car components used in the UK are sourced from across the EU. Similarly, an EU manufacturer will frequently source a material percentage of the car components in the cars it manufactures from the UK.

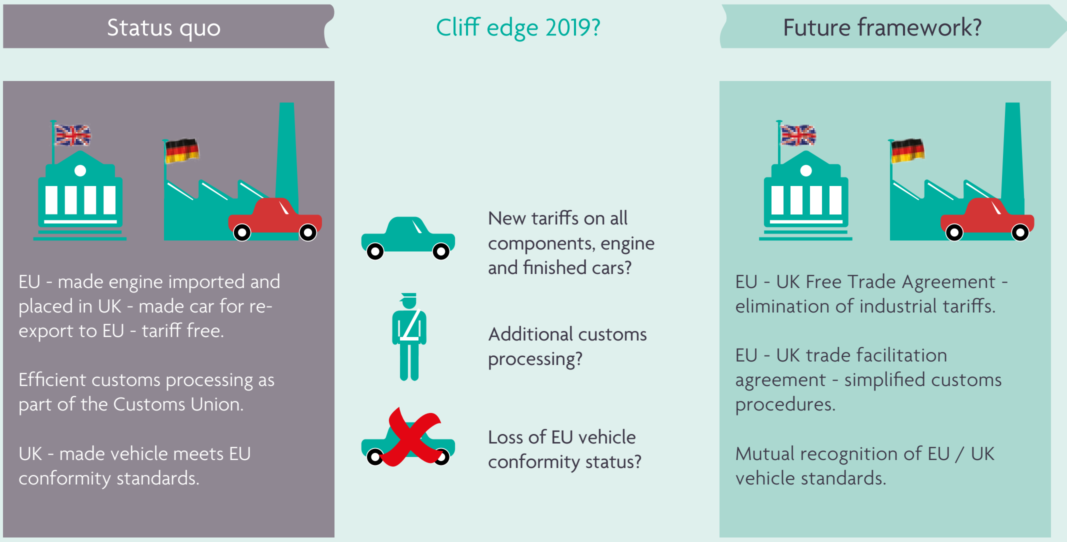
The UK is also a huge consumer of finished European cars and a huge seller of finished cars to Europe: almost six in ten of the 1.2 million cars manufactured in the UK in 2015 were ultimately sold in the rest of the EU. For the six largest EU car-making states (Germany, Spain, France, Belgium, Poland and Italy), the UK is a huge market for components and finished vehicles worth almost €50 billion a year. More than half of these exports are components or finished vehicles from Germany. The UK runs a very large deficit in finished cars with the rest of the EU.

A UK exit from the EU poses serious risks to this dense network of production and supply.

- Every leg of this supply chain that crosses the English Channel in either direction is potentially subject to a new tariff – from a few percentage points for components, to almost five percentage points for engines and a full 10% tariff for finished vehicles. If imposed overnight at the point at which the UK left the EU, such tariffs could see multiple new costs added to the cost of production of a European car.
- All of this EU-UK trade will be subject for the first time in four decades to customs processing at the point of import and export to and from the UK. This means new documentation, new processing and processing fees, potential physical checks and delays. Because almost half of the UK's trade goes to the EU, and almost a tenth of the EU's comes to the UK, this is a significant new volume of traffic through systems that currently manage around half of what they may have to process in future. This is a huge adaptation problem not just for the auto sector but for all sectors. With new potential delays, manufacturers dependent on just in time processing will find themselves having to stockpile and inventory more materials in process – with implications for working capital and other costs.
- The European networks of production are built on a single system of safety conformity standards – so a car authorised for the market in Germany needs no further authorisation in the UK. Unless or until the EU and the UK agree to recognise each others' vehicle conformity standards, carmakers may have to begin duplicating testing and approval systems in both markets from the day of exit.

[3] Source: SMMT 2014, ACEA 2016.

Figure 4



For all of these reasons, a sudden change to the status quo for European carmakers has the potential to be highly disruptive to an ecosystem of production that matters a lot for both sides.

An example using a UK-based automotive manufacturer can illustrate how disruptive a 'sudden stop' could be without transitional arrangements in place. Such an example also applies to a manufacturer in continental Europe supplied from and distributing to the UK.

- Overnight, all components imported from the EU27 or sent to the EU27 for processing could be subject to new tariffs. All of its manufactured cars exported to the EU27 would also be subject to new tariffs. While its exports may be boosted by a weaker UK currency, any such advantage will quickly be eroded by the higher cost of imported components.
- Overnight, it will face substantial additional customs processing requirements, including possible fees. Adapting to this change in trade processing will require internal training and may require additional administrative staff. It may also mean changed inventory practice for just in time manufacturing – with more working capital potentially tied up to pay for it.
- It will need to duplicate conformity standards to satisfy both UK and EU requirements unless and until a mutual recognition regime is implemented.

Transitional arrangements are one way to minimise these impacts – and give companies like this carmaker and their customers time to adapt to change.

2. Making transitional arrangements work

Article 50 provides that, if the UK and the EU negotiate and conclude a withdrawal agreement within the two year period, the UK will exit the EU on the date that the withdrawal agreement enters into force. It appears probable that the negotiations and the processes for all parties' approval of the withdrawal agreement will consume almost all of the two year period, so that the agreement will only be concluded at the end of that period.

Transition arrangements are needed to avoid damaging cliff edge effects from sudden and significant changes and provide time to adapt to the changes both in the legal and regulatory framework and operationally. The case studies on pages 16 to 20 above illustrated some of the risks and damaging consequences that could crystallise if there are no transitional arrangements. Such arrangements should enable firms to respond to the terms of an agreement between the UK and the EU as to their future relationship rather than forcing them to anticipate such agreement. Such arrangements should be temporary, and should not be (or be seen as) a form of delay in arriving at the UK and EU27's final arrangement.

Box 1: Objectives of transitional arrangements

Transitional arrangements should serve the following three purposes for users, providers, market infrastructure, governments and national economies:

- To avoid market and economic disruption through damaging cliff edge effects at both the point the UK exits the EU and the point of entry into the new partnership.
- To give sufficient time to take steps to conform to the regime that will apply when the transitional period comes to an end.
- To prevent precipitous action before the new partnership is agreed. For example, without transitional arrangements it may be rational for banks, businesses and customers to plan on the basis of conservative assumptions as to the content and timing of the new partnership (or, indeed on the basis there will be no formal partnership). The result could be that, whilst the new partnership is in the early stages of being negotiated, UK-based banks start to withdraw services from a wide range of EU27 customers and vice versa, and banks and/or their customers take irrevocable steps to restructure or terminate contracts or lines of business.

2.1. Timing and sequencing

In a perfect world, at the time the UK exits the EU there would be complete clarity as to the terms of the new partnership between the EU27 and the UK, and the new partnership would be immediately in force. In all likelihood, however, for a variety of practical and political reasons this is unlikely to be the case.

It is therefore prudent, in designing transitional arrangements to meet the above objectives and mitigate the risks identified in section 1 of this paper, to consider each of the dates at which a cliff edge effect could potentially occur in a conservative scenario:

The date a withdrawal agreement is concluded between the UK and the EU27.

The date the withdrawal agreement enters into force and the UK exits the EU.

The date that the terms of the new partnership between the UK and the EU27 becomes certain (which will be when the agreement giving effect to that partnership has been signed, ratified and becomes unconditional), or it becomes clear that there will be no such new partnership.

The date the new partnership agreement enters into force.

Two or more of these dates may occur at the same time. Thus, for example, if the UK and the EU27 were able to simultaneously conclude a withdrawal agreement and the agreement establishing the new partnership between the UK and the EU27, and the new partnership agreement were ratified without delay, then both could come into force at the same time. This would be challenging to achieve, but would be greatly advantageous as there would then be one cliff edge, and not two.

Alternatively, the changes could take place in stages. For example, the withdrawal agreement could come into force first and the new partnership agreement could be agreed, ratified and come into force at a later time. In this scenario, the gap between both agreements would give rise to potential disruption and would need to be managed.

It is anticipated that the precise sequence of events will not be certain until relatively late in the process of the Article 50 negotiation. It is therefore important that the proposed transitional arrangements are pragmatic and not dependent upon any one particular sequence. Their objective should be to minimise disruption and allow an orderly transition under any new partnership.

This paper therefore proposes a staged transitional arrangement, made up of a 'bridging period' and an 'adaptation period'.

The bridging period

The 'bridging period' would 'bridge' the gap between the date of the UK exit from the EU and the date the new partnership agreement is signed, ratified and becomes unconditional. At that point businesses, banks, their customers, regulators and providers of market infrastructure would have certainty as to the shape of the regulatory landscape post-exit, and could begin to adapt their operations, contracts and business models accordingly.

Absent a bridging period, if the new partnership agreement does not enter into force at the same time as the withdrawal agreement, banks, their customers and regulators, and market infrastructure providers will face market and economic disruption through a damaging cliff edge resulting from the immediate cessation of all the rights, privileges and obligations of the single market at the point that the UK exits the EU. Trade between the UK and EU27 would then be governed by general WTO/GATS rules, and these make very limited provision for the provision of financial services.

The withdrawal agreement under Article 50 must include realistic and practical transitional arrangements. This 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 new partnership agreement may eventually restore some or all of those rights, privileges and obligations (in the same or a different form) if and when it enters into force. However, before this new partnership and absent transitional arrangements, banks, their customers and regulators and market infrastructure would have to adapt to a regime under which the EU treats the UK as a third country and the UK applies corresponding treatment to the EU27. Even if the new partnership eventually restores some or all of the rights, privileges and obligations of the single market, it is likely that business will have been permanently diverted to less efficient channels during the post-exit period.

It is possible the bridging period could be very short; there might even be no bridging period if the withdrawal agreement itself provides for exit to take effect on the date the new partnership agreement is ratified and becomes unconditional – although achieving agreement, signing and ratification within a two year period would be challenging and therefore seems a less likely outcome.

In the event the EU27 and the UK decide not to enter into a formal partnership then the bridging period would cease on the date of that decision and the adaptation period would commence, to enable businesses, providers and customers to adapt their contracts and business structures to the new regulatory landscape.

The adaptation period

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.

The operational complexity and scale of banks' businesses are such that banks are likely to need a substantial period to implement their plans to adapt to the changes in the legal and regulatory framework in which they operate. The process of adaptation to the new partnership (or the absence of any formal partnership) will therefore take time, particularly for large banks. For the reasons noted in Annex 1 – Implementing bank adaptation plans, in many cases these plans will take materially more than two years to put into effect.

However this is not just an issue for banks – regulators, providers of market infrastructure and bank customers will also have to make substantial changes to their approach to business. As a practical matter, it will be difficult for all parties to finalise their approach until the precise form of the new partnership is clear.

The transitional arrangements should therefore include an 'adaptation period' which starts on the date the bridging period ends (or, if there is no bridging period, the date of exit) and 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 becomes clear. The regulatory regime in force during the adaptation period would be identical to that during the bridging period, save that the adaptation period would include 'settling-in' mechanisms permitting processes such as applications for licences and equivalence determinations to commence in advance of the point when they would be required (for which see page 31 below).

The bridging period and adaptation period should together ensure an orderly transition between the current legal and regulatory regime and the eventual future regime under the new partnership.

Nature and length of the adaptation period

The nature and length of the adaptation period will depend on the nature of the new partnership between the UK and the EU27:

- Similar market access to that for the 'single market': If the new partnership closely replicates the market access provided by the existing main features of the single market for banking services, there should be limited need for transitional arrangements. It should be possible for banks, their customers and regulators and market infrastructure to transition directly from the current position to the new arrangements, with limited additional provisions to smooth the way. An adaptation period could be short or even unnecessary.
- More limited market access via an 'FTA+': If the new partnership takes the form of an enhanced FTA which provides rights benefiting crossborder financial services (in ways that most traditional FTAs do not), the parties will need an adaptation period in order to avoid commercial and economic disruption as a result of the likely difference between the existing position and any future agreement which does not closely resemble the high levels of market access provided via the single market. The length of this adaptation period will be dependent on the degree of difference to the existing position.

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.

The UK and the EU27 should, from the outset, fully resource a workstream dedicated to structuring and agreeing the transitional arrangements.

- Most restricted market access under 'WTO rules': If the new partnership takes the form of an FTA based on WTO rules (or the UK and the EU27 decide to abandon negotiations on any formal new partnership), then the need for an adaptation period will be more acute as a result of WTO rules and typical FTA provisions falling materially short of the financial services market access offered under the single market.

Making transition work

Whilst it is important to begin constructing transitional arrangements from the moment that the Article 50 notice is delivered, it is equally important that a commitment to complete effective transitional arrangements is made up front.

As a practical matter, and in order to avoid banks, businesses and customers prematurely (and potentially unnecessarily) being forced to adapt their businesses in the face of uncertainty – it is unlikely to be enough for the UK and the EU27 to merely include transitional arrangements in the withdrawal agreement. Customers may require banks to move faster and the timescales for implementing those adaptation plans is such that, in the absence of convincing early assurances from both the UK and the EU27, banks and their customers will have to act to implement their plans on the conservative assumption that the UK will exit the EU without any transitional arrangements at the expiry of the two year negotiating period allowed by Article 50. In many cases, they will not be able to wait to see the outcome of the negotiations, and will therefore commence implementation of adaptation plans in the near future (for which see Annex 1 – Implementing bank adaptation plans).

In order to defer enactment of bank and customer contingency plans, it is important that all parties agree in principle at the outset that transitional arrangements will be included within the withdrawal agreement, and that they communicate this publicly and persuasively.

This will require a strong political signal at the outset of the negotiations by both the UK and the EU27 that the UK will not exit the EU without a withdrawal agreement, that the withdrawal agreement will contain transitional arrangements including both a bridging period and adaptation period, and that during the transitional period firms will be broadly able to conduct business in the same way as they do today.

The Council should include transitional arrangements in the negotiation guidelines it provides to the Commission.

A staged transition would raise the issue of confidence. In particular, at the time that the withdrawal agreement comes into force and the UK leaves the EU, there may be increased uncertainty as to whether a new partnership agreement would be concluded, when it would be concluded and what the nature and content of it would be. Thus the UK and the EU27 should indicate at a high level the scope and substance of the wider relationship they will seek to establish with one another and that they similarly communicate this publicly and persuasively at or around the point that notice under Article 50 is delivered, in order to minimise uncertainty.

The transitional arrangements will form a complex and demanding part of the negotiations between the UK and the EU27. The UK and the EU27 should treat this as an important and fully-resourced workstream in its own right from the outset – not something to be addressed at a late date and only when the main features of the overall withdrawal agreement have been determined.

2.2. Structuring considerations

The previous section established the basic framework for the proposed transitional arrangements, including that of a bridging period and an adaptation period. There are, however, a number of technical questions that must be resolved before the transitional arrangements can be put in place.

The following paragraphs discuss the impact of these issues on the structure of the transitional arrangements and, where appropriate, provide suggestions for how they may be resolved.

Legal framework for transitional arrangements

EU Treaties

The withdrawal agreement to be negotiated under Article 50 provides the only appropriate legal framework for agreeing and applying transitional arrangements. As such, there is no requirement for a separate or standalone agreement between the UK and the EU27 setting out or establishing transitional arrangements.

A separate agreement outside the Treaties or to amend the Treaties would require the unanimous consent of (and possibly ratification by) all Member States (possibly as well as the consent of the European Parliament), while the withdrawal agreement and its contents only requires the approval of the Council of the EU acting by a qualified majority and the consent of the European Parliament. For as long as the UK remains a Member State, there is no other framework within the EU Treaties for reaching a separate binding international agreement between the UK and the EU governing the relationship between the UK and the EU after the UK ceases to a Member State.

In principle, the withdrawal agreement should be able to create transitional arrangements covering both the bridging period and the adaptation period. It is usual for there to be transitional arrangements when a country joins the EU and, equally, there should be transitional arrangements when a Member State leaves. The withdrawal agreement should be able to provide for both the bridging period and the adaptation period because Article 50 expressly provides that the withdrawal agreement must 'take into account' the framework for the future relationship between the UK and the EU.

For the EU, the withdrawal agreement should be expressed in terms that make the provisions relating to the transitional arrangements directly effective within the EU legal order. This would avoid unnecessary delay and uncertainty occasioned if using other external mechanisms to achieve effectiveness.

For the UK, legislation will be required to give effect to the terms of the withdrawal agreement in UK law (because international agreements do not automatically have effect as part of UK constitutional law). The legislation could take the form of either an Act of Parliament or secondary legislation under the Great Repeal Bill.

WTO/GATS considerations

The GATS generally prohibits countries from giving preferential rights to other countries (other than through FTAs) unless those rights are generally available to all GATS Members. However, under Article 5 of the GATS, this prohibition can be disapplied for States which are party to an 'economic integration' such as the EU.

Article 5 has historically facilitated the transitional arrangements agreed when a new Member State joins the EU, notwithstanding that those arrangements give the new Member State and the EU preferential rights in relation to each other which are not available to other GATS Members. In the same way, Article 5 should facilitate the proposed transitional arrangements for the UK's exit. For GATS purposes, the transitional arrangements can be said to be reasonably necessary in order to achieve an orderly exit of the UK from the EU, and therefore should be regarded as part of the overall 'economic integration' constituted by the EU.

Scope of transitional arrangements

The transitional arrangements should avoid pre-empting the outcome of the negotiations on the new partnership. If the arrangements only address a narrow range of the rights, privileges and obligations of the single market, this will likely limit the ability or willingness of the negotiators to agree to address a broader range of rights, privileges and obligations in the eventual new partnership. By the time the new partnership agreement comes into force, no-one will be relying on the previously existing broader range of rights, privileges or obligations and restoring them may be of little practical benefit.

There are two broad approaches to determining the scope of the transitional arrangements: a 'negative list' approach and a 'positive list' approach. This paper recommends that the 'negative list' approach be used. The rationale is similar to that considered by the UK Government in relation to the Great Repeal Bill.

'Negative list'

Under the 'negative list' approach, the practical effects and outcomes of the entire body of Treaty rights and obligations and existing EU legislation would be preserved during the bridging period and the adaptation period, subject only to specified exceptions.

For example, the UK and the EU27 might agree that, during the transitional arrangements, they will comply with (or, in the case of the UK, give effect to) the obligations under specified parts of the Treaties and the related secondary legislation adopted under them – in so far as they relate to financial services – as if the UK were still a Member State. This would be a different legal basis for market access to the pre-withdrawal state of affairs, but the practical effects would be identical for the period of the transitional period.

The advantage of this approach is that it will likely be more comprehensive than the 'positive list' approach discussed below. It would preserve all the rights, privileges and obligations of all market participants, unless expressly excluded. The Great Repeal Bill will work on a similar basis, whereby it will convert existing European Union law into domestic UK law, save for certain specific laws which are to be repealed.

Therefore, this approach is also less likely to require a pre-emption of the new partnership negotiation outcome (if not yet concluded) and it may be more suited to providing a 'bridge' to an eventual new partnership.

This paper sets out the damaging cliff edge effects which may impact the financial sector and its customers. Similar issues will be faced by many other business sectors, and for that reason it may be that broad transitional arrangements will be put in place covering all economic sectors. If that is not the case, and transitional provisions are limited to specified business sectors only, then an important question is how the scope of the EU laws relevant to those business sectors is defined. Identifying EU directives and regulations specifically relating to financial services is relatively straightforward. However the provision of cross-border financial services is also greatly affected by general/cross-sectoral EU law, such as tax, data protection, corporate law, insolvency law and rules on jurisdiction and judgments in civil proceedings. Cross-border financial services also relies upon general Treaty rights, such as the freedom of establishment and the general EU prohibition against discrimination in the provision of services. Care would need to be taken that the transitional arrangements preserve EU law in a sufficiently precise way as to minimise contractual and other legal uncertainty as to which rights, privileges and obligations are preserved during the transitional period.

'Positive list'

Under the 'positive list' approach, the transitional arrangements would continue the effects only of specified rights, privileges and obligations under the Treaties and existing EU legislation during the bridging period and the adaptation period. This approach might take the form of a broad positive list which continues all rights, privileges and obligations under particular identified EU legislation (including the obligations that fall on the authorities) as if the UK were still a Member State. Depending on the extent of the list of legislation, this may approximate to the 'negative list' approach.

Alternatively, this approach might take the form of a narrower list of specific rights, privileges and obligations under particular EU legislation, focusing only on those items which directly affect cross-border activity. For example, the withdrawal agreement might provide that, during the bridging period and adaptation period, the UK and the EU27 shall each ensure that:

- The activities listed in Annex I of CRD IV may be carried out within the territory of the EU27 and the UK respectively, either through a branch or by providing services, by any credit institution authorised and supervised by the competent authorities in the other's territory, provided that such activities are covered by the credit institution's authorisation.
- Activities under the Payment Services Directive may be carried out within the territory of the EU27 and the UK respectively, and therefore both authorised Payment Institutions and Credit Institutions can continue to provide payment services between the EU27 and the UK.
- The other party's investment firms that are authorised to execute orders to deal have the right of membership or have access to regulated markets established in their respective territories by means of the arrangements specified in Article 36(1) MiFID II.
- In relation to civil and commercial matters, persons can be sued and judgments enforced in their respective territories in the circumstances and manner prescribed by the recast Brussels Regulation as if the UK were still a Member State.

This approach has the advantage of precisely identifying the rights, privileges and obligations that are to be continued during the transitional period.

However, it also presents a number of issues. In particular:

- Ensuring provisions are comprehensive: It is necessary for the UK and the EU27 to identify the rights, privileges and obligations that are to be continued and thus runs the risk of under-inclusion. For example, it would be necessary to consider the extent to which the transitional arrangements should continue a broad range of rights, privileges and obligations under sectoral legislation on banking, payments, retail products, market regulation, funds, prospectuses and other areas, as well as cross-sectoral legislation, tax, data protection, corporate law, insolvency law or rules on jurisdiction and judgments in civil proceedings (as well as general Treaty rights such as nondiscrimination). The potential for accidental exclusion of material provisions, and the accompanying disruption, is high under this scenario.
- Interconnectedness of regulation: An approach of adopting a 'narrow positive list' requires the parties to examine each identified right, privilege or obligation to ensure that it is capable of functioning without other related rights, privileges and obligations. For example, the passport rights not only allow credit institutions (and investment firms) to carry on activities in another Member State through a branch or by providing services but also prescribe the extent to which the host Member State may impose requirements on the firm (as well as relationships between home and host state regulators). This is likely further to increase the complexity of the negotiations.
- Pre-emption: The narrower the 'positive list', the more this approach has to pre-empt the subsequent negotiations on the new partnership. It is less likely that the new partnership will restore rights, privileges and obligations that are not covered by the transitional arrangements. In addition, a narrower 'positive list' presents banks, their customers and regulators and market infrastructure with the damaging cliff edge of the immediate loss of the remaining rights, privileges and obligations with effect from the date the UK exits the EU.

Responding to future regulatory change

If there is a substantial transitional period, it is not realistic to assume that there will be no material changes in the legal or regulatory regimes in the UK or the EU27 during that period. Nor will it be realistic to prohibit any such changes.

The transitional arrangements should include robust arrangements for prior notice and consultation on relevant changes of law that might take effect during the bridging period or the adaptation period, so as to avoid any unintended consequences or inadvertently restrict the effectiveness of the transitional arrangements.

The transitional arrangements would also have to provide for a mechanism which permits the UK or EU27 to bring the bridging period to an end, and start the adaptation period, in the event that a divergence of the legal or regulatory systems arises which either party considers could undermine the effectiveness of the transitional arrangements or their general regulatory framework. The adaptation period therefore needs to be sufficient in length to enable providers, clients and regulators to respond to such an eventuality.

Application of the transitional arrangements to firms and situations

The transitional arrangements should apply to all activities of existing and new businesses, subject only to specified exceptions.

The negotiating partners will have to decide whether the transitional arrangements should:

i. continue the effect of existing legislation during the bridging and adaption period on all firms and situations; or

ii. be more narrowly focused on preserving rights and obligations already being exercised in relation to specific firms and situations at the date the UK exits the EU.

The former approach maximises continuity and avoids a 'chilling effect' on new business and economic activity during the transitional period and indeed provides a better 'bridge' between the current position and the position under an eventual new partnership. For example, it might allow an EU27 bank to establish a branch in the UK for the first time after the date of the UK exit from the EU or allow a newly formed UK investment firm to start providing cross-border services into the EU27 after that date. This will be particularly important and help avoid a period of unnecessary disruption if an eventual new partnership could restore these aspects of the single market. It would also preserve a level playing field between new and existing firms by applying the same set of rules and regulations under a transitional arrangement. This would also assist both new and existing firms to transition smoothly into any broader relationship established under an eventual new partnership.

The latter approach focuses more narrowly on not disrupting the rights and privileges of existing firms or attaching to existing situations – avoiding defeating legitimate expectations and preserving accrued rights so far as practicable. For example, under this approach, only firms that are already exercising passport rights, either through a branch or on a services basis, would be able to continue to exercise those rights during the transitional period. New business activities would not be enabled. While the latter approach may be simpler to implement, it is more damaging to the economies of the UK and EU27 because of the 'chilling effect' that the absence of simple arrangements for new business activities during the period of uncertainty will have for jobs and growth.

EU legislation commonly restricts transitional arrangements to existing firms and situations – often at the date that the legislation enters into force. However, the transitional arrangements in EU legislation are usually designed to smooth the transition towards a pre-defined regulatory position. They are not designed to serve as a 'bridge' between the current position and a future regulatory state that has not yet been specified.

In addition, the latter approach is less effective for products such as prospectuses, funds or benchmarks where market participants regularly develop and launch new products. Restricting the transitional arrangements to existing products or products in the course of being launched at the date of the UK exit from the EU would disrupt the market by introducing an immediate separation between the UK and EU27 markets for new products. The intention of the transitional arrangements is to give the parties time to negotiate arrangements which continue a high degree of integration between the UK and EU27. It is therefore inconsistent if the transitional arrangements prevent (for example) a fund manager launching new funds during the period of transition.

Furthermore, 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.

Settling-in mechanisms

The transitional arrangements during the adaptation period may need to include settling-in provisions under which banks, businesses and customers operating under the transitional arrangements can act to bring themselves into conformity with the regime that will apply when the adaptation period ceases and the terms of the new partnership apply. The new partnership may itself need to include settling-in provisions, but that is outside the scope of this paper.

In particular, the transitional arrangements should provide mechanisms to ensure that entities and branches benefiting from passports or single licence arrangements under EU law today (and during the adaptation period) can apply for local licences or for recognition under third country regimes and continue their current business while their application is considered. This will be relevant for both UK-based banks and other entities doing business in the EU27 and EU27-based banks and other entities doing business in the UK. Otherwise providers and clients may face a damaging cliff edge and have to halt their business when the transition period ends until they have obtained a licence/recognition.

In some cases, this will involve a commitment to take other steps. For example, in order for ESMA to consider UK CCPs for recognition under EMIR, the European Commission will have to have completed its 'equivalence assessment' on UK legislation, ESMA will have to have entered into a regulatory cooperation agreements with the Bank of England and the EU27 Member States will have to have determined that the UK has 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 under the EU Anti-Money Laundering Directive.

Similarly, if the Great Repeal Bill has created a corresponding UK system under which the Bank of England can recognise non-UK CCPs for the purposes of the UK legislation replacing EMIR, there will need to be corresponding action by the UK authorities before the Bank of England can consider EU27 CCPs for recognition in the UK.

The transitional arrangements may also need to address cases where existing EU law (and the corresponding UK arrangements created under the Great Repeal Bill) provide for 'equivalence assessments' of third countries. For example, EU banks are required to put more regulatory capital aside for exposures to non-EU banks unless the non-EU bank's home jurisdiction has been the subject of an equivalence determination by the European Commission. The settling-in mechanism will need to provide for this determination to be made before the end of the adaptation period to avoid a sudden increase in regulatory capital requirements for EU27 banks. Given the significant size of interbank lending among UK-based banks and EU27 banks and the focus on avoiding unnecessary charges against bank regulatory capital levels, this is a consideration that is likely to be of material concern for many EU27 banks.

Dispute resolution

Resolving dispute resolution within the transitional arrangement will require a number of different approaches depending on the parties to the dispute. At its simplest, where a dispute between UK parties arises as to the scope, meaning or application of the agreement (for example between a UK regulator and a UK firm), that will be a domestic matter for the English courts (unless the UK Government chooses to structure the transitional arrangement in such a way that it is subject to the jurisdiction of the Court of Justice of the European Union ('CJEU'), or there is agreement to use another designated independent forum akin to the European Free Trade Association ('EFTA') court).

This will be equally true of a dispute between a UK person and a non – EU person (for example, a UK regulator and a Swiss firm). In the same way, a dispute between EU persons will be a domestic matter for the laws of the countries concerned, but will of course be ultimately subject to the jurisdiction of the CJEU.

The question of how a dispute between the EU27 and UK (in their capacity as the contracting parties to the withdrawal agreement) should be resolved is a function of the operation of UK and EU public international law, and is beyond the scope of this report.

However it should be noted that most trade and investment agreements contain a dispute resolution mechanism and the operation of such mechanisms is reasonably well established as a matter of international law. There are also EU constitutional law criteria which would have to be satisfied to enable the EU to enter into such an agreement, and these would also have to be addressed. However, provided that these obstacles could be overcome, we do not believe that there would be great difficulty in constructing such a mechanism.

It should be noted that where the UK chooses to continue to implement EU law, or to copy out provisions from directives into UK law, it is highly likely that UK courts will continue to pay close attention to the decisions of the CJEU (and, to some extent, other Member State courts) as to the interpretation of these provisions. Thus EU law and EU tribunals will unquestionably continue to be cited as persuasive authority in English courts, in the same way that (say) Australian decisions are today.

Third country issues

When the UK leaves the EU, the UK will cease to benefit from treaties and other arrangements with third countries negotiated by the EU on behalf of all Member States. It is unlikely that agreement on the transitional arrangements that apply as between the UK and the EU27 could have any effect on this outcome.

The loss of the benefit of the EU's FTAs is unlikely to have significant adverse impact on cross-border banking services provided from the UK, since these FTAs generally do little to liberalise cross-border financial services. However, there may be other features of these FTAs that are important for financial services which would need to be addressed by negotiations with the third countries. The more immediate impacts are the loss of the benefit of non-Treaty based arrangements with third countries.

Two important examples of these are the arrangements with the US or other countries for the recognition of EU derivatives rules for the purposes of substituted compliance with the rules under the US Dodd-Frank Act or the commitments made by the US authorities to the EU with respect to data protection issues in the context of the so-called 'Privacy Shield'.

When the UK exits the EU, the UK will cease to be subject to any formal restrictions on its ability to negotiate arrangements with third countries. Before then, there may be restrictions under the Treaties on the UK formally negotiating with third countries in the area of the common commercial policy, but these may not in practice prevent preliminary discussions and in any event would not restrict the UK's ability to pursue negotiations on regulatory cooperation.

The UK will also need to put in place arrangements in its own law to recognise third country firms and arrangements where previously recognition has been addressed at the EU level (e.g. for CCPs and credit rating agencies) or the UK is required to rely on recognition given by another Member State (e.g. benchmarks). While UK law may be able to provide transitional arrangements for existing firms and arrangements, the UK authorities may need to take additional steps if it is intended to replicate the existing EU arrangements (e.g. the UK authorities would need to put in place new regulatory cooperation arrangements with the regulators of non – EU CCPs to replace those between those regulators and ESMA).

In summary, there will be a host of third country issues that the UK will need to promptly address outside of any UK/EU27 transitional arrangements in order to avoid negative cliff edge impacts similar to those discussed in this paper in relation to UK/EU27 relationships also damaging activities between the UK and such third countries. In many cases this will require the UK to agree new arrangements with the third country.

2.3. The potential for transitional arrangements under domestic UK and EU27 law

Even in the absence of transitional arrangements in a withdrawal agreement, the UK could take action in its own law to smooth the transition. For example, the Great Repeal Bill could include provisions empowering the UK Government to adopt transitional measures, e.g. to allow EU27-based banks with branches in the UK to apply for permissions to become authorised in the UK in the same way as non-EEA banks today or to give EEA firms that rely on the passport to provide cross border services a temporary permission to continue to provide those services. This would have operational and resource implications for UK regulators that would have to be planned for appropriately. The Great Repeal Bill could also empower the UK Government to assist UK-based banks using market infrastructure in EU27 Member States by, for example, including in UK law transitional arrangements that continue to recognise EU27 systems as designated systems for the purposes of the UK rules implementing the Settlement Finality Directive. This would ensure that insolvency proceedings in the UK against a UK-based bank do not disrupt transactions settling through EU27 systems.

In principle, new EU legislation and national legislation in the EU27 Member States could also provide transitional arrangements even in the absence of transitional arrangements in a withdrawal agreement. However, in practice, it is likely to be more difficult to secure legislation of this kind. The EU legislative process does not readily allow significant delegation of powers to amend existing legislation and the speed of the EU legislative process is likely to make it difficult to adopt extensive detailed legislation in advance of the UK exit from the EU. Similarly, it is likely to be difficult to coordinate effective legislative action across the EU27 in the absence of a binding international instrument. There could, furthermore, be conflict with WTO/GATS rules if the UK and/or EU27 create unilateral transitional arrangements which sit outside the framework of EU law. As noted in section 2.2 above, GATS generally prohibits WTO members from giving any country preferential terms for market access, unless they are prepared to offer similar access to other countries in a comparable position.

There is an exception for 'economic integrations' which potentially prevents transitional arrangements contained in the withdrawal agreement from contravening GATS, but that exception seems unlikely to apply to unilateral transitional legislation.

Annex 1: Implementing bank adaptation plans

Relocation: phases and timing

There are three principal phases to the development and implementation of a reorganisation to implement any adaptation plan that requires the relocation of elements of a bank's business activities, whether for a UK-based bank relocating all or part of its business to the EU27, or an EU27-based bank relocating all or part of its business to the UK.

For many banks the completion of these three required phases is likely to take materially more than two years. This is because of the dependencies on regulatory approvals for obtaining new or amended bank licenses and the timeline sensitivities for complex and multi-phase project planning involving numerous stakeholders and many different technical considerations.

Any banks' overriding objective will usually be to minimise disruption to its customers. However some disruption may be unavoidable, with customers who were previously dealing with one point of contact within the bank now having to deal with a variety of different personnel and branch/ entity locations.

In some cases customers may have to enter into novation/ transfer agreements with the bank to migrate particular contracts (such as hedges) to new bank entities. It may not always be possible to migrate existing contracts without incurring taxes or other costs and without the new arrangement being less beneficial to a customer than the original.

For many banks the uncertainties regarding the existence (or not) of transitional arrangements, and the absence of visibility regarding the terms of any eventual partnership among the UK and the EU27, mean that they will seek to build as much flexibility as possible into their adaptation plans. Whether and the extent to which this is feasible will depend upon the individual business structure, affected business lines, and customer locations and needs, of each bank.

The three phases are summarised below:

Figure 5: Key adaptation phases

Phase 1: Business planning and due diligence

The first phase involves extensive business planning and due diligence. This phase will allow the bank to assess whether or not to continue all or some of the business under review, and the degree of flexibility which can be built into its planning. If the decision is taken to continue the business, this phase will also allow the bank to analyse if it will be able to continue to serve all or only some of its customers:

- Business impact assessment. The bank will finalise its detailed analysis of the likely business impact of the UK exit on each of its business lines.
- Location strategy. The bank will carry out an evaluation of the possible locations for the relocated business and make a location decision, after considering the legal and regulatory environment, labour regulation, corporate and personal tax issues, real estate availability and available talent pool.
- Business model development. The bank will need to develop a detailed business model for the relocated business and the residual UK or EU business, including funding strategy and financial projections.
- Preliminary engagement with regulators. The bank will carry out preliminary discussions with regulators in the selected location and its current regulators. If the bank is headquartered outside the UK or EU it will also need to discuss the proposals with its principal home state regulators and group resolution authorities.
- Implementation planning. The bank will develop a detailed implementation plan, including evaluating and making a choice of the implementation method and addressing the sequencing of actions. This will include technology and operational implementation plans.
- Due diligence. The bank will carry out due diligence on client, vendor and other contracts that may be affected by the relocation process.

Phase 2: Regulatory engagement and build-out

The second phase involves two key elements:

- engagement with regulators to obtain any necessary licences and approvals; and
- building out the implementation plan from planning to execution.

This phase cannot start until the bank has completed the preliminary work in the business planning and due diligence phase, although some aspects of planning and due diligence are likely to continue into this period.

Engagement with regulators

The duration of this phase is critically dependent on how long it takes the bank to obtain any necessary regulatory licences and approvals.

The most demanding case will be where the bank needs to licence a new transferee bank in the selected location.

However, even if the bank already has a licensed bank in the selected location, a significant change in the business model of the transferee bank will require extensive discussion with regulators. This may take as much time as a new licence.

The transferee will likely need to obtain a number of different regulatory approvals in connection with the transfer. In particular, the transferee will likely need approval for the complex models required by more sophisticated banks to manage their capital requirements. The regulator may need to review technology plans, as well as to approve new officers and other staff. In some cases, it may be necessary to reorganise group structures which may trigger the need for prior change of control approvals. The reorganisation may also require tax clearances.

The bank will have to deal with the national regulators in the transferee jurisdiction. There are additional issues where the transferee bank is in the Eurozone, as the European Central Bank ('ECB') will have a role. The ECB is responsible for approving all applications for new bank licences. The ECB directly supervises 'significant' banks within the Eurozone and is responsible for most regulatory decisions for those banks although it works in conjunction with the national competent authority. For less significant banks, the national competent authority is the frontline regulator but the ECB still has indirect supervisory responsibility including the right to prior notice of all material supervisory decisions.

The licensing of a new bank or a significant change in the operations of an existing bank will also require the bank to engage with resolution authorities to develop or modify resolution plans for the transferee entity. In the Eurozone, this may mean engaging with the Single Resolution Board, which has responsibilities for resolution planning for many Eurozone banks.

The transferee bank may need to establish branches in other jurisdictions if, for example, it is taking over branch activities from the transferor entity or is establishing a branch in the UK for the first time as part of the reorganisation. This may require discussions with the regulators of the branches, as well as with the home state authorities of the transferee bank.

The bank will need to ensure that the plans are acceptable to the transferor bank's UK regulators and, if different, the group's home state regulators, including its group resolution authorities.

One crucial concern will be the capacity of the regulators and resolution authorities of the proposed transferee to handle the application, alongside demands from other applicants. Each application will require regulators to devote significant resources. In some cases, regulators may need to acquire additional skills, e.g. to approve regulatory capital models. If multiple and complex regulatory approvals are required, then individual approvals are likely to take longer to achieve than would otherwise be the case. This would increase the risk of restructuring taking longer than would be required for effective business continuity. This consideration may lead banks to conclude that the most effective way to avoid that risk is to execute any adaptation plans sooner than may otherwise have been the case.

The agreement of an orderly transition at the outset of the UK's withdrawal process would allow banks the time to properly assess their situation in the light of their assessment of the merits for their business of the new partnership.

Building out the implementation plan

Building out the implementation plan will involve a series of complex and interlocking range of actions. These will include:

- Real estate: committing to leases or purchases of real estate and the fit-out needed to house the business.
- Technology and operations: carrying out the technology and operational development, build and testing, including the regulatory reporting framework for the new or expanded business.
- Communications: developing the client and other external communication plans and materials.
- Operational, compliance and legal framework: preparing the operational, compliance and legal framework for the newly located business, including new policies and procedures, any new standard client documentation and legal opinions.
- Governance and senior management: developing the governance and senior management framework for the business including arrangements to ensure that the 'mind and management' is located in the jurisdiction of the transferee bank.
- Human resources: preparing the employee policies, communications, redundancy and hiring plans, as well as starting the hiring programme for the new location.

AAA/AA+

- Ratings: engaging with rating agencies to acquire or confirm credit ratings for the local entity.

- Funding strategy: developing a funding strategy for the local entity, including loss absorbing capacity for resolution purposes which may combine intra-group funding with external sources of funding.
- Market infrastructure: engaging with market infrastructure to obtain memberships of exchanges, CCPs, securities settlement systems and payment systems and to put in place the required technology links.
- Vendors: engaging with suppliers and other vendors, including custodians, new external and intragroup outsourcing arrangements.

Tax

- Tax: migrating customer contracts from one jurisdiction to another could have adverse tax effects on customers or the bank itself (for example by triggering a taxable gain for a customer that would ordinarily only be crystallised when the customer exited the contract).
- Legal implementation: taking the preliminary legal steps necessary under the selected implementation method and preparing the legal documentation for the final phase.

Phase 3: Client engagement and implementation

In this last phase, the bank will have to engage with clients to implement its plan, including arrangements to transfer customers so they face the branch/entity that will be providing the services in the future. Where the plan uses a statutory framework such as the EU Mergers Directive for the business transfer, there will be specific timetables that need to be followed, such as applications to the court, public filings and defined waiting periods between steps. Where individual client consents are needed, it may be difficult to complete the exercise within this period if there are very large numbers of customers. The bank will also need to carry out employee consultations among affected employees in this period, if not already done in the earlier phase.

The final phase cannot start until it is clear that the necessary regulatory licences and approvals have been obtained or will be in place in time and the build-out is on schedule for completion. In particular, the bank may not wish to engage with customers until it can make a clear proposal that is not contingent on regulatory approvals.

There is an important timing complication for banks utilising the EU Mergers Directive to effect business transfers by merging a UK entity into an EU27 entity. If the merger is not complete by the point that the UK exits the EU, then the EU Mergers Directive will not apply and the merger will not be effective. Hence banks adopting this approach have an additional incentive to initiate implementation as soon as possible.

Co-location with customers: structures

A bank cannot shorten these periods by opting for a 'brass plate' presence. The local regulators of the regulated entity will require the entity to have 'substance', i.e. proper governance, local management and staffing, risk management, compliance and robust systems and controls. This is reinforced by the legal requirement under EU legislation for a bank or investment firm to have its head office in its place of incorporation, which at least requires the 'mind and management' to be located there. The entity also has to have the management, financial and operational 'substance' actually to provide the required services to, and to book substantial volumes of transactions with customers in the target jurisdictions.

Loss of service to customers: implementation

A bank will also need to plan the implementation of any strategy to reduce the scale or scope of affected business by cutting back the services it provides from the UK to customers or counterparties in the EU27 and vice versa. In particular, banks have duties to treat customers fairly and customers will require adequate lead times to locate alternative services. The bank may need to consider how it will deal with legacy business that is difficult to terminate or move (e.g. longer term derivatives contracts). The bank also will need to address the redundancy and other staffing consequences and any consequences for the viability of other business that it intends to retain.

Likely overall timing

Depending on the scale and complexity of a banking business, it is likely to take at least two, and often materially more than two, years to implement any plan to relocate a significant banking business into the EU27 and vice versa. By way of comparison, the reorganisations to implement the UK ring-fencing regime will take much longer than this to execute, even with the benefit of the statutory transfer scheme.

Annex 2: Explanation of frequently used terms

European Economic Area ('EEA')

The European Economic Area in which there is free movement of people, goods, services and capital within the single market. The EEA consists of the 28 EU members plus Iceland, Liechtenstein and Norway. In common parlance the term 'EEA states' is used to refer to the three countries who are not also members of the EU. These three EEA states have access to the single market and passporting rights for financial services. They are required to make a financial contribution to the EU, implement EU legislation relating to the single market, but have no vote at the European Council, representation on the Commission or MEPs in the European Parliament.

Equivalence

Some EU financial service regulations provide rights to providers in third countries that are somewhat akin to, but considerably narrower and uncertain than, passporting, provided that the third country in question's legal, regulatory and supervisory rules are 'equivalent'. Whether third country rules are 'equivalent' is determined by the Commission on advice from the three EU regulatory bodies. Obtaining equivalence has historically taken several years. Importantly there is no equivalence rule for the Capital Requirements Directive, for cross border access, which means that third country financial services providers cannot provide wholesale and retail banking in the EEA without obtaining local regulatory approval.

Free Trade Agreements ('FTA')

Free trade agreements are bilateral or multilateral agreements under which the contracting states agree preferential trading terms which go beyond the standard WTO rules. FTAs generally apply to cross-border trade in goods, with either no provision for cross-border services or very limited provision. The recently agreed comprehensive economic and trade agreement (CETA) with Canada only contains commitments on a narrow range of cross-border financial services, and even then allows the host state to impose licensing requirements on cross-border services. These rights are, therefore, much more limited than the passporting rights described below.

General Agreement on Trade in Services ('GATS')

The General Agreement on Trade in Services is a WTO treaty which facilitates cross-border trade in services by reducing or eliminating tariff barriers and non-tariff barriers. However GATS reserves WTO members' rights in respect of financial services regulation (the so-called 'prudential carve-out'), and it is therefore in practice of very limited application to the cross-border provision of financial services.

Great Repeal Bill

The UK Government has proposed that the UK constitutional and legal consequences of the UK leaving the EU will be implemented by a 'Great Repeal Bill'. This will annul the European Communities Act 1972, which incorporates EU law into UK law. At the same time, it will transpose EU law as at the date of exit into UK law so that there is legal continuity. There may be provisions enabling Ministers to subsequently repeal individual EU law provisions by secondary legislation, or alternatively this may be effected by subsequent primary legislation.

Passporting	A financial services provider authorised in one EEA state is entitled to carry on certain financial services activities in another, either by establishing a branch or by providing cross-border services (and without any requirement for separate regulatory authorisation in the other state). This is referred to as 'passporting'.
Third country	A country that is not a member of the EU (or, depending on the context, the EEA).
Withdrawal agreement	Under Article 50 of the Treaty on European Union, a Member State which has decided to exit the EU may notify the EU of its withdrawal. There is then a two-year period during which a 'withdrawal agreement' setting out the terms of exit may be negotiated. If no such agreement has been concluded two years after the Article 50 notice was delivered, then the Member State in question immediately ceases to be a member of the EU. The two-year period can be extended by unanimous agreement.
World Trade Organisation ('WTO')	The World Trade Organisation sets out the rules governing the worldwide multilateral trading system. The WTO sets out maximum tariffs which WTO members may apply, certain limitations on non-tariff barriers, and a 'most favoured nation' ('MFN') principle which prevents WTO members from discriminating in favour or against other individual members. There are exceptions to the MFN principle where countries enter into comprehensive free trade or economic integration agreements.

Glossary

ACEA	European Automobile Manufacturers' Association
AIF	Alternative Investment Fund
CCP	Central counterparty
CJEU	Court of Justice of the European Union
CRD/CRD IV	Capital Requirements Directive
EEA	European Economic Area
EFTA	European Free Trade Association
EMIR	European Market Infrastructure Regulation
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
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
MiFID	Current EU Markets in Financial Instruments Directive
MiFID II/MiFIR	New EU Markets in Financial Instruments Directive and Regulation replacing
MiFID SEPA	Single Euro Payments Area
SMMT	Society of Motor Manufacturers and Traders
UCITS	Undertakings for Collective Investment in Transferable Securities
WTO	World Trade Organisation