The overwhelming victory of the Conservatives in the 2015 General Election has brought the potential exit of the UK from the EU – or, “Brexit” – to the political forefront of UK and European politics. By the end of 2017, David Cameron has promised a referendum on whether to leave the EU or not.

The UK government intends to put a choice to the UK population based on “renegotiated relations” with the EU. The key objectives of the renegotiation will be to:

1. increase sovereignty,
2. reduce “welfare tourism”,
3. repatriate powers (primarily linked to social legislation such as the working time directive), and
4. protect the interests of the City of London (although it remains unclear what that means exactly).

In this paper we will assess potential consequences of a Brexit, from a macro-perspective as well as from the perspective of the loss of sovereignty, foreign direct investment and detailed financial regulatory framework. One of the fundamental differences that lies at the heart of the current discussion is the UK’s vision on European integration, which has since its accession to the EU been an economic-focused project, in contrast to continental Europe (i.e. France and Germany) for whom the European Union is a political, security, economic and social project as well as an economic one.

This briefing will focus on the objective of safeguarding the City of London. An interesting point to make upfront is that some of the most contentious interventions in the financial markets are actually inspired by the UK rather than by the EU: Vickers (ring-fencing of retail banking from investment banking), the bank levy and the ban on inducements.
Brexit – the procedure

If a majority of the UK population votes for a Brexit, it would not lead to an immediate change. Most commentators predict a transitional period of 2 years in which the next steps would be defined and shaped. Many scenarios are possible, ranging from no special relationship, to membership of the European Economic Area (EEA), to a broad trade agreement, to a Swiss construction which is based on many sectoral bilateral agreements between Switzerland and the EU. The exact effects of a vote for Brexit will depend, to a great extent, on the type of agreement chosen/negotiated. It is safe to say that an EEA membership solution would be unsatisfactory for the UK, as the UK would consequently have to apply legislation it cannot influence. It is also important to note that the Swiss construction is not similar to the situation with the UK. On the one hand, when bilateral Swiss-EU negotiations started, it was from the perspective of Switzerland eventually joining the EU; clearly a different starting point than after a vote for Brexit. On the other hand there is less and less appetite within the EU to allow the Swiss to “cherry pick”: enjoying the benefits of the internal market without showing the counterbalance of solidarity that comes with it. Perhaps one of the most substantial risks of a vote for a Brexit is exactly this period of uncertainty between the vote and the clarity of what the new situation would look like. Financial market participants do not like uncertainty.

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The period of uncertainty that would follow after a no-vote is likely to be one of the arguments encouraging people to vote yes, or at least frighten them away from voting no.

In addition, an aspect of the discussion that is often taken for granted is what the reaction of the remaining Member States will be. A Brexit would be a traumatising occurrence in the history of the EU which could lead to irrational reactions and possibly a resistance to negotiate favourable terms for the UK.

The European Commission is keenly aware of the importance of the situation. The UK is on its way to becoming the biggest member state in the EU in terms of population in the next 20 to 30 years. Maybe politically more important is the UK’s key role in balancing the scales of power in the EU. Often, finding a solution to highly political issues depends on a common position developed by the big three member states and their respective supporters. In this configuration, the balance of power consists on the one hand of France supported by traditional allies such as Italy, Spain, Portugal and Belgium. On the other side of the balance is the UK supported by its traditional allies such as Sweden, Finland, Ireland, Netherlands, Luxemburg and the Czech Republic. In the middle is Germany supported by Austria, Poland and others. This is a relatively high level (and in some ways very unfair) characterisation but it demonstrates well the potential effects of a Brexit. The balance of power in the EU would shift dramatically.

Demonstrating the importance of the situation, the EU has recently appointed Jonathan Faull, former Director General of DG MARKT/FISMA and DG JUST as special advisor on Brexit. He will be tasked with advising the European Commission on this discussion – the obvious objective being to prevent a Brexit.

Effects – regulatory sovereignty

One of the main arguments deployed by the British government to leave the EU is to regain regulatory sovereignty. Looking at the most likely scenarios, UK membership of the EEA, the “Swiss solution” or a broad trade agreement, regaining full regulatory autonomy might be slightly illusory. First, much of the global financial regulatory change has emanated from global bodies such as the G20, The Financial Stability Board (FSB) and The International Organization of Securities Commissions (IOSCO). The current Bank of England Governor, Mark Carney, is even Chair of the FSB. The UK would follow these global standards even if they were not part of the EU.

Second, in all of the scenarios regarding potential future EU–UK cooperation described above, assuming that the UK would like to maintain access to the internal market in general and the financial markets in particular, the UK would have to align its regulations with the EU. However, whether it is EEA membership, a broad trade agreement or individual agreements, in none of these cases would the UK have an influence or say in how the EU rules are designed. Its regulatory sovereignty might even be smaller, as Britain would not be represented in the Council or the European Parliament or be able to use the European Court of Justice (ECJ) to defend its single market rights.

Effects – Existing financial regulation

Asset Management (AIFMD)

The above can be well illustrated by looking at the impact of EU regulation on the asset management industry. The impact of EU regulation on asset managers has been cited as being burdensome and costing British asset managers 2 billion pounds a year according to a report published by Open Europe and New City Initiative (Open Europe, 2015). According to the report, the (lack of a) system for distributing funds has been a deterrent for some fund managers. They recommend that national obstacles to the distribution of funds domiciled in other EU countries should be removed, as they undermine the essence of the single market. Non-EU managers can still market their funds in the EU via national private placement regimes, which means they do not have to comply in full with the Alternative Investment Fund
Managers Directive (AIFMD). However, these private placement regimes could be abolished after 2018.

Regarding the AIFMD, the UK is unlikely to gain much regulatory autonomy by leaving the EU when it comes to marketing and passporting of funds. The AIFM Directive would still require non-EU alternative funds to comply with EU requirements including capital requirements and pay guidelines. Those managers wanting to continue to market their funds in the EU would not be exempt from regulatory burden. Indeed, under AIFMD, non-EU regulations must be deemed equivalent for the cross-border provision of products and services. Should the UK decide to stay in the EU, it would have more leverage in making sound recommendations in improving policy making on funds.

**UCITS**

Undertakings for Collective Investment in Transferable Securities (UCITS), unlike an AIF, can only be established in the EU, and consequently the impact of a Brexit on UCITS is likely to be severe. Managers seeking to market their funds with ease across the EU would be required to restructure their location, operations or business models. For those managers who currently use the UK as a base from which to passport their financial services, a settlement that permits the UK to remain a domicile for UCITS would need to be negotiated. Without such a settlement, those managers would have to be re-domiciled to an EU country and seek re-authorisation under the UCITS Directive, or cease to continue as UCITS altogether. In this case the fund managers would need to manage the fund as a collective investment scheme as defined by UK law.

Under a potential agreement between the EU and the UK, full compliance with the UCITS directive would still be required. There have been suggestions that the UK would build their own UCITS-style vehicle to compete with the EU one, but this is likely to take time and will not have the benefit of being pass- portable across the EU.

**One of the biggest risks of a Brexit is the UK’s loss or restricted access to the single market.**

**MIFID and presence within European Supervisory Authorities (ESAs)**

One of the biggest risks of a Brexit is the UK’s loss or restricted access to the single market. Under the Markets in Financial Instruments Directive II (MiFID II), the EU has tightened rules on third country access. Third country firms who want to sell their products and services to retail investors in the EU are required to open a branch within EU borders. This branch is regulated and supervised by the home country’s supervisors, in coordination with the host country. In addition, the Commission (based on ESMA advice) must recognise the regulations of the third country as “equivalent”, and the branch would have to appropriately meet EU capital requirements (Centre for European Reform, 2014).

Should the UK exit the EU, it will be treated as a third country, and for British investment firms wanting to continue to sell investment services or retail products to clients in the EU, British rules would have to be deemed equivalent by the European Commission and ESMA. In the short run this should not be problematic. Assuming the UK will correctly implement MiFID II, the UK legislation is of course equivalent to the legislation in the EU. However, in the long run there will clearly be obstacles. First, the UK does not agree with all aspects of the implementing measures under MiFID II. Once the UK is free to make its own determinations, it is likely that the UK will make different choices on certain elements (for example liquidity determinations or position limits), and thus will no longer be equivalent to the EU legislation.

Second, and this is a more general comment, the equivalence determination is preceded by advice by the ESAs. In the event of a Brexit, the UK would no longer be a member of the ESAs (ESMA in this case). Knowing that the UK currently play a very active role in the decision making process within the ESAs, the absence of the UK will surely influence those decisions. Relating this situation to equivalence determination, it is not unlikely that the standards drawn up by the ESAs will deviate further from what the UK would deem acceptable, and moreover, in the aftermath of the politically painful divorce, a majority of the members of the ESAs might not be keen to decide favourably on UK equivalence.

**Banking**

EU banks would still have the possibility of setting up a branch in London. It is more problematic for non-EU banks, which would no longer be free to set up a subsidiary in London and then branch out to EU Member States. Currently the UK is the largest centre for foreign bank branches. In order to have access to a banking passport, non-EU banks would be required to open up a subsidiary in an EU Member State. The regulatory burden of having to set up a subsidiary in the EU and a branch in the UK would weigh heavily on non-EU banks: they would have to satisfy the requirements of their home country as well as those of the EU Member State in which they established their subsidiary in, and also adhere to any further supervisory requirements demanded by the British authorities. As a result, many banks might choose instead to move their operations from London to the EU.

**EMIR**

UK investment managers active in the derivatives market have found certain elements of the European Market Infrastructure Regulation (EMIR) difficult. However, mandatory clearing, minimum margin requirements and reporting to a centralised trade repository would continue in the UK whether it left the EU or not. This is because the reform of derivatives markets is coordinated at a global level, stemming from the 2009
commitment by the G20 to global reform. It is difficult to see how the UK, as one of the leading global jurisdictions for derivatives trading could deregulate its own derivative market, under the watch of the FSB chair Mark Carney. Under EMIR, CCPs authorised in any EU jurisdiction are treated as authorised throughout the EU. In the case of a Brexit, UK CCPs are likely to be treated as “third country CCPs” and will need to apply for “recognition” under EMIR in order to be able to continue offering their services to financial institutions based in the EU. EMIR stipulates that a CCP established in a third country may provide clearing services only if it is recognised by ESMA. This recognition process can go fast (four jurisdictions were recognised rather quickly Hong Kong, Singapore, Japan and Australia) or slow (the US). In a way, one would expect high potential for a fast recognition but this is dependent on the priorities of the European Commission and ESMA and such decisions could be influenced by politics.

Prospectus Directive
The UK is a jurisdiction where many companies are listed because of its deep financial markets. The prospectus directive lays down that Member States shall not allow any offer of securities to be made to the public within their territories without prior publication of a prospectus. A prospectus that has been approved in one Member State is valid for the public offer or admission to trading throughout the EU as long as this is notified to ESMA and host Member States. This means that no further approvals of such prospecti are required. This would change if the UK were to leave. Prospecti approved in the UK would no longer be automatically valid throughout the EU which could decrease the attractiveness of the UK as a location for listing. The European Commission can deem other jurisdictions equivalent to the EU. Here once again we come back to the principles that such equivalence might or might not be easily determined.

Short Selling
A Brexit would not result in much change for financial institutions such as investment funds when it comes to the application of the Short-Selling Regulation. This is because the rules relate to where the shares or instruments are listed, rather than where the fund manager is based.

Payments
Another area where the EU has stepped up its legislative and anti-trust interventions is in payments, with the recently adopted Interchange Fees Regulation (IFR) and the revision of the Payment Services Directive (PSD2) as well as the several anti-trust cases it launched against the major payments companies. Of course, a Brexit would mean that the IFR and PSD2 would no longer apply to payments in the UK. However, the antitrust powers of the European Commission could still impact activities and institutions in the UK in case activities deployed from the UK could have impact on European consumers or merchants. In addition, a Brexit would unlikely lead to less stringent laws in the UK on payments, as the UK – a market where electronic payments is more innovative and developed than most European countries – has been a frontrunner in terms of oversight and intervention in the market. A Brexit would mean the UK, with its recently established Payment Systems Regulator, would be able to pursue an even more independent policy – to the advantage or disadvantage of certain market players.

Effects – Future financial regulation
Banking Union
It might be surprising to place the Banking Union under the heading of future legislation. However, the Banking Union is a developing concept. Increasingly, the harmonisation of supervisory requirements and practices is impacting businesses. The financial crisis led to fragmentation (with a notable example of national regulators demanding of branches to subsidiarise within their jurisdiction, even contravening the Treaty). One of the objectives of the Banking Union is to counter this fragmentation through a single rule book and through single authorities for Eurozone Member States. Within the structures of the EU, the Banking Union cannot (formally) discriminate against non-Eurozone Member States. The UK battled hard to ensure this principle of non-discrimination was even reflected in the voting procedures of the EBA through double majority voting. In addition, the European Court of Justice offers a significant safeguard against discriminatory policies, as has been demonstrated by a case brought by the UK against the ECB for requiring that Euro denominated contracts would be cleared by CCPs within the Eurozone.

It can be assumed that the Banking Union will be deepened further. More Member States will voluntarily subject their banks to the single supervisory mechanism (hosted by the ECB). Within the EU, the UK can ensure that this development does not disadvantage the banks located in London. However, by exiting the EU, the UK loses the possibilities to enshrine non-discriminatory treatment in the Banking Union.

In addition, the UK would certainly lose the power of the Court of Justice to challenge policies that it considered to disadvantage the UK. The UK won the challenge against the ECB location policy for CCPs, but by placing itself out of the Union, the UK would lose that protection and the ECB could demand that Euro denominated contracts are cleared within the Union (instead of within the Eurozone).

Capital Markets Union
The Capital Markets Union (CMU) is a project under development and it is as yet hard to predict what would be covered. However, the intentions of the CMU are to strengthen a single market for capital and thereby create non-bank funding possibilities for companies and empower investors to be more active directly on the financial markets throughout the EU. Ideas that are floated include creating private placement regimes within the EU. Often, the CMU is seen as a project that would benefit the City of
London as it is the deepest financial market in the EU. Of course, a Brexit would mean that automatic access to the Capital Markets Union is closed.

"Often, the CMU is seen as a project that would benefit the City of London as it is the deepest financial market in the EU"

Effects – Foreign direct investment (FDI)

A Brexit is likely to impact the flow of FDI into the UK, particularly into the financial services sector (Standard & Poor’s, 2015). Currently, the stock on inbound FDI into the UK is the third highest in the world (around $1.6 trillion) and nearly half of the FDI into the UK financial services sector comes from EU investors (S&P, 2015). The main factors that determine whether a company wants to invest in a country include the regulatory and tax environment, a competitive exchange rate but also its access to key markets. The uncertainty that surrounds the UK’s economic environment leading to the referendum puts the flow of FDI at serious risk, and could potentially stir a disinvestment from the City of London.

The City of London is also prone to losing its status as the centre of gravity for European financial markets. Indeed, major global banks and financial institutions may choose to shift their business operations to other financial centres such as Frankfurt, Paris or Dublin.

Conclusion

The financial sector appears to be particularly vulnerable to a Brexit, and it is difficult to identify the advantages the UK would gain by leaving the EU while wanting to maintain access to the internal market. More colour is needed on the newfound freedoms the UK claims it would achieve post-Brexit, by repealing EU legislation and how it would structure its operations vis-à-vis the rest of the world.

The effect of Brexit on UK financial services will depend largely on the kind of arrangements the UK will be able to negotiate to replace EU membership (S&P, 2015). One option would be to become a member of the EEA, in order to retain access to the Single Market. An alternative could be a bilateral agreement with the EU, in the same vein as Switzerland. However, the situation would not be comparable to negotiations between the European Economic Community (EEC) and Switzerland: while Switzerland negotiated with the aim of eventually acceding to the EU, the negotiation dynamics are different for a country seeking to leave the bloc. Potential negative economic implications of a Brexit outlined in this briefing could be decreased by alternative arrangements. However, if these are not negotiated successfully, a more adverse outcome is not unthinkable.

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