First published 03/03/16
Updated 29/06/16

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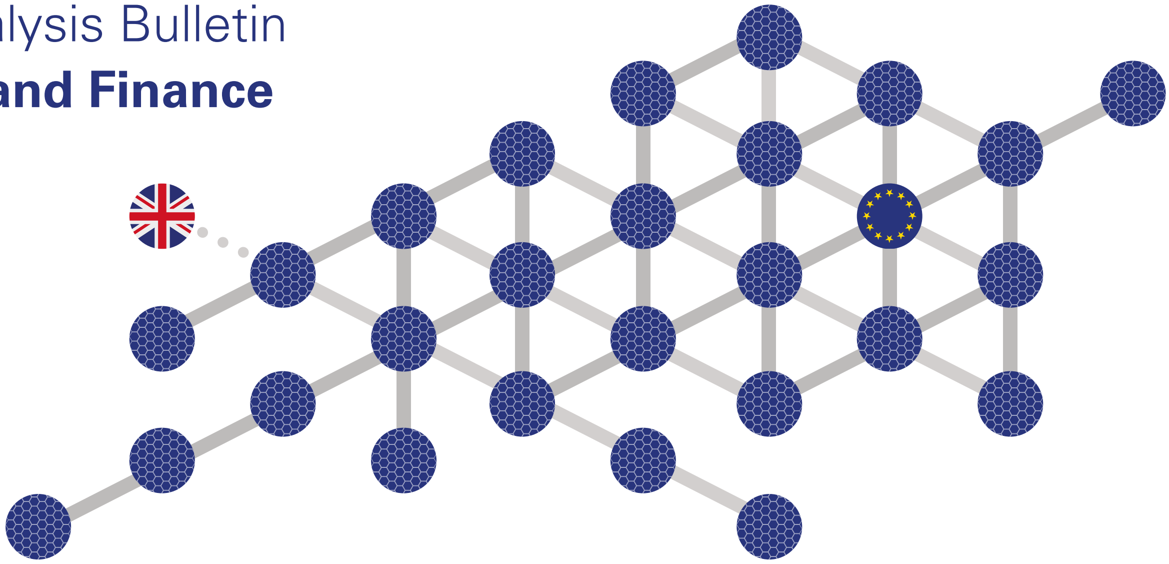
Brexit Analysis Bulletin
Banking and Finance



On Thursday 23 June the UK public voted in a national referendum in favour of leaving the EU. The referendum result has already had a significant impact on financial markets worldwide, as banks, businesses and other organisations consider the possible outcomes of the vote.

The Current Position: UK as an EU Member State

At present, the financial sector in the UK is heavily affected by the UK's membership of the EU. Large volumes of legislation and regulation issued by the EU affect capital requirements and banking practice and regulate the UK banking and financial services sector. Access to the European market via 'passporting' out from a UK base is of substantial benefit for businesses in the UK financial services sector. The UK's departure from the EU may have a large impact on the operations of the UK financial services sector.

Legislation and Regulation

Legislation regulating the UK's banking and financial sector derives largely from the EU. This legislation may now have to be significantly amended. In practice, it is likely that much of this legislation will be replaced by similar legislation to conform to the EU's requirements for free trade partners.

Many pro-Brexit proponents have claimed that the EU imposes too many restrictions and regulations on the UK financial services industry without proper democratic scrutiny. They have additionally argued that the UK could remove many requirements for regulation if it were to leave the EU. However, in practice if the UK intends to continue to operate in European financial markets in a similar way as at present it is very likely that it will need to comply in substance with EU regulation.

Passporting

Financial services businesses in the United Kingdom currently carry on their activities in other European Economic Area (EEA) states by way of 'passporting' their UK authorisations and without further local authorisations being required. As we will discuss in more depth below, businesses in the United Kingdom may continue to have access to other countries via passporting if the United Kingdom decides to join the EEA in a similar manner to Norway. The current availability of the passporting system is of major benefit to UK-based banks, financial institutions, and other businesses within the financial sector, and the free movement of services via this avenue is a major concern for the financial services industry.

Brexit avenues: alternatives for the UK

The UK government now require to look to the potential models for the UK with a key consideration being continued trade with the EU. The financial services sector will obviously be most interested in the free movement of services, and in choosing which model to adopt the movement of service provision will be a key consideration for the financial sector.

In the government's policy paper on Alternatives to membership: possible models for the United Kingdom outside the European Union, the four possible models which the UK could adopt could be a Norwegian-style EEA Agreement, a Turkish-style customs union, a number of bilateral accords, as currently is seen in Switzerland, or trading purely under World Trade Organisation rules.

Norwegian-Style EEA Membership

Norway, Iceland and Liechtenstein are three out the four European Free Trade Association (EFTA) member states that have joined EU's Internal Market through the EEA Agreement and they are for the large part governed by the same basic free movement rules.

From the point of view of the banking sector and financial industry in the UK that relies on passporting to do business within EU member states, adopting a similar model and joining the EU's Internal Market through the EEA Agreement would allow passporting of financial services.

However, from the wider UK standpoint, this option may negate much of the benefit of Brexit, as it would require the UK to adopt EU market legislation and provide financial contributions toward the EU, without having the benefit of voting rights in respect of this legislation. For the financial and business sectors, this would impose much of the same legislative burden as currently exists, and service providers looking to trade with the EU would find that the regulatory burden in respect of activities carried out with EU member states would subsist, further complicated by additional regulations put in place by the UK government, and reduced influence in the Eurozone.

Turkish Customs Union Bilateral Treaty Model

To avoid the requirement to continue to allow the free movement of persons, one of the main concerns of pro-Brexit campaigners in the run-up to the referendum, the UK could turn not to EFTA membership, but to a Turkish-style customs union and bilateral agreements with the EU, which combined offer free movement of goods, but not persons. However, tariffs on services would apply, as services are not included in this model. This would cause a major burden for the financial industry and provision of financial services by banks, investors and other institutions situated in the UK.

Swiss Bilateral Treaty Model

Another option for the UK would be to follow Switzerland in adopting comprehensive bilateral treaties with the EU. Switzerland is included in EFTA but has made its own agreements with the EU in respect of the free movement of persons, capital, services and goods, and additionally Switzerland currently does not have to follow EU court rulings. Switzerland does however have to follow EU trading standards and makes substantial financial contributions to the EU. Membership of the EFTA would necessitate allowing free movement of persons, one of the major sticking points of proponents of Brexit. Tariffs may also be imposed during treaty negotiations.

Some take the view that when markets settle, the UK will still be in an economic position to renegotiate a better deal than Switzerland, although it is obviously not currently clear what this might look like as regards free movement of persons. The financial sector would clearly be most concerned about the implementation of treaties allowing free movement of services and capital, passporting and influence on the Eurozone, but in order to reach agreement on this the government will likely require to be bound by EU regulation in the financial services sector.

World Trade Organisation Model

The fourth alternative would be to operate under WTO rules in a similar manner to the USA's approach when trading with the EU. In this scenario tariffs would be imposed but the United Kingdom would not be required to make any financial contributions to the EU. Free trade deals already made by such countries as Canada require payment of tariffs and crucially do not include the provision of services. Any trading and services provided to the EU would, as discussed above, still be subject to EU regulation and other trade requirements imposed by the EU, as with the Turkish model.

From the perspective of the financial services industry, a Turkish-style model or use of the WTO model would pose little benefit if agreement in respect of free movement of services was not reached, and banks and financial service firms' operations in the City could be affected if the United Kingdom could no longer be used as a gateway to Europe for the financial services industry.

Concluding Remarks

For the UK to leave the EU, a formal notification of intention to withdraw from the EU must be given to the European Council in line with Article 50 of the Treaty on European Union. Once Article 50 is triggered by this notification, the UK will have a maximum of two years to negotiate an agreement for its future relationship with the EU, and this agreement will need to be ratified by a qualified majority of EU leaders and a majority in the

European Parliament. If the agreement involves a new free trade agreement it will also require to be ratified by the national parliaments of the 27 EU members.

It is likely that Article 50 will not be invoked at least until after October, when a successor to David Cameron as Prime Minister takes office. It is unclear at present whether EU members will enter any informal discussions on a trade agreement before that time, with many EU officials calling for Article 50 to be invoked immediately to avoid further uncertainty.

Additionally, although the UK has voted in favour of leaving the EU, 62% of the Scottish electorate voted to stay in the EU. The First Minister for Scotland, Nicola Sturgeon, has indicated that she will be seeking to represent the people of Scotland who voted against departing from the EU by exploring all avenues to allow Scotland to remain in the EU or re-join the EU, whether by Scotland coming to an arrangement to remain within the EU and still remain a part of the United Kingdom, or by Scotland becoming an independent country and joining the EU as a new member. The feasibility of Scotland remaining in or re-joining the EU, and the means by which this could be realised, are unclear at present.

Clearly all involved have a vested interest in ensuring that workable arrangements are put in place in advance of a departure from the EU. Clearly there are various routes which could be followed when adopting an effective trading model. It is less clear at present which model will be followed and where negotiations may lead.

SHEPHERD AND WEDDERBURN'S BREXIT ADVISERS
JOINING THE DOTS OF THE EU REFERENDUM

What next?
Shepherd and Wedderburn has been for many years offering balanced and impartial advice on how the different scenarios might play out in the event of constitutional change.

Now that the vote has been cast to leave the EU, members of our dedicated Brexit group continue to interrogate the regulatory and commercial issues and to advise clients on next steps and outcomes.

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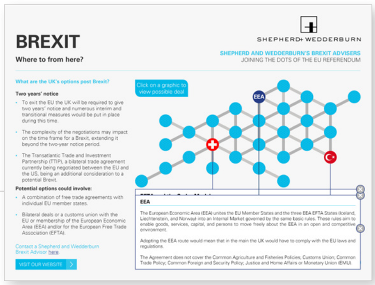

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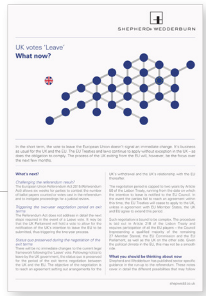

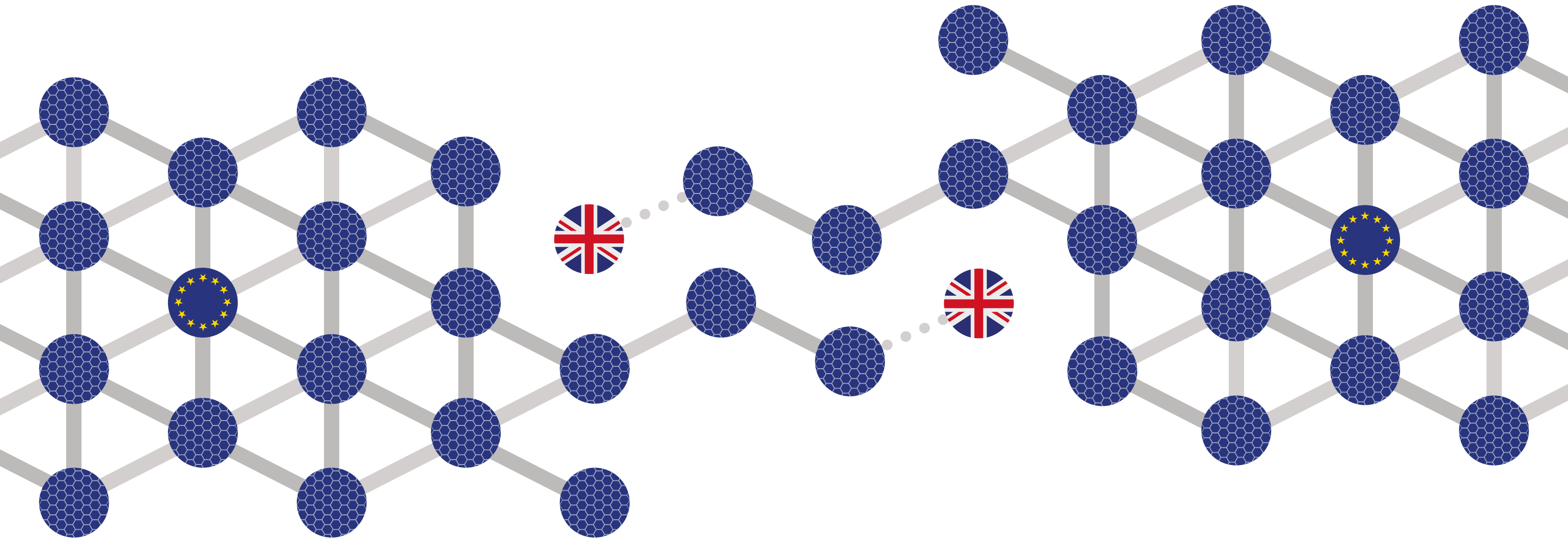

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