Client Update
Brexit – Regulatory Implications for Banks, Insurers and Financial Services Firms

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If the UK votes to leave the European Union ("EU") in the referendum on 23 June 2016, the future application of EU-based legislation to the banking, financial services and insurance industries will ultimately depend on how the UK renegotiates its relationship with the EU.

POST-BREXIT RELATIONSHIP WITH THE EU

In general terms, one of three different post-Brexit relationships is the most likely outcome:

- membership of the European Economic Area ("EEA"), like Norway;
- negotiating a bilateral agreement, whether that goes as far as Switzerland's membership of the European Free Trade Agreement ("EFTA"), joining the EU Customs Union alongside Turkey, or agreeing tariff-free access for certain goods and sectors in the way Canada has done; or
- reliance on the World Trade Organisation ("WTO") rules for trading access.[1]

The first two options, EEA and/or EFTA membership, would result in the closest possible ties between a post-Brexit UK and the EU. This relationship would be subject to the UK's on-going compliance with EU legislation governing access to the single market – including the freedoms of movement. It is unlikely that under such an agreement the relevant EU-based rules and obligations on companies and institutions active in the UK and EU would substantially change, or that the UK would repeal significant legislation. As an EEA member the UK would not, however, have full access to the single market for financial services as that is limited in some parts of the sector. The outcome of EFTA membership

[1] "*Alternatives to membership: possible models for the United Kingdom outside the European Union*", 2 March 2016, Policy Paper of The Cabinet Office.

would depend on what was negotiated. Switzerland, for example, does not have an agreement in respect of financial services and Swiss banks are required to operate in the EU through subsidiaries located in the EU.

The third option, at the other end of the spectrum, would be a relationship only on the basis of the UK's WTO membership. This would result in the current benefits of the UK's participation in the EU single market falling away. The UK would instead only benefit from and be subject to the same principle of non-discrimination as other WTO members. The UK would be free to retain, repeal or modify EU-based legislation, and would no longer be required to interpret national law consistently with EU law.

TIMING AND PROCESS

Following a vote to leave the EU, the UK would need to serve notice on its EU membership.[2] The relevant Treaty provision sets out the timeline for exit, which states that the UK would cease to be an EU Member once the withdrawal agreement comes into force or automatically two years after notification, but this period can be unanimously extended by the UK or the European Council.

In practice, agreeing withdrawal terms may well take longer than two years and agreeing the UK's new legal relationship with the EU significantly longer again. Any new agreement regulating a post-Brexit relationship between the UK and the EU would also require the agreement of each of the remaining 27 Member States, which may in turn require domestic ratification.[3] The only country previously to leave the EU is Greenland in 1985 after a process that took six years to complete.

Whilst the eventual outcome may therefore be very uncertain, one can still identify certain implications that Brexit would have for the UK financial services sector.

THE UK AND THE SINGLE MARKET

The most immediate effects of Brexit will likely be felt around issues of access to the EU Single Market.

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[2] Article 50 of the Treaty on the Functioning of the European Union.

[3] Theoretically, it would be possible for the UK to retain its EEA membership, which would not require any additional consents, but as above, would require the UK to adhere to most EU legislation.

Currently UK-based financial service providers are not required to obtain parallel authorisations in any other Member State that they offer their services in. The so-called "passport" scheme allows financial service firms incorporated in one EEA Member State to establish a branch or provide services remotely in another Member State on the basis of their authorisation and supervision by their state of incorporation. This means UK insurers, for example, can operate subsidiaries and branches throughout the EU under the approval and supervision of the UK's Financial Conduct Authority and Prudential Regulation Authority.

The "passporting" principle is not limited to cross-border establishment, and the principle of mutual recognition also applies to other areas. For example, it is sufficient for a company to seek approval of a prospectus in only one Member State, in order to offer shares or bonds to investors across the EU, or to list them on an EEA 'regulated market'. At the same time, companies with dual listings do not have to comply with separate disclosure and transparency obligations in different Member States. Similarly, clearing houses that handle Euro denominated currencies do not have to be within the Eurozone, but can offer their services EEA-wide.[4]

Following a Brexit, it is unlikely that the passporting rules, and similar abilities of UK institutions would change if the UK was to enter into a Norway-type combined EEA and EFTA relationship with the EU. In such case, the majority of rules regulating access to the single market, including the freedom to provide services, would remain unchanged. The UK would, however, need to implement future EU legislative developments without having the same influence in determining any rule change.

Under any emerging relationship that is less closely aligned with the EU single market, UK-based financial institutions may, subject to any special bilateral agreements to the contrary, lose the above advantages they enjoyed as part of the EU Single Market. At the same time, should a UK-based institution wish to continue offering services in the EU, it would have to continue to comply with the prevailing EU legislation. That will have greater impact on some areas than on others, as not all financial services (in particular those at the retail level) necessarily or directly benefit from single market access. UK insurers, for example, could be required to localise funds and report to the regulators of the EU states they wish to operate in. UK reinsurers could also face further consequences as their third-country status could lead to collateral requirements

[4] The European Central Bank tried to require clearing houses handling Euro-denominated operations to be located within the Eurozone, but lost the UK's challenge before the General Court of the European Court of Justice.

for UK reinsurers and high capital charges for EU cedents, absent a finding of "equivalence" as discussed below.

FINANCIAL REGULATION

The UK's model of financial regulation is, as is the financial regulatory environment in all other EU Member States, derived from EU legislation. Convergence has further increased since the 2008 financial crisis as a result of large scale reform of the EU financial sector regulatory framework. A defining feature of the post-Global Financial Crisis reforms (2008 and onwards), however, is that they have been shaped by the EU's obligations to implement G20-driven international standards on matters such as bank and insurance capital, liquidity, leverage and prudential regulation.

In principle, Brexit could mean lighter regulation in the UK as regulators would no longer be obliged to enforce certain regulations, and the UK would be able either to repeal or simply no longer be subject to certain financial regulations that it was required to abide by or transpose into national law. Examples include the cap on bank remuneration, the power of the European Securities and Markets Authority to ban short selling in case of emergency, and the proposed Financial Transaction Tax.

A recent review of the post-Global Financial Crisis EU financial regulatory framework concluded, however, that, absent a number of exceptions such as the above, it is likely that the UK would have implemented the vast bulk of the financial sector regulatory framework had it acted unilaterally, not least because it was closely engaged in the development of the international standards from which much EU legislation derives.[5]

For that reason, the future legislative impact of Brexit on the financial services sector may be less than in other areas. The UK leaving the EU may not therefore necessarily lead to a lighter touch from a regulatory standpoint.

INSURANCE REGULATION

As is the case with financial regulation, the insurance sector in Europe, too, relies on EU single market principles. This includes the passporting scheme which facilitates easy access of insurers to the EU's single market, without the need for reauthorisation and supervision in every Member State. Following a Brexit,

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[5] "*The post-crisis EU financial regulatory framework: do the pieces fit?*", 2 February 2015, House of Lords European Union Committee.

insurance companies registered in the UK and operating cross-border in the EU would thus have to re-establish a route to access to market in the EU.

While UK regulators would no longer be obliged to enforce the European Solvency II regulations, the UK would likely seek third-country equivalence (as is currently afforded to Bermuda and Switzerland) in order to retain at least some of the benefits afforded to European insurers. As such, regulators are unlikely to stray far from EU insurance prudential supervision in order to make the equivalence process run more smoothly. Further, UK regulators have tended to favour more conservative and restrictive regulation, "gold plating" EU directives, where possible and prudent to do so, to keep such legislation equivalent to existing comparable UK laws.

A finding of Solvency II equivalence on its own in the absence of trade agreements would not allow the UK to access the EU market on a cross border or branch basis. Ultimately, the concrete impact of a Brexit on re/insurers would depend on the results of negotiations around passporting and individual trade agreements with EU Member States.

CONCLUSION

In light of a possible Brexit, and the possible resulting withdrawal from the EU single market, financial services providers may wish to review existing agreements. The prudent insurer, for example, could begin to look at their re/insurance agreements and consider whether termination or renegotiation could be triggered by an exit; for instance, under the possible increased collateral requirements for reinsurers mentioned above or by a change in law. Other contractual risks that could be triggered by an exit include material adverse change, force majeure and frustration clauses.

Where such issues arise, creating a dialogue and reaching out to advisors sooner rather than later is advisable in order to make satisfactory contingency plans.

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Please do not hesitate to contact us with any questions.