Brexit and financial services: navigating the negotiations

September 2018

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Preface

This is the seventh in a series of succinct board papers from EY assessing the potential direction and likely implications of Brexit for the financial services sector. In anticipation of UK withdrawal from the EU on 29 March 2019, this paper considers the continuing uncertainty around negotiations over the next seven months and its impact on financial institutions. Given the important role UK and EU politics will play, we examine the process of ratification for both an Article 50 Withdrawal Agreement and any new treaty-based relationship, some of the possible implications of a 'no deal', the possibility of extending the negotiations, and other UK and EU political mechanisms that might impact the negotiation. While we anticipate a bumpy ride and believe negotiations may go to the wire, our view on Brexit and the City remains largely unchanged: that the process will ultimately be one of evolution rather than revolution and that far more fundamental challenges for financial institutions lie ahead. However, the possibility of a disorderly or no-deal Brexit has increased.

Most boards have now made their major decisions in respect of business models and locations on a 'hope for the best, prepare for the worst' basis. Privately, many senior City leaders admit that Brexit (coupled with US tax reforms) has prompted a strategic reflection and refresh. In particular, this has given rise to a rethink of the default 'serve everything in Europe from London' model. Regulators in the EU have indicated strongly that they expect institutions serving customers within their borders to have business substance in the EU and be subject to local supervision, in addition to whatever other supervisory arrangements they may have.

Many financial institutions are already well into implementation projects, and based on EY's Brexit tracker, we anticipate moderate relocation of some activities from London and the establishment of new operations and capabilities in Frankfurt, Paris, Dublin, Brussels, Luxembourg and elsewhere. Since an acrimonious UK exit without agreement would be in nobody's best interests, great effort and a good deal of compromise should be made to avoid this. Nevertheless, boards should be prepared for six months of tension and should think through plans for communicating with staff and customers during that period. All boards should have prepared in outline a contingency plan for a no-deal Brexit (i.e., a unilateral UK withdrawal from the EU without a negotiated agreement), given the uncertainty. This means that decisions that impact firms' people, operations, clients and customers are now being taken in order to support new future contracting arrangements and fixing existing arrangements. Decisions and progress are increasingly public, with Brexit becoming an increasingly competitive issue.

In the event negotiations are not successful, preparatory work is being done by officials on both sides of Europe. Recent announcements from the European Central Bank (ECB), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupation Pensions Authority (EIOPA) have emphasised that risk and have advised financial institutions to take immediate compensatory actions. However, even if the industry did everything in its power to be prepared, some form of public intervention would be needed on key issues such as cross-border data transfers, insurance contract servicing and access to market infrastructure. Unilateral or bilateral solutions will need to be considered by the UK and EU, though any mitigants are likely to be time limited and imperfect in their effect.

Of course, all Brexit strategies will also need to be set in the context of volatile international politics; an upsurge in populism and accompanying scepticism around financial institutions; an unpredictable economic and monetary policy environment; the looming spectre of trade wars; the threat of highly disruptive technology; and the impact of changes in macro- and micro-prudential regulation. However, for almost everyone in the short term, tactical actions to ensure stability in March 2019 will need to be prioritised, with as much flexibility as possible to allow for optimisation against any confirmed future state.

In addition to our own thinking, the ideas contained in this paper are based on a continuous programme of Chatham House Rule discussions with governments at both political and administrative levels, as well as with firms, regulators, professional observers and analysts across Europe. We would like to take this opportunity to thank all who have contributed to the debate.

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Navigating the negotiations

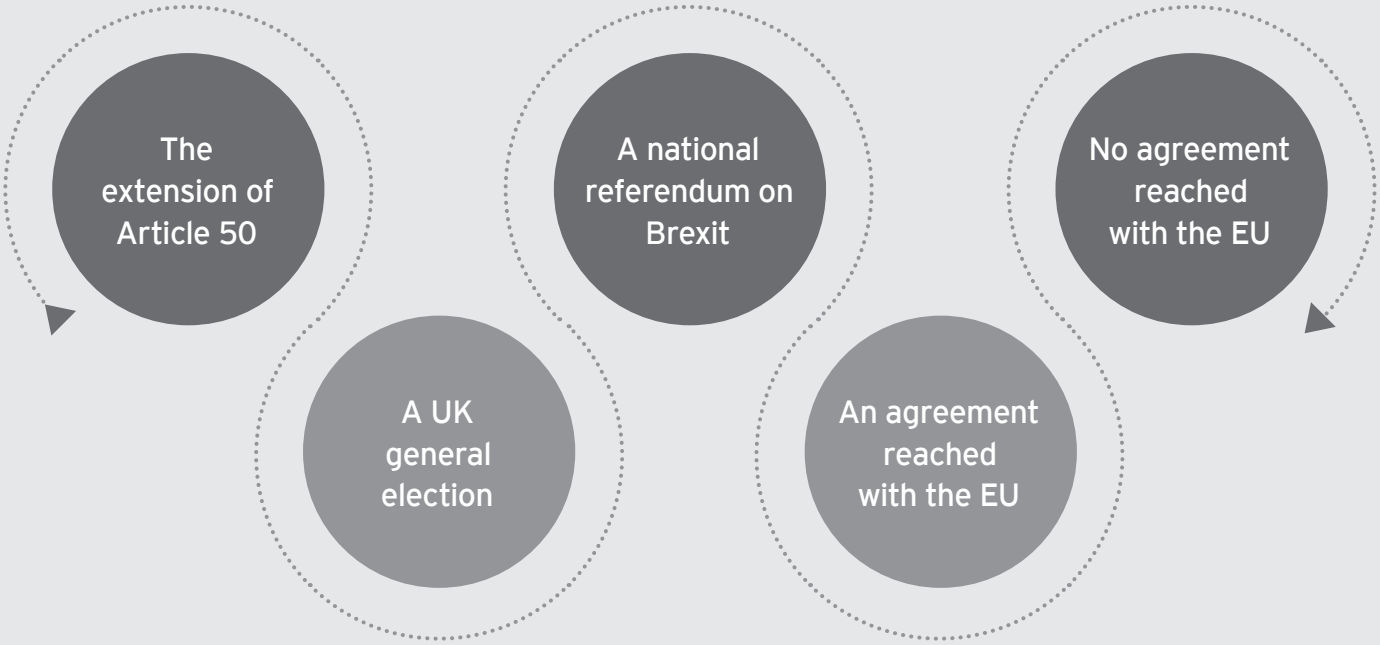
Ideally, the proposed Article 50 withdrawal deal would be in place by October 2018, in order to allow most latitude to the EU Commission, parliamentary, and national government timetable, leading to a smooth confirmation by the EU Parliament by March 2019. There are three major items that need to be agreed (along with a host of smaller issues) before that can happen:

1. Finalisation of a 'backstop' solution for the border between the Republic of Ireland and Northern Ireland to ensure there is no hard border in the event of no other agreement
2. Confirmation of the enforcement mechanism for the Article 50 agreement (the Court of Justice of the European Union mechanism or an alternative arrangement)
3. The political declaration setting out the details of the new EU–UK relationship that should start in 2021 following the 'implementation period'

The first issue is inherently difficult technically and politically. The second can almost certainly be resolved. The third has been subject to much internal debate in the UK, given the breadth of differing opinions as to how close the UK should try to remain to the EU post-Brexit.

The UK Government's thinking for a future relationship with the EU was publicly confirmed after a cabinet meeting at Chequers in July 2018. Essentially, it sees the UK remaining in close alignment with the EU rule book for manufactured goods and agricultural products, sets up a special arrangement to allow UK and EU goods to travel cross-border without customs checks while allowing both to negotiate their own third country free trade agreements, but sets apart services, including financial services, to negotiate bespoke arrangements. At the time of writing, the proposal had prompted the resignations of nine members of the Government, who believe that it does not deliver a sufficiently robust Brexit. This political instability within the Government around its Brexit plans may well continue. Currently, it is difficult to identify a parliamentary majority for any version of Brexit, be it soft, no-deal, an extension to negotiations, or the revocation of Article 50. Some are suggesting a second referendum or another general election centred on the Government's Brexit proposals may be the only way to attempt to resolve a constitutional impasse.

There are a number of scenarios that firms are considering in the run-up to 29 March 2019:



If the Withdrawal Agreement were to be ratified at the last EU Council meeting of the Article 50 period on 21–22 March 2019, the following would need to be in place:

1 Content

1. Sets the terms of the UK's exit from the EU including the transition period, a financial settlement, the rights of citizens and the Irish Border.
2. Provides details of the terms of the future relationship (the Political Declaration) which will set the parameters for the future relationship negotiations during the implementation period.

2 Parties agreement

1. European Parliament
   - Guy Verhofstat, the EU Parliament's representative in the Brexit negotiation, has stated the European Parliament will need three months to approve the Withdrawal Agreement.
2. UK Parliament
   - The Government will provide Parliament with appropriate analysis on the contents of the Withdrawal Agreement.
   - The House of Commons may have a minimum of five sitting days to debate, vote on and approve the Withdrawal Agreement. The House of Lords will have up to five sitting days, beginning on the date of the Common's resolution, to consider the Withdrawal Agreement.
   - The Government will introduce a Bill.
   - The Withdrawal Agreement must be laid before the Houses for 21 days, prior to the UK Government ratification.
3. European Council
   - A vote will take place at the EU Council meeting on 21–22 March 2019.
   - A qualified majority is needed (72% or 20 out of 27 EU Member States).

3 Timelines

The UK parliamentary process provides for a minimum of 21 days before the Withdrawal Agreement can be ratified.

The EU Parliamentary process is unclear but Guy Verhofstadt, the EU Parliament's representative in the Brexit negotiations, has stated that the EU Parliament needs three months to ratify the Withdrawal Agreement.

The EU Council can ratify the Withdrawal Agreement during the EU Council meeting on 21–22 March 2019.

The President of the European Commission and the Prime Minister of the UK sign the Agreement

If there is failure to obtain substantive agreement by March 2019, we would arrive at the completely uncharted territory of resolving a no-deal exit; or seeking an extension to the Article 50 negotiating period; or choosing in substance to remain subject to EU rules with no involvement in their formulation.

Potential political uncertainty in the UK and the extent of the EU's flexibility in its negotiation stance are perhaps the most significant threats to the relative success, or otherwise, of the Brexit negotiations. In the UK, talk of an early general election or second referendum is increasing, although polls do not currently indicate there would be a big shift in Parliamentary or Brexit arithmetic.

A second referendum remains challenging to envisage given the political and legal complexities in delivering one before March 2019, but there is a growing campaign and increasing funding to push this.

Also difficult to envisage is the prospect of the UK withdrawing Article 50 and reverting to the previously existing arrangement. The EU would need to consider its response and whether the UK's special membership terms can continue. It is still legally unclear whether the UK can unilaterally revoke Article 50 and remain in the EU on its current terms. This is regarded as a point the Court of Justice of the European Union may need to clarify; the Edinburgh Court of Session is due to deliver a judgement in the coming weeks which will confirm if it will refer this question. There is also increasing chatter as to whether the UK could seek a soft, and perhaps temporary, landing in the European Economic Area.

In the event of a no-deal Brexit in March 2019, occasioned by a failure to reach agreement, we would anticipate the following immediate significant elements:

- Considerable economic instability with the probability of major intervention by the Bank of England (BoE)
- Retraction of transition arrangements but limited 'exit issue' agreements or unilateral measures being put in place to mitigate the more severe elements of EU frameworks falling away overnight
- Concerns over the validity of cross-border contracts
- Uncertainty over the use of cross-border Central Counter Party Clearing House (CCPs) and reliance on other finance and market infrastructure
- Lack of clarity over the storage and transfer of data
- The adoption of new trade rules, such as World Trade Organization rules (see diagram in appendix)
- The UK will most likely fall out of the EEA and not be able to participate as an EEA member in the single market
- Members of the EEA could refuse to accept free movement of goods from the UK and impose restrictions on UK workers
- Lack of clarity over the legal status of EU citizens living in Britain, and British citizens living in the EU

How early general elections could take place under the Fixed-term Parliaments Act 2011.

1. The next general election is currently scheduled for May 2022, five years after the previous general election as under the Fixed- term Parliaments Act 2011.
2. There are two ways in which an early general election can be held:
   - A motion of no confidence can be initiated by the Government or the opposition under a simple majority. If the motion is passed, there are 14 days for a new Government to gain the confidence of parliament, if not a General election is held.
   - At least two thirds of the House of Commons pass a motion calling for an early general election.
3. Parliament must be dissolved 25 working days before polling day; the latest Parliament can be dissolved in order for the Withdrawal Agreement to be agreed by a new Government by 29 March 2019, is 14 February 2019.

How could the UK hold another referendum and how long might it take?

1. Parliament votes to hold a referendum.
2. The Electoral Commission is required to scrutinise the wording and publish a statement on its intelligibility. The Electoral Commission suggest a 10-week campaign period and a 6-month gap between the passing of referendum legislation and the vote taking place.
3. An Act is passed providing details of the date of the referendum, the question, conduct rules, the threshold (such as a percentage of the electorate or a qualified majority) and whether it is pre-legislative, where the result can be a mandate for the government to proceed with an aim, or post-legislative where if the referendum result is in favour of legislative changes, they are made without further recourse to government.
4. There is a statutory 28-day period, the bare minimum permitted, absent of new legislation, before the referendum vote, known as 'purdah', when restrictions on the activities of government departments and civil servants apply.
5. The referendum is held.

EU/UK negotiation timeline

There are time constraints

- The EU Commission has stated that the final version of the Withdrawal Agreement, together with an accompanying political declaration on the framework for the future relationship, should be agreed by the EU and the UK by October 2018 to allow for the timely ratification by the European Parliament, the Council and the UK, according to its own constitutional requirements.
- In the UK:
  - Parliament must vote on the final Withdrawal Agreement.
  - If approved, the Government will introduce the EU (Withdrawal Agreement) Bill to implement the Withdrawal Agreement in UK law.
  - Once the Bill is enacted, the Government can ratify the Withdrawal Agreement for conclusion by the European Council.
- Guy Verhofstadt, the EU Parliament's representative in the Brexit negotiations, has stated that the ratification process takes three months, implying that if an agreement is not reached before December 2018, it may not be ratified before 29 March 2019, which sets the stage for a no-deal scenario.

Brexit is not the EU's only concern

- Council meetings have extremely busy agendas, and Brexit is only one of the issues that is discussed.
- The agenda of the most recent EU Council meeting (28–29 June 2018) focused on migration, security and defence, economic and financial affairs and the Eurozone as well as Brexit.
- The European Parliament should ratify the Withdrawal Agreement well ahead of a Council meeting to ensure that the European Council has sufficient time to include the ratification vote in its meeting.

2018

Sep 20 — **Informal meeting of the heads of state or government**

- One of the final opportunities for the UK Government to pitch its Brexit proposal to EU leaders.

Oct 18 — **EU Council meeting**

- Negotiation deadline for the agreement on the Withdrawal Agreement and the political declaration on the framework for the future relationship.

Nov — **EU Council meeting**

- This is suggested as the latest the EU and UK should finalise a deal, according to existing EU guidance.

Dec 13 — **EU Council meeting**

- This is a further opportunity for the UK and EU to finalise a deal, before the year ends.

The type of future partnership agreement matters

- If the agreement is an association agreement, as preferred by the EU, the ratification of all the 38 regional and national parliaments is needed in addition to ratification by the EU Parliament and EU Council, as was the case with the EU-Canada Comprehensive Economic and Trade Agreement (CETA), a 'mixed agreement', which took two years to ratify.
- Other type of agreements, including some free trade agreements (FTAs), require ratification by the EU Parliament and Council only.

Article 218 of the Treaty on the Functioning of the European Union (TFEU)

- Article 218(8) states that the EU Council will need to act unanimously, instead of by qualified majority, when the agreement covers specific fields, or when the agreement is an association agreement.
- The specific fields include trade in services, intellectual property and foreign direct investment.
- Therefore, a comprehensive trade agreement including services will require ratification by all member states, including all the regional and national parliaments, implying that any EU 27 country could block the agreement.

2019

21 Jan — European Parliament consent

- Plenary sessions take place monthly, and consent in Plenary could take place in any month, as long as it takes place before the EU Council Summit on 21-22 March.
- The European Parliament needs to consent to the Withdrawal Agreement by a simple majority (including UK MEPs) majority.

Mar 21 — European Council ratification

- The latest European Council meeting that can ratify (conclude) the Withdrawal Agreement between the UK and the EU will take place on 21-22 March 2019.
- A qualified majority is needed (72%, or 20 out of 27 EU Member States).

29 — UK to leave the EU

- If the Withdrawal Agreement is concluded, the implementation period begins on 29 March 2019.
- If the Withdrawal Agreement is not concluded or Article 50 TEU is not extended, a no-deal Brexit will occur on 29 March 2019.

2020

Dec 31 — The UK's new relationship with the EU begins

- The future trade agreement should be finalised by 31 December 2020.
- As the implementation period ends on 31 December 2020, the UK's future relationship with the EU starts on 1 January 2021.

Conclusion

As negotiating deadlines pass, more pressure will be exerted on firms, as well as UK and EU authorities, to demonstrate they are taking the necessary steps to protect financial stability and integrity. Firms need to ensure they are sufficiently prepared for no deal.

Where even the best-laid plans of industry for no deal are insufficient, public solutions that emerge from the ECB and BoE technical working group and others may prove vital. However, it will be difficult to rely on these as the timing of such interventions may be last minute in order not to impact negotiations. The EU will also want to ensure they do not set up a new EU–UK market access model by default, so tools will be rigorously time limited.

For boards, the long-term focus should remain on the transformation of the global economy and the financial services industry that disruptive technology will bring. In the short term, navigating the Brexit brink will likely remain at the top of the priority list.

For boards, that means they should focus on answering the following questions:

- What impact will Brexit have on our business's future viability? Does our short-term contingency planning align with our strategy?
- Are our clients and customers aware of our plans, and are we discussing how we will continue working with them where appropriate? Have we got their feedback?
- Are we keeping our people informed and engaged about our plans, particularly if they are personally impacted by our business planning or the wider politics?
- Are we keeping abreast of the market landscape? Where do our plans scale in comparison with our competitors?
- Have we identified areas of our business that will not be prepared in time if there is no deal on 29 March 2019 and raised the issue with our supervisors?
- Have we followed all appropriate guidance from EU and UK supervisors and flagged where there might be conflicts?
- Have we considered any financial reporting implications?
- Is our clients working capital able to sustain short and long-term periods of potential political and economic uncertainty, and how might we need to support them?

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Appendix

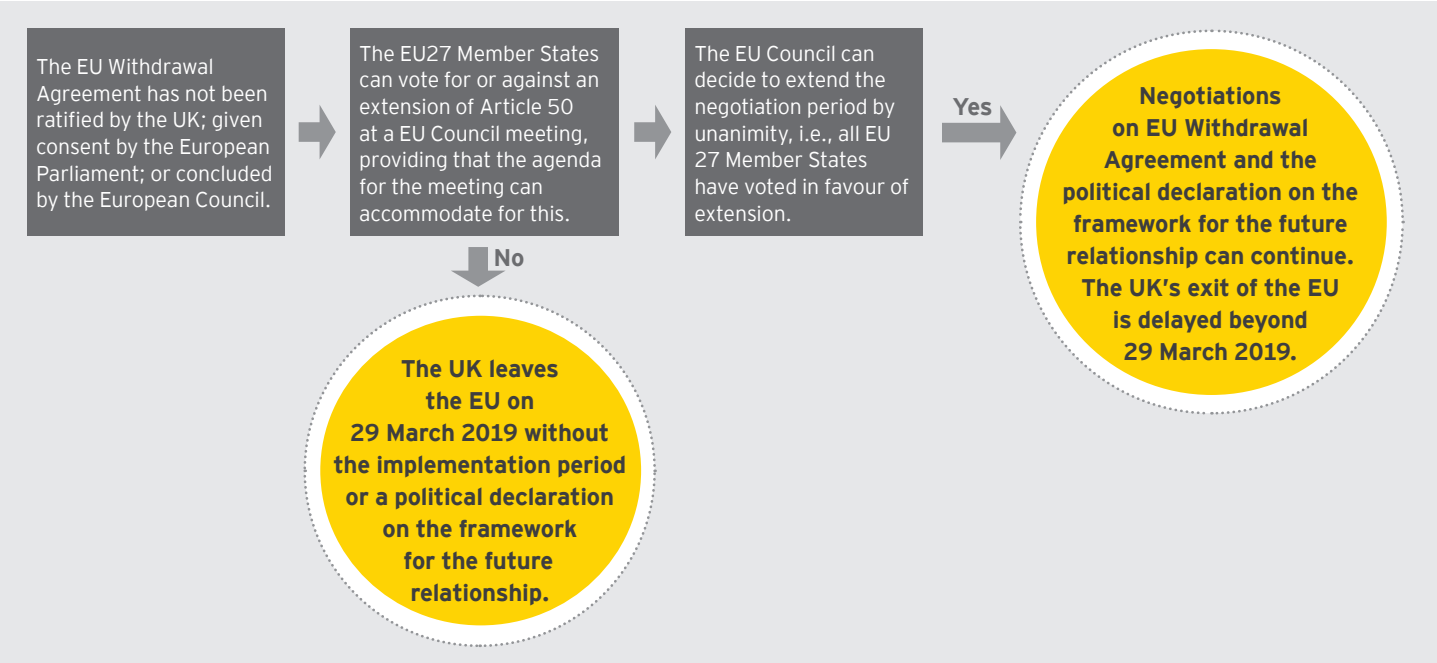
Chequers plan

Key themes and proposals	
Goods	The UK and the EU would maintain a **common rulebook** for all goods. The UK would make an upfront treaty commitment to ongoing harmonisation with EU rules, covering only those necessary to provide for frictionless trade at the border
Services	Where it is in the parties' interests to have **regulatory flexibility**, the Government would strike different arrangements for services, the **UK and the EU will not have current levels of market access to each other's markets**
People	End free movement of people and replace with a **mobility framework**
Political governance	An **association agreement** overseen by a joint institutional framework, which draws on agreements such as CETA and the EU-Ukraine Association Agreement
Irish border	The common regulatory rulebook and the **facilitated customs arrangement** would see the UK and the EU meet their commitments to Northern Ireland and Ireland

Week commencing 18 July 2018 saw several amendments to the EU Customs Bill, three relating to the Chequers plan:

Details of amendment	For amendment	Against amendment
The UK cannot **collect tariffs** on behalf of the EU, unless the rest of the EU does the same	305	302
The UK will not stay within the EU's **VAT regime**	303	300
The UK Government will negotiate to **stay in a customs union** with the EU if an agreement for a UK-EU free trade area has not been achieved by 21 January 2019	301	307

The process for extending Article 50 of the Treaty on the European Union (TEU)



Overview of WTO rules

Key WTO principles

- **Most-favoured nation:** ensures non-discrimination by requiring all countries to grant their 'most-favoured' treatment to all their trading partners.
- **National treatment:** imported and locally produced goods have to be treated equally after the foreign goods entered the market.

Trade in goods under the WTO

- Exports from the UK to the EU will be subject to the same customs checks, tariffs and regulatory barriers that the EU charges on trade with third countries with whom it does not have a free trade agreement.
- Tariffs applied in the EU depend on sectors: for instance, cars and car parts imports have a tariff of 10%, and the average tariffs on agricultural products is 11%.
- In addition to tariffs, there are other non-tariff barriers including quotas, product standards and regulations.
- UK importers would have to apply the same tariffs and other barriers to all imports.
- This could hurt British exporters, who will have to pay tariffs to the EU and other countries, and British importers, thereby increasing costs to consumers.

Trade in services under the World Trade Organization (WTO)

- The degree of liberalisation for services is generally low; negotiations have been ongoing since the Doha round in 2001.
- The EU's schedule of commitments on services contains many exceptions.
- The UK would have to create its own schedule of commitments, as it currently relies on the EU's schedule; this could take several years.

Rules of origin in the WTO

Rules of origin are an important way of determining where a product comes from and what tariffs, quotas, trade preferences, anti-dumping measures or other trade policies should be applied:

- Following Brexit, products which moved freely in the customs union may be considered imports and exports between the UK and EU.
- The country of origin of a product traded between the UK or the EU may need to be established, and this will affect how it is treated when it is traded.
- UK businesses may incur a number of administrative and compliance costs linked to proving their product's origin.

Notes

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