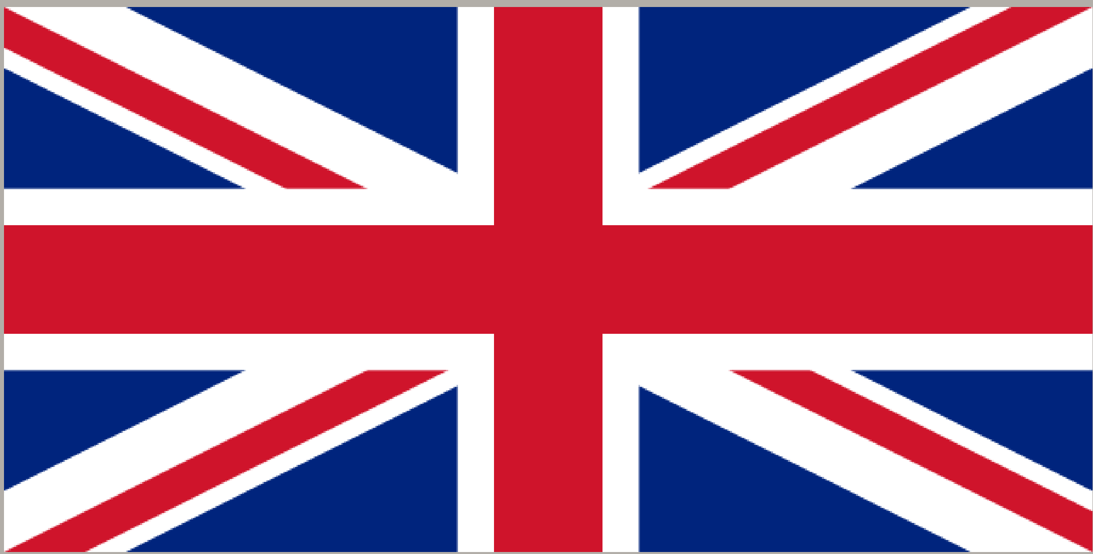
Insight

February 2016

Brexit and the impact on the UK's Regulatory Framework.

In 2018 the UK Government may have to set out its plan for Britain's exit of the European Union. This article looks at how the regulation of UK based financial institutions could be affected.



On 17th December 2015 the House of Commons voted in favour of holding a referendum on the United Kingdom's membership of the European Union by the end of 2017[1]. Opinion polls[2] show that the country is consistently near 50-50 split on a so-called 'Brexit'. Commentary shows David Cameron did not achieve agreement on many of the demands he outlined for a new British deal during talks held with Donald Tusk ahead of the EU summit on 18th and 19th February, with Paris warning that it would block any attempt to secure a backdoor veto for the City of London over new financial rules. Without getting into the positions of both sides, there is a realistic possibility that we will be facing Brexit come this summer; and if so, what would be the impact on the FS regulatory landscape in the UK?

The Current Relationship

Since the financial crisis in 2008, the UK has tightened its regulation of financial institutions in line with other EU member states, with the City becoming more integrated with the Eurozone than with any other markets[11]. European policy standards are implemented in European Union member states through either directives (which need to be adopted locally, e.g. Markets in Financial Institutions Directive II, or MiFID) or regulations (e.g. Market Abuse Regulation), which are enforceable in member states with no further intervention.

The EU Set-Up

The regulation of financial services across Europe is overseen by the European System of Financial Supervision (ESFS). This is comprised of three European Supervisory Authorities (ESAs):

- The European Banking Authority (EBA)
- The European Securities and Markets Authority (ESMA)
- The European Insurance and Occupational Pensions Authority (EIOPA)

The European Systemic Risk Board (ESRB) is an independent EU body responsible for macro-prudential oversight of the EU financial system. The European Central Bank and the authorities of the Banking Union also play a role in supervising the financial markets.

The UK Regulatory Framework

The Financial System in the United Kingdom is governed by two regulatory bodies: the Prudential Regulatory Authority and the Financial Conduct Authority.

The PRA

The PRA, governed by the Bank of England, is responsible for the regulation of banks, building societies, credit unions, insurers and major investment firms in the UK[4]. The policy framework for the PRA's supervision is to a large extent agreed internationally, both at a global level and within the European Union. Relevant EU Regulations, including binding technical standards that apply directly to UK firms, will not be reproduced in the PRA's Rulebook but will be part of the PRA's requirements of firms. Firms are also subject to guidance by the European Supervisory Authorities.

Effective international cooperation has thus far been essential to the PRA's success. The PRA attaches great importance to being an influential and persuasive participant in international policy debates, seeking to achieve agreement at the global and European level to the reforms necessary for a strong, coherent and clear prudential framework for supervision.

As a consequence of the UK's role as an international financial centre, a key responsibility of the PRA is the supervision of overseas firms operating in the UK, as well as UK groups operating abroad. To support this, the PRA maintains co-operation agreements including memoranda of understanding with overseas counterparts to enable the sharing of confidential information on cross-border firms. It participates in "supervisory colleges" for firms with significant operations in the UK, and organises and chairs the colleges for UK firms.

The PRA is involved in the ESFS and is the UK representative on the EBA and EIOPA. Part of the role of the ESAs is to improve coordination between national supervisory authorities in the EU. They have significant powers to propose draft rules and to take decisions binding on national supervisors, and to a lesser extent, firms. The PRA is involved in ESA working groups that develop rules and guidance.

The FCA

The FCA is focused on the supervision of markets, rather than the activities of individual firms, with

the aim of mitigating risk to the financial services industry[5]. In order to complete their mandate, the FCA draw on a wide range of sources to help them identify risks to the industry and the statutory objectives, including:

- Intelligence gathering while supervising firms including site visits and monitoring transactions
- Contacting consumers directly
- Monitoring markets and the economy

They then use this information to assess the level of risk and decide what we need to do to mitigate it. The authority has significant powers, including the power to regulate conduct related to the marketing of financial products. The Financial Conduct Authority (FCA) represents the UK at ESMA and the Bank of England is the voting member on the ESRB.

Alternative Regulatory Models

In order to assess the potential future regulatory framework for the UK, were it to leave the EU, examine three countries which all have differing relationships with Europe. As Britain would be the first economy to leave since the formation of the single market, it would have to debate internally which of the following might be most appropriate to follow after 2018.

Norway

Norway is not a member of the EU, but is still part of the EEA. Therefore the country has access to the European Internal Market, however it does not play a role in establishing any of the Guidelines or Directives of the ESFS. Finanstilsynet is the Norwegian government agency that builds on laws and decisions emanating from the Parliament (Stortinget), the Government and the Ministry of Finance and on international standards for financial supervision and regulation[6].

Through its supervision of enterprises and markets, Finanstilsynet strives to promote financial stability and orderly market conditions and to instil confidence that financial contracts will be honoured and services performed as intended. In addition to its preventative work, Finanstilsynet maintains a preparedness for dealing with concrete problems that may arise. Finanstilsynet's premise is that Norwegian enterprises must be afforded competitive conditions which all in all are in line with those enjoyed by institutions in other EEA member states. Moreover, in order to gain access to the EEA, non-EU countries must abide by all financial regulations laid out in the ESFS. Therefore, unless the UK were able to negotiate a new type of trade agreement, it would still be subject to all of the existing rules.

Switzerland

Switzerland is neither a member of the EU or the EEA, and instead maintains relationships with the EU nations through bilateral agreements. FINMA is Switzerland's independent financial-markets regulator[7]. Its mandate is to supervise banks, insurance companies, exchanges, securities dealers, collective investment schemes, and their asset managers and fund management companies. It also regulates distributors and insurance intermediaries. It is charged with protecting creditors, investors and policyholders. FINMA is responsible for ensuring that Switzerland's financial markets function effectively.

Ultimately, FINMA fosters national cooperation and, on the international stage, it represents Switzerland, its principle-based regulatory approach and the financial sector in competent specialist committees. It also responds to requests for assistance from foreign supervisory authorities.

FINMA organises a supervisory college for various groups based in Switzerland and participates in colleges run by foreign supervisory authorities, provided these foreign groups engage in supervisory activities in Switzerland. Playing an active role in international standard-setting bodies enables FINMA to influence the international regulatory framework and represent Switzerland's supervisory interests.

United States of America

In comparison to other major financial centres, banking regulation in the United States is highly fragmented, with banks being regulated at both federal and state level. Banks operating in the US could be regulated by the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency and the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC).

The Office of the Comptroller of the Currency is the primary regulator of banks in America, as an independent bureau of the U.S. Department of the Treasury[8]. A primary role of the OCC it to issue rules and regulations, legal interpretations, and corporate decisions governing investments, lending, and other practices. It is also authorised to take supervisory actions against national banks and federal thrifts that do not comply with laws and regulations or that otherwise engage in unsound practices. Furthermore, it has the power to remove officers and directors, negotiate agreements to change banking practices, and issue cease and desist orders as well as civil money penalties.

Part of the OCC is the International Bank Supervision (IBS), which resides within Large Bank Supervision (LBS). IBS conducts the Federal Branches and Agencies supervision program and coordinates the OCC's international work in line with the agency's primary bank supervisory goals. IBS also supports LBS in its supervision of the international activities of its globally active banks, including through its London office, where a team of examiners is deployed to enhance OCC's oversight of the US banks' London operations.

The IBS serves as the primary point of contact for international banking supervisors, and as a clearinghouse for various requests the agency receives, such as for supervisory information, bilateral meetings, and participation in international working groups. The mission of the IBS includes a strong focus on working with foreign supervisors through various means such as information exchange and technical assistance.

In addition, the OCC's core supervisory work has an expanding international emphasis, requiring increasing interaction with foreign supervisors. This interaction includes regular sharing of information regarding the risks faced by OCC supervised institutions. The OCC has established productive ongoing working relationships with a number of key foreign counterparts. A further important vehicle utilised by OCC to facilitate communication with foreign colleagues is the supervisory college, which affords its members the opportunity to confer regularly on supervisory matters of significance to the group as a whole. The OCC, together with the Federal Reserve Board, co-chairs supervisory colleges for Bank of America, Citigroup, JPMorganChase, and Morgan Stanley and participates in a number of other supervisory colleges as a host supervisor.

The Federal Reserve System is responsible for supervising and regulating banks and other important financial institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers.

The SEC's mission is to protect investors and maintain fair, orderly, and efficient markets. The SEC establishes and maintains a regulatory environment that promotes disclosure, financial reporting, and governance, and that prevents abusive practices by registrants, financial intermediaries, and other market participants. It highlights in its strategic plan[12] that coordinating efforts with other regulators and enforcement authorities plays a vital role in maintaining economic stability.

The CTFC is to foster transparent, competitive, and financially sound markets, to avoid systemic risk and to protect the market participants from fraud, manipulation, and abusive practices. Their Regulatory Working Group[13] provides guidelines ensuring international regulatory cooperation activities that are reasonably anticipated to lead to significant regulatory actions, significant and cross-cutting international regulatory cooperation activities, and the promotion of good regulatory practices.

Following the US model might be attractive for critics of the EU who wish to distance the UK from the single market, and allow for more flexibility in the UK's regulatory approach. However Britain's financial system is far less complex that that of America, with firms operating under unified legal system, so the UK is unlikely to require multiple regulatory bodies.

International Regulatory Organisations

In addition to the national regulatory bodies, there are several international organisations, which seek to monitor the health of the global banking system. As a major financial centre, the UK would still qualify for membership of these organisations were it to the leave the EU.

The Financial Stability Board

The Financial Stability Board coordinates the ongoing development and promotion of measures to enhance stability between sector-specific standard-setting bodies. It helps national authorities to implement effective regulatory and supervisory measures and also acts as the interface between sector-specific standard-setting bodies and the G20. The FSB is run by The Plenary, of which Mark Carney, Governor of the Bank of England, acts as Chair.

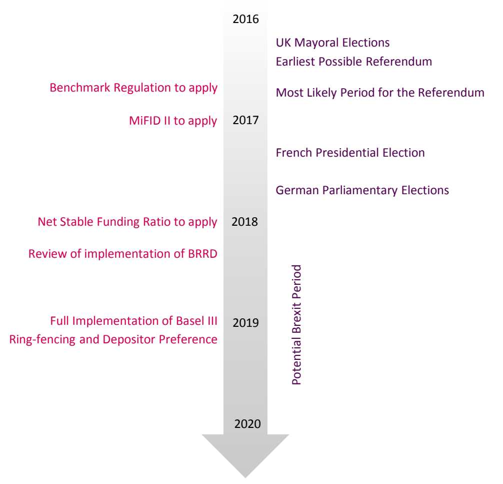
BCBS

The Basel Committee on Banking Supervision (BCBS) aims to enhance the security and reliability of the international banking system. Its main tasks include fostering exchanges of information and cooperation between supervisory authorities, as well as issuing minimum standards and guidelines. The UK has been a member of the BCBS since it was established, in 1974.

IOSCO

The principal aims of the International Organisation of Securities Commissions are to protect investors, ensure fair, efficient and transparent markets, prevent systemic risk, promote international cooperation, and define uniform standards for stock market and securities admission. FINMA is a long-standing member of this organisation and the United Kingdom is represented on the board. This sets the regulatory

UPCOMING POLITICAL AND REGULATORY MILESTONES



Source: Sia Partners

standards and governs the organisation.

FATF

The Financial Action Task Force on Money Laundering (FATF) is an international, intergovernmental organisation. It was established by the G8 and is comprised of 36 members, of which 34 are member jurisdictions and two are regional organisations (EU Commission and the Gulf Cooperation Council).

The FATF's main objective is to set international standards for combating money laundering and terrorist financing. It also ensures that standards have been implemented effectively via legal, regulatory and operational measures as part of mutual country evaluations. Moreover, the FATF draws up guidelines on implementing standards, compiles best practice documents and issues typology reports on money laundering.

Supervisory Colleges

Supervisory colleges offer a permanent platform for cooperation between various authorities which supervise a financial group or conglomerate. The aim of this regular exchange of information and experience is to step up cooperation between supervisory authorities and improve supervision of internationally active groups and conglomerates. Colleges often prompt the conclusion of agreements between the participating authorities.

As a supervisory college has no legal personality it cannot take any decisions. Cooperation within the college must always take into account the applicable local legal systems of the participating authorities. International standards do not have direct legal force, but complying with them and/or transposing them into national law can be crucial for a financial centre's reputation. Furthermore, compliance with international standards is often a minimum requirement for maintaining access to foreign markets.

The Timeline

The UK Government has already ruled out holding the referendum to coincide with the Mayoral Elections[3] on 5th May 2016, so the earliest possible date the In/Out Vote could be held is June 2016. If a country wishes to leave the EU, it has to notify the European Council of its intentions two years before leaving, meaning that the earliest date the UK would be independent from the EU would be June 2018.

At the time of writing, the remaining EU directives due to come into force impacting UK Investment Banks after this date are:

- Full implementation of Basel III requirements (1st January 2019)

- The deadline for key provisions of the Financial Services (Banking Reform Act) 2013, including ring-fencing and depositor preference (1st January 2019)
- Regulation on improving securities settlement in the EU and on central securities depositories (CSD Regulation) (1st January 2023)

In addition to these reporting deadlines, there is the implementation of the Markets in Financial Instruments Directive (MiFID II). The current timelines require banks to have achieved full implementation by January 2017, however this is likely to be pushed until January 2018 or even later that year. As a member leaving the European Union is unprecedented, it is unclear whether an economy would have to become compliant with a directive if it had already expressed its intent to leave.

The latest date the UK could leave the EU under the current legislation is December 2019 which would mean all but improvements to securities settlements would have come into force. Therefore, the referendum should not significantly impact the planning of UK based financial institutions prior to the exit date.

Consequences of a Brexit

On the 10th January 2016 David Cameron announced the UK Government does not, at present, have a plan for how it would manage the UK leaving the EU. However, it is unlikely that the mandate of the UK's regulatory bodies would change, at least in the interim transitionary period. It is also improbable that the UK would increase complexity by moving towards a US model.

There is an argument to say that the UK might have to reduce the regulatory burden it places on banks in order to persuade them to remain in the UK, rather than moving certain or entire operations to a similar country within the EU, such as Ireland. This could include making some of the regulations optional, increasing the implementation deadlines, or reducing the capital requirements. This would mean that organisations with banking activities in the UK would be subject to an additional regulatory framework, meaning further regulatory reporting projects would have to be initiated to ensure compliance. Banks would then have to compare the business case for remaining in the UK, with the additional costs of monitoring the requirements of a diverging regulatory body, compared to restructuring their operations.

Following a Brexit, the UK would then have to renegotiate its relationship with Europe. For comparisons of what structure a new contract would entail, it is possible to look at the example of the Transatlantic Trade and Investment Partnership (TTIP), which the EU is currently negotiating with the US. This shows that if non-EU countries are to archive trade deal agreements, they must comply with the same rules as member countries[10]. Therefore, it is very likely that is the UK wishes to maintain a formal trading relationship with Europe, this will not coincide with a lesser regulation of financial institutions. In conjunction to this, President Francis Holland[9] of France has stated his own strong opposition to any separation of the UK's regulatory framework to that of continental Europe. Any disruption to the Anglo-French relationship could cause difficulties during any future negotiation, making the terms of trade less favourable for Britain in the future.

Furthermore, due to Alternative Investment Fund Managers Directive (AIFMD), the UK would not gain additional control of its hedge and private equity funds if they still wished to operate across Europe. AIFMD requires these institutions to comply with capital requirements, pay guidelines, and other rules if they market funds in the EU[11]. As Europe is the largest trading partner of the UK, this would leave Britain in a similar position as Switzerland who constantly have to update their internal regulations to ensure they are compliant with those in EU nations.

The only certain change to the remit of the PRA and the FCA is if Scotland were to leave the UK, following an 'Out' result. This would leave the Bank of England no option but to rethink the structure of the UK's regulatory authorities.

Conclusion

The regulatory framework and the international outlook of EU and non-EU financial centres are largely similar, and have expressed intent for closer regulatory integration. If the UK were to leave the EU, but remain part of the European Economic Area, it would not be subject to directives from the European System of Financial Supervision (ESFS); however, as the Norwegian case shows it is vital for all major economies to remain competitive in order to attract banking institutions and act in a bilateral manner. If the UK were to distance its regulatory policy from other European nations it would become a less attractive market, adding another layer of complexity to banks already struggling with the current volume of regulations.

Following a 'Brexit' it is likely that politicians will focus on a course of stability as they attempt to ensure Britain remains an attractive financial market. Therefore, for at least the foreseeable future, the UK's Regulatory Framework will most likely remain unchanged.

Sources

[1]http://services.parliament.uk/bills/2015-16/europeanunionreferendum.html

[2]http://whatukthinks.org/eu/opinion-polls/poll-of-polls/[3]http://www.bbc.co.uk/news/uk-politics-33141819

[4]http://www.bankofengland.co.uk/pra/Pages/policy/default.aspx

[5]http://www.fca.org.uk/about/what/regulating

[6]http://www.finanstilsynet.no/en/Secondary-menu/About-Finanstilsynet/

[7]https://www.finma.ch/en/finma/finma-an-overview/

[8]http://www.occ.gov/topics/international-banking/international-banking-supervision/index-international-banking-supervision.html

[9]http://www.ft.com/cms/s/0/05e96a10-c846-11e5-be0b-b7ece4e953a0.html#axzz3yvsXLKfC

[10]http://www.telegraph.co.uk/finance/economics/12138611/Brexit-would-not-lead-to-golden-world-of-deregulation-says-Bank-deputy.html

[11]http://www.cer.org.uk/sites/default/files/publications/attachments/pdf/2014/pb_city_brexit_js_pw_8may14-8816.pdf

[12] http://www.sec.gov/about/secstratplan1015f.pdf

[13]https://www.whitehouse.gov/sites/default/files/omb/inforeg/eo_13609/eo13609-working-group-guidelines.pdf

YOUR CONTACTS

CHESCA VEAL

Consultant – CIB & Regulartory
+ 44 7825 083 266
chesca.veal@sia-partners.com

ABOUT SIA PARTNERS

Founded in 1999, Sia Partners is an independent global management consulting firm with over 600 consultants and an annual turnover of USD 120 million. The Group has 16 offices in 13 countries, including the U.S., its second biggest market. Sia Partners is renowned for its sharp expertise in the Energy, Banking, Insurance, Telecoms and Transportation sectors.

For more information visit : www.sia-partners.com . Follow us on Twitter @SiaPartners

Asia

Hong Kong
701, 77 Wing Lok St,
Sheung Wan, HK
T.+852 3975 5611

Singapore
3 Pickering street
#02-38
048660 Singapore
T.+ 65 6635 3433

Tokyo
Level 20 Marunouchi
Trust Tower-Main
1-8-3 Marunouchi,
Chiyoda-ku
Tokyo 100-0005
Japan

Europe

Amsterdam
Barbara Strozzilaan
101
1083 HN Amsterdam
- Netherlands
T. +31 20 240 22 05

Brussels
Av Henri Jasparlaan,
128
1060 Brussels -
Belgium
+32 2 213 82 85

London
Princess House,
4th Floor, 27 Bush
Lane,
London, EC4R 0AA –
United Kingdom
T. +44 20 7933 9333

Lyon
Tour Oxygène,
10-12 bd Vivier
Merle
69003 Lyon - France

Milan
Via Medici 15
20123 Milano - Italy
T. +39 02 89 09 39
45

Paris
18 bd Montmartre
75009 Paris - France
T.+33 1 42 77 76 17

Rome
Via Quattro Fontane
116
00184 Roma - Italy
T. +39 06 48 28 506

Middle East & Africa

Dubai, Riyadh, Abu Dhabi
PO Box 502665
Shatha Tower office
2115
Dubai Media City
Dubai, U.A.E.
T. +971 4 443 1613

Casablanca
14, avenue Mers
Sultan
20500 Casablanca -
Morocco
T. +212 522 49 24 80

North America

New York
115 Broadway, 12th
Floor
New York, NY10006 -
USA
T. +1 646 496 0160

Montréal
600 de Maisonneuve
Boulevard West,
Suite 2200
Montreal, QC H3A
3J2 - Canada