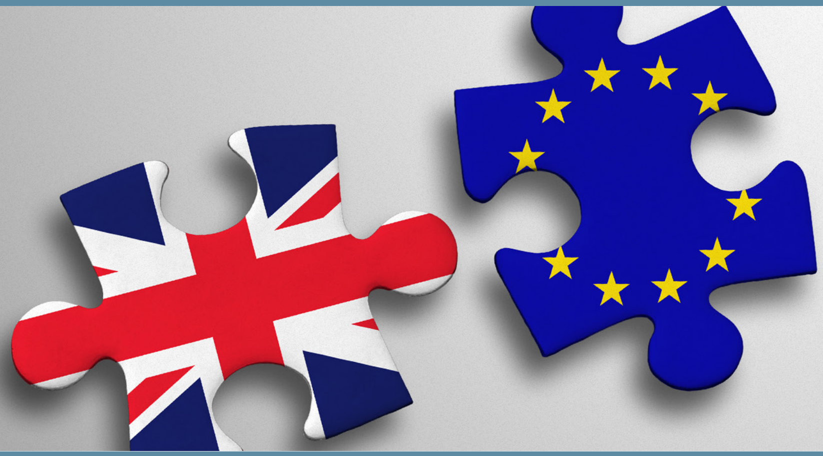

Executive Insights

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Red Lines and Red Rags: Why UK-based International Financial Services Firms Are Planning for the Worst, but Still Hoping for the Best

Immediately following the result of the Brexit referendum, the most common initial reaction of the financial services community in the UK was a combination of shock at the result, and hope for a minimally disruptive outcome for the industry. The optimistic part of this reaction was founded upon the (asserted) irrationality of a hard exit, from the economic perspective of the financial services industry.

Nearly a year on, and now that the negotiation period has started (albeit only very recently in earnest), the mood is less optimistic, principally following political developments. The recent manifestos of both major parties explicitly indicate an exit from the Single Market. Exiting the Customs Union is an explicit aim of the Conservatives' manifesto, and not specifically addressed by Labour's. And the Conservative Party's mantra "no deal is better than a bad deal" has raised the very real risk of the collapse of negotiations and, in consequence, reversion to WTO rules and discontinuation of current passporting arrangements. The current political uncertainty following the General Election could moderate these positions, but whether this happens remains unclear, and may remain so for some time.

But how likely is a disordered UK crash out of the EU? The UK's financial services businesses quite naturally should and do seek certainty. What could be the consequences of these potential outcomes for the UK's financial services businesses? How are they and how should they be responding to this possibility, both now and as the negotiations proceed, especially given their need and responsibility to minimise risk?

Content and conduct of the negotiations: red lines and red rags

Theresa May's red lines are clearly articulated in the recent manifesto, the most important of which are control of the UK's borders / immigration, and ending the supranational jurisdiction of the ECJ over the UK. These may or may not be moderated by current political uncertainty.

From the EU side, the key issues appear to be firstly what to do about the UK's significant contribution to the EU budget and the associated "divorce bill", and secondly how to secure the rights of EU citizens in the UK.

- The first of these issues has the potential to become a red rag for both sides and has already been the topic of heated public statements. An economically rational case can be put forward for a wide range of values, but the outcome must be politically acceptable to both parties.

Red Lines and Red Rags: Why UK-based International Financial Services Firms Are Planning for the Worst, but Still Hoping for the Best was written by **Peter Ward**, a Partner in L.E.K. Consulting's Financial Services practice. Peter is based in London.

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- On the second issue, the current "mood music" from both sides is positive, but who would arbitrate adherence to the guaranteed rights of EU citizens in the UK, a responsibility currently undertaken by the ECJ, is already proving to be a vexed question.

The political obstacles to negotiation are therefore substantial, and the inevitable economic and political changes that will happen during the period of negotiation, some of which will likely be surprises, also carry risk of disrupting the process.

It is common ground between the two parties that "nothing is agreed until everything is agreed", meaning that little genuine clarity will emerge until the end of the negotiating period. This presents an undesirable period of uncertainty for all parties involved, and for UK-based financial services firms in particular.

The will to succeed: the role of economic self-interest and rationality

However, public statements from both the EU and the UK indicate a strong will at least to attempt to reach a deal, and it would be wrong simply to assume that negotiations will fail. There is a strong long-term economic rationale for constructive co-operation. Within this, financial services is a major industry making very significant contributions to employment, economic output and taxation, and also attracts substantial overseas investment into the UK.

Nonetheless, in overall terms, the UK financial services industry is a small part of the economy. And on close examination, the generally tough question of how to define economic rationality itself is especially difficult in this instance because:

- One "party" to the negotiation is comprised of 27 separate states, each with its own levels of economic development and prosperity, balance of economic activity and relative strength in trade. As a result, "economically rational" from the perspective of the EU taken as a whole is hard to define in a meaningful way; and
- The timescales over which such rationality might be measured are unclear: businesses views on the right answer to this question are likely to differ from those of the politicians and negotiators involved.

Consequently, the likelihood that economic rationality from the perspective of the financial services industry will form the principal or even a substantial part of the objectives of negotiations is remote. This is true even on the UK side, where the industry is relatively more important.

How to operate in the Single Market from the outside: prospects for passporting and equivalence

What can internationally-operating UK-based financial services firms do to preserve access to their European markets? And, more specifically, are either passporting or equivalence likely to represent viable options to underpin this? In our recent experience, financial services firms are increasingly saying that they cannot rely on the prospects of either continued passporting or continued equivalence: why is this?

The essence of passporting is mutual market access, with the central idea being that the different markets within the passporting arrangement have "very similar" rules, albeit not necessarily the same "rule book", as such. It is interesting to note that more firms have passports into the UK from Europe than have passports out of the UK into Europe. This is therefore a mutual interest issue with a rationale for resolution from both sides of the negotiating table.

However, passporting only applies within the EEA. It has not, so far, been extended beyond this. As such, given that Theresa May's red lines would exclude the possibility of EEA membership, maintaining passporting for the UK would require huge goodwill, which, in turn, would require the success of the political process of negotiation on this specific issue. In the current political context, it is far from a safe assumption that this will succeed.

As a further alternative, the concept of equivalence is used to extend this sometimes beyond the EU/EEA. Whether another jurisdiction is considered to be equivalent to the EU is again judged (by the EU) according to whether the relevant jurisdictions have very similar rules, based on an assessment of outcomes in that jurisdiction, rather than having the same "rulebook": differing legal systems mean that the same words won't necessarily achieve the same result.

On "Day 1", UK regulation and rules will, by definition, be the same as the EU. Equivalence, therefore, ought logically to be achievable at that date. However, equivalence can be revoked within 30 days under current EU legislation, which is no basis for long-term business planning. Neither does equivalence currently include, for example, primary insurance or commercial banking, so this is far from a complete or robust solution, even if viable.

At the point of the UK's exit:

- It would be up to the EU to decide when / if equivalence has ceased and what the consequences would be in terms of continued market access, where this exists; and

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- Equivalence to the EU may not be desirable or even feasible for the UK, especially if "local" EU interests contradict the requirements resulting from the UK's current and desired future more global role in the world's financial ecosystem.

Relying on passporting or equivalence arrangements for continued access to EU / EEA markets therefore requires confidence that current arrangements will be extended beyond their existing scope, and that such extension will continue indefinitely. It also requires tolerance of the possibility, at least in theory, that the EU could decide to terminate the arrangements at short notice. The UK has an exceptional position with respect to the EU, which could and perhaps should result in exceptional arrangements. However at the very least the range of potential outcomes is wide.

It is also essential to note that upon leaving the EU, the UK will vacate its position of substantial influence in EU financial services regulation: given the strength, size and sophistication of the UK industry, it has historically played a major part in this area. Absent this influence, the EU may ignore UK-specific preferences, resulting in diverging interests and changes to the rules, albeit likely incrementally, certainly at first.

Unintended consequences: the certain impact of uncertainty

Given the risks and uncertainty discussed above, and the fact that it can take18 months to establish an EU branch, businesses cannot wait until the end of the negotiating period to decide whether to do so, especially if long-term contracts are in place. It is therefore no surprise that some are establishing EU subsidiaries and licences now. Lloyd's of London, RSA, QBE and CNA Hardy are just four examples of companies that have made public announcements of this nature. Similarly in banking, Deutsche Bank, Goldman Sachs, UBS and JPMorgan are amongst an increasing number of institutions to announce that they will definitely move jobs out of London to the EU imminently, rather than waiting for the outcome of negotiations.

Within this trend, various approaches are being taken. Initially operations were being set up on an "absolute need" basis, i.e., moving the minimum viable amount of resources and activity to the EU, principally regulatory capital and local staff to deal with the regulator. However, it is commercially illogical to have physical separation of these things from the actual business activity that they are undertaking, so commercial activity is already moving, and will continue to move, to the EU.

Some firms are simply moving head offices and substantial operations now, while others are taking a more incremental approach - Lloyd's of London, for example, has been clear that a continued arrangement for direct access to EU markets is still "Plan A" - but we are already far away from "absolute need" as the baseline.

The ultimate degree of this movement is uncertain. However, given the operational nightmare of a sudden choking-off of access, risk-conscious UK-based financial firms with European operations have no choice but to plan for the worst (but also hope for the best), while there is still time to do so in a smooth and orderly fashion.

Consequently, even in the most positive outcome in which a deal is reached making EU branches / subsidiaries unnecessary, the de facto reality is that significant business is already and irreversibly "leaving the building", causing a definite drain out of the UK / London.

Empty threats: why the end isn't nigh

However, it is also clear that suggestions that the City of London could cease to be a major financial centre are greatly exaggerated. The key factor is that it simply isn't possible for the EU to force the City's activity into Europe. For example, a significant volume of Euro clearing happens in New York now, which is obviously very far from being part of the EU. In consequence, forcing activity out of the City carries the risk of forcing it entirely out of the EU, which does not contain a world-class financial centre except London. This would be worse for both the UK and the EU and is therefore a remote possibility as a policy aim for the EU, let alone the UK.

Equally, a "race to the bottom" on regulation by the UK towards very lightly regulated "tax haven" status seems extremely unlikely: the UK is a major global financial centre in significant part because of its world-class regulatory regime. Moving to the complete opposite would therefore cause certain substantial damage with uncertain upside. In this regard, which is solely within the UK's control, rationality is highly likely to prevail.

Brexit has wounded the City of London, giving businesses no choice but to move some operations to a new EU base. But negotiations have a long way to run and the UK remains a large market with unrivalled expertise and respect as a financial centre, a fact that will not be lost on other EU members. The smart money will plan for the worst, but keep its options as open as possible.

About the Author:

Peter Ward is a Partner in L.E.K.'s London office. Having joined L.E.K. in 2000, his primary focus has been corporate strategy development, complemented by substantial experience in buy and sell side commercial due diligence, commercial bid support and litigation support. He also has significant expertise in performance measurement and incentive structures, both within organizations and across contractual boundaries. Peter has deep sector expertise in regulated industries, principally financial services, including advice on regulatory submissions.

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