What might Brexit mean for financial services?

On 29 March 2017 the UK’s Article 50 Notice was delivered to the European Council in Brussels, triggering the formal process for the UK’s exit from the EU.

Immediately following delivery of the notice, the UK Government's Department for Exiting the European Union issued a White Paper on the Great Repeal Bill (entitled “Legislating for the UK’s withdrawal from the European Union”). The paper focuses on the legal changes that will result from the UK’s exit from the EU. The Government's aim is one of stability: to ensure that “the same rules and laws will apply on the day after exit as the day before”.

The intention is that the Great Repeal Bill will repeal the European Communities Act 1972 (giving effect in UK law to the UK’s exit from the EU), while at the same time ensuring that the body of EU law (known as the “acquis”) as it exists at the time of Brexit is preserved in domestic UK law. Pre-Brexit EU law would therefore continue to apply unless and until such time as the UK Parliament (or, where appropriate, the devolved legislatures) decided to make any amendments. This has a number of advantages in the financial services context, not least the ability to demonstrate that post-Brexit UK law provides for equivalence with EU law, with corresponding benefits for third party or other equivalence tests which might apply to the provision of financial services across Europe.

The UK’s Article 50 Notice stated that negotiations around Brexit and the UK’s continuing relationship with Europe should be run in tandem, but the EU looks likely to prefer a phased approach that deals with the immediate terms of exit first. Politicking aside, it is hard to see how one can be agreed without a clear view of what the other will look like, at least in principle. The future UK-EU relationship is an issue of particular importance for the UK financial services industry, which has national importance in itself - as at March 2016, nearly 2.2 million people in the UK worked in financial and related professional services, with two-thirds being employed outside London. Financial and related professional services contributed £190 billion to the UK economy in 2014, representing 11.8% of UK economic output (The City UK ‘Key facts about UK Financial and Related Professional Services’ March 2016).

We have set out below some of the key considerations for market participants in the financial services industry, including finance providers and borrowers.

The Financial Services Regulatory Regime

The Prime Minister made it clear in her Lancaster House Brexit speech on 17 January 2017, which set out the UK’s 12 key objectives and ambitions for the Brexit negotiations, that the UK does not intend to remain part of the Single Market. Instead the UK will seek the greatest possible access to the Single Market through a “bold and ambitious”, fully reciprocal, comprehensive free trade agreement. Such an agreement could take in elements of the current Single Market regime, including the freedom to provide financial services across national borders (known as “passporting”).

The potential impact of Brexit on the UK financial services sector could be significant. Much will depend on whether the UK Government can negotiate a bespoke free trade agreement that allows the provision of services, ideally encompassing the equivalent of reciprocal passporting rights for UK and European businesses.

Passporting, third country regimes and equivalence

EU legislation has driven much of the UK’s financial services legislation in recent years. The advent of the European Single Rulebook has resulted in the harmonisation of financial services legislation across EU Member States and a unified regulatory framework for the EU financial sector through directly applicable EU legislation.

The Great Repeal Bill will transpose EU law into domestic law. Assuming that the UK Government will seek to maintain the UK’s competitive position in the financial services sector, and to reduce both uncertainty for businesses operating in the sector and the costs associated with the implementation of new operating and regulatory procedures, it seems likely that many aspects of the existing EU financial services regime will be retained post-Brexit, at least in the short-to-medium-term.
However, unless the UK and EU agree alternative arrangements as part of a comprehensive free trade agreement, the UK’s exit from the Single Market will result in the loss of the passporting rights that allow UK-authorised firms to provide certain financial services in European Economic Area (EEA) countries without having to obtain a separate licence in any of those countries. In such a scenario, Brexit would result in the UK acquiring “third country” status. Some EU financial services legislation affords third countries limited access rights where the country’s regulatory regime is considered “equivalent” to the EU, and this could help mitigate the effects of any loss of passporting.

Third country rights are not, however, a reliable substitute for all passporting rights. Not all financial services (including core banking services such as deposit taking, lending and payments) are covered by the third country equivalence regime. Where the regime does apply the European Commission is not obliged to grant a determination of equivalence, and such determinations can take years or ultimately be refused on political grounds. However, if no agreement can be reached on continued passporting, the UK will hope to get the EU to at least agree that a determination of equivalence can take effect upon Brexit. The requirement to maintain an equivalent regulatory regime would mean the UK having to follow changes in EU rules. While this would be inconsistent with the aim of taking back control of legislative and regulatory functions, the UK Government has recognised that the UK may have to accept EU rules in areas where continued equivalence is necessary or desirable.

**What are the alternatives?**

Should the UK Government fail to achieve a free trade agreement affording the desired level of access to the Single Market, UK firms that currently rely on passporting to provide financial services in the EEA may need either to establish a branch in a remaining EEA State and apply to the local regulator for authorisation, or establish a subsidiary in an EEA State, which would then be eligible to apply for full passporting rights. Establishing a subsidiary could have capital implications for banks and certain other financial institutions, and may mean certain business operations transferring out of the UK.

For those EEA firms which operate in the UK via passporting rights, new authorisations may be required from the Financial Conduct Authority and the Prudential Regulation Authority.

**Brexit bites: the impact on loan documentation**

Businesses that are based in, trading with, or investing in the UK have been questioning the implications of Brexit on both existing and impending financings. From a documentation perspective, there are a number of key points for borrowers and lenders to consider when analysing and drafting loan documents:

**Choice of law and enforcement**

Courts in the UK are required to give effect to the parties’ choice of law under the Rome I and Rome II EU Regulations (the ‘Rome Regulations’). There may well be a willingness to agree that the Rome Regulations should continue to apply to the UK post-Brexit, but European courts do in any event tend to recognise parties’ express agreements on choice of law, regardless of whether it is the law of an EU Member State. Scots law is likely to remain a popular choice of law and, while automatic mutual recognition may not continue between UK and EU courts (as the basis for mutual recognition derives from the Rome Regulations), reciprocal recognition may well continue albeit in a different, and perhaps more inconsistent, form.
Illegality
Creditors may wish to include contractual provisions providing greater flexibility to lend in certain jurisdictions. Illegality provisions in documents may enable creditors to demand repayment if it becomes illegal or unlawful for them to maintain their participation in a loan (for example, if a UK Bank could no longer lend in a Member State due to a loss of passporting rights).

Increased costs
Typical increased costs clauses often contain drafting derived from EU legislation such as Basel III and CRD IV (being the reforms to the international prudential framework for capital requirements, and associated implementing agreements or legislation). As a high level of analysis has been carried out in terms of banks’ understanding of how such provisions are applied, it is anticipated that such rules would continue to apply in the UK, but their application may differ from that adopted by the EU over time. As such, there may be greater focus on how increased costs clauses are drafted.

Article 55 of the Bank Recovery and Resolution Directive (BRRD)
The main aim of Article 55 of the BRRD is to equip EU national authorities with powers to tackle crises at banks as quickly as possible by including contractual terms in certain agreements obliging counterparties to recognise certain write down or recovery powers available to national regulators in EU Member States. If the UK does not remain within the EEA post-Brexit, EEA financial institutions would have to include specific contractual “bail-in” clauses in documents governed by Scots (or English or Northern Irish) law in order to comply with Article 55.

Material adverse effect
Material adverse effect clauses generally empower creditors to terminate lending arrangements due to the occurrence of an event or change which could have a negative impact on the borrower or the borrowing arrangements. Whether Brexit constitutes a material adverse effect will depend on the drafting of the documents, and will be considered on a case-by-case basis. However, it seems unlikely that Brexit in itself will trigger a MAE event of default under standard provisions of a loan agreement based on the Loan Market Association form. MAE provisions are very much a last resort provision for funders and are seldom (if ever) invoked, but Brexit may test that approach depending upon the longer term economic impact of any trade deal.

Withholding tax
Gross-up baskets may be relevant as, although allocation of risk tends to rest with the borrower, both parties will want as little cash leakage as possible. Borrowers should consider the make-up of lending syndicates to see whether withholding tax issues might arise following Brexit. The rules are based more on treaties than on EU membership, although there may be a re-writing of some of the arrangements as a result of Brexit.

Financial collateral
The European directive relating to financial collateral arrangements was implemented in the UK by the Financial Collateral Arrangements (No. 2) Regulations 2003. The Great Repeal Bill should therefore ensure that these Regulations continue to be in force following Brexit. Going forward, it will be for the UK Parliament to decide whether the legislation should be kept in its current form, or whether it is repealed or reformed. Given the importance of the legislation to the UK markets, however, in the absence of agreement it is anticipated that any change would be preceded by holding measures to ensure consistency in the interim.
Market impact: focus on infrastructure finance

As set out above, while it does appear that loan documentation is unlikely to require major changes in the run up to and post Brexit, the wider market impact must also be considered. Taking the example of the infrastructure sector, one potential consequence is that European Investment Bank (EIB) funding will be lost. Over the past five years, the EIB has accounted for 19.5% of all debt raised for UK infrastructure projects – however, its rationale is mainly to invest in improving infrastructure in Member States, related European Free Trade Association States and potential accession States, so alternative sources of investment may need to be found in the UK. Additional funding costs may arise as a result, as the EIB has provided funding at a relatively low cost.

One new source of funding may come from the UK Government, which will no longer have to finance its 16% shareholding in the EIB. In Scotland in particular, the Scottish Government now has enhanced borrowing powers that can be used to raise funds for investment in new Scottish projects. Innovative funding solutions are also being examined to minimise the impact of Brexit, such as utilising the capital markets to fund projects, as took place on the recent £370 million bond issue by Aberdeen City Council (on which Brodies acted for the Council). In the infrastructure sphere this type of financing may be particularly suitable, due to its long term nature and the flexibility of interest and capital payment terms.

Restructurings/insolvency

The current insolvency and administration rules for corporates are set out in UK legislation. However, the application of those rules to entities registered across Europe and the recognition of proceedings raised in EU Member States are subject to the EU Insolvency Regulation. Whether a particular enforcement procedure is available in respect of an entity, or proceedings will be recognised by other EU Member States, is currently down to the location of the entity’s centre of main interests (COMI). Accordingly, an EU corporate registered outside the UK may be subject to insolvency or administration proceedings in the UK if its COMI is in the UK. Similarly, a UK corporate may be subject to proceedings in another EU Member State if its COMI is in that state.

If the EU Insolvency Regulation were to be incorporated into UK law by the Great Repeal Bill, the current rules would continue to apply in the UK after Brexit. However, while the Great Repeal Bill could require UK courts to recognise EU Member State proceedings in respect of an entity that has its COMI in that Member State, it cannot unilaterally require other Member States to reciprocate. With that and similar issues in mind, the Government’s White Paper on the Great Repeal Bill notes that there may be little point preserving EU laws that are based on reciprocity between Member States unless there is agreement on that reciprocity continuing post-Brexit.

To maintain the full benefits of the EU Insolvency Regulation the UK and EU will have to agree that reciprocity will be preserved between the UK and the other Member States. Otherwise, UK insolvency law permits the winding up of entities whether registered in the UK or not, provided the relevant UK court has jurisdiction. Accordingly, there is a default position under UK law that would allow proceedings to be raised in the UK to deal with UK assets. Similarly, the UK administration regime is currently available in respect of UK entities, EEA State entities and companies not incorporated in an EEA State but having their COMI in a Member State (other than Denmark). This position would continue unless amended post-Brexit.

However, UK insolvency procedures would not benefit from automatic recognition under the EU Insolvency Regulation. The pre-EU Insolvency Regulation procedure would need to be followed, meaning an application to the courts of the relevant EU Member State for the UK proceedings to be recognised. Similarly, EU insolvency proceedings would not be recognised automatically by the UK courts without an application being made to that effect.
The question of an independent Scotland

The Scottish Government, backed by an SNP-Green majority in the Scottish Parliament, has asked the UK Government to make an order under section 30 of the Scotland Act 1998 (a ‘section 30 order’), to allow a further independence referendum to take place between autumn 2018 and spring 2019. The Prime Minister’s refusal of that request has been well-publicised, but the response that “now is not the time” suggests a second referendum may be a matter of when rather than if, albeit that the UK Government’s rationale is that both Brexit and the future UK-EU relationship must have bedded in before the Scottish electorate would be able to make an informed choice.

There is at present no clarity over what the Scottish Government’s proposals would be for an independent Scotland’s relationship with the EU – both full membership and EEA membership have been mooted. Other key questions such as currency and regulation would also have to be addressed, with it being likely that the prospectus would have to be significantly different from that put forward in the 2014 referendum.

Irrespective of political viewpoint, the ongoing debate on Scottish independence adds an additional layer of complexity to the current market environment, as well as its wider economic implications, opportunities and risks. There are certain elements of contracts that can be future-proofed at this stage to ensure the position of the parties is preserved or risks mitigated irrespective of any potential referendum outcome.

Consumer credit and mortgage regulation

Existing EU consumer finance protections and mortgage regulation (under, for example, the Mortgage Credit Directive) are incorporated into UK law by legislation and FCA handbook rules. These provisions will continue post-Brexit unless and until new legislation amends or repeals them. This creates certainty in the short term although there is potential for divergence from the EU in the medium to long term. There is unlikely to be a significant dilution of protection although certain policy decisions may be impacted. The protection of consumers remains one of the FCA’s key objectives.

That said, the White Paper disclosed that the UK Government intends to bring forward a Green Paper, which will closely examine markets that are not working fairly for consumers.

Financial institutions are excluded from the EU Insolvency Regulation, with two EU Directives (implemented into UK law by the Credit Institutions (Reorganisation and Winding Up) Regulations 2004 and the Insurers (Reorganisation and Winding Up) Regulations 2004) forming a separate European framework for allocating jurisdiction and ensuring recognition of insolvency proceedings. On Brexit, while the provisions of UK law which implement the Directives will continue, financial institutions will need to consider the cross-border rules of the UK and the remaining EU Member States in case there is no longer reciprocal recognition of insolvency proceedings commenced in the institution’s home jurisdiction.
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Key contacts

Bruce Stephen
PARTNER
+44 (0)131 656 0260
bruce.stephen@brodies.com

Marion MacInnes
PARTNER
+44 (0)131 656 0288
marion.macinnes@brodies.com

Christine O’Neill
PARTNER
+44 (0)131 656 0286
christine.oneill@brodies.com

Charles Livingstone
PARTNER
+44 (0)131 656 0273
charles.livingstone@brodies.com

brodies.com