



# Brexit: Practical Implications for Capital Markets

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## Summary

Following the renegotiation of the terms of UK membership of the EU, agreed by the UK Government in the European Council on 19 February 2016, there is to be a referendum in the UK on 23 June on whether to remain in the EU or to leave. If the UK votes to remain in the EU, the practical implications for capital markets are unlikely to change significantly from the position at present, where the UK has unrestricted free access through the “single passport” to the EU Single Market, but is not a member of the euro area. The main change affecting capital markets in the UK is the introduction of safeguards designed to prevent discrimination between members of the euro area and non-members of the euro area in the rest of the EU. If the UK votes to leave the EU, there will be considerable uncertainty in capital markets about the implications. It is quite possible that the uncertainty will affect capital markets before the referendum if the expectation is that the UK will vote to leave. In the event that the UK votes to leave, this paper discusses: the negotiation of withdrawal terms; the implications of the withdrawal negotiations; the implications for capital markets in the UK; the implications for the rest of the EU; and contingency planning for Brexit.

### Introduction

1 Following the renegotiation of the terms of UK membership of the EU, agreed by the UK Government in the European Council of all 28 EU Member States on 19 February 2016, there is to be a referendum in the UK on 23 June on whether to remain in the EU or to leave. This paper does not address the pros and cons of UK membership of the EU, nor make a recommendation whether the UK should remain in the EU or leave. That is a decision for the British people. But the paper does consider the practical implications of UK exit from the EU (ie Brexit) for financial institutions involved in the capital markets.<sup>1</sup>

### If the UK votes to remain

2 If the UK votes to remain in the EU, the practical implications for capital markets are unlikely to change significantly from the position at present, where the UK has unrestricted free access through the “single passport” to the EU Single Market<sup>2</sup>, but is not a member of the euro area. The main change affecting capital markets in the UK, under the Decision of the European Council on a New Settlement for the UK within the EU<sup>3</sup>, is the introduction

of safeguards designed to prevent discrimination between members of the euro area and non-members of the euro area in the rest of the EU. If – but only if – the UK votes to remain in the EU, the European Council Decision provides for the following:

- Acknowledging that Member States not participating in the euro area will not create obstacles to further deepening of Economic and Monetary Union in the euro area, any further integration by euro-area Member States will conversely respect the rights and competences of non-participating Member States.
- Discrimination between the euro area and the rest of the EU is prohibited. Any difference in treatment must be based on objective reasons.
- EU law on Banking Union applies only to credit institutions in the euro area and in other EU Member States which have opted in to Banking Union. In these Member States, measures may be needed that are more uniform than in the rest of the EU, while preserving the level playing field within the EU Single Market and contributing to financial stability.

1. This paper is based on an earlier ICMA working paper on *Brexit: Practical Implications for Capital Markets*, posted on the ICMA website on 24 February 2016. ICMA has been encouraging international capital market integration for almost 50 years.

2. The “single passport” allows financial services operators legally established in one EU Member State to establish or provide their services in the other Member States without further authorisation requirements.

3. Decision of the Heads of State or Government, meeting within the European Council, concerning a New Settlement for the United Kingdom within the European Union, 19 February 2016.



## If the UK votes to leave the EU, there will be considerable uncertainty in capital markets about the implications.

- Crisis measures safeguarding the financial stability of the euro area will not entail budgetary responsibility for Member States not in the euro area nor opting in to Banking Union.
- The supervision or resolution of financial institutions and markets, and macroprudential responsibilities, to preserve the financial stability of Member States not in the euro area are a matter for them, unless they join common mechanisms to which they can opt in.
- Any Member State can ask the President of the European Council for an issue relating to the application of the European Council's Decision to be discussed in the European Council, and due account will be taken of the urgency of the matter.

3 Now that these safeguards for EU Member States not in the euro area have been agreed by a European Council Decision of all 28 Member States in advance of the UK referendum, financial institutions involved in the capital markets should be in a good position to assess the implications for their EU business, if the UK votes to remain in the EU.

### If the UK votes to leave

4 If the UK votes to leave the EU, there will be considerable uncertainty in capital markets about the implications.<sup>4</sup> It is quite possible that the uncertainty will affect capital markets before the referendum if the expectation is that the UK will vote to leave. The focus in this paper is on the practical implications of Brexit for capital markets rather than the broader political issues at stake or the potential impact of Brexit on the UK economy, the sterling exchange rate, UK interest rates, the UK's credit rating and the stability of the UK financial system. These will no doubt be continuing issues for debate during the referendum campaign.

### Negotiation of withdrawal terms

5 In order to leave the EU, the UK must invoke Article 50 of the Treaty on European Union.<sup>5</sup> Under the terms of Article 50, before the UK leaves there will be a two-year period for the negotiation of a withdrawal agreement with the Council, acting by enhanced qualified majority voting<sup>6</sup> with the consent of the European Parliament, and "taking account of the framework for its future relationship with the Union". The negotiating period will have a two-year limit, "unless the European Council, in agreement with the Member States concerned, unanimously agrees to extend this period".<sup>7</sup> In other words, either agreement is reached on the terms of withdrawal, including on the withdrawal date, within two years of the notification of the UK's decision to withdraw, or withdrawal will take place automatically at the end of two years, unless there is unanimity among the other 27 Member States on extending the negotiating period beyond two years.

6 In the negotiations with the EU on the terms of UK withdrawal, the main question affecting capital markets will be the terms for future UK access to the EU Single Market, given that the UK currently has unrestricted free access through the "single passport" as a member of the EU. While the UK runs a trade deficit with the rest of the EU, the UK runs a surplus in financial services. Around 45% of the UK's exports of goods and services go to the rest of the EU, while less than 10% of the rest of the EU's exports go to the UK because of the EU's much larger size.



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4. If the UK votes to leave, the UK Government has ruled out a second referendum (eg to vote on any subsequent offer by the EU, if there were to be one). If the UK votes to remain, another referendum on the EU at some point in the future has not been ruled out, should a future UK Government so decide.

5. The EU has two Treaties: the Treaty on European Union; and the Treaty on the Functioning of the European Union. If and when the UK withdraws from the EU, the Treaties would no longer apply to the UK, and the UK would no longer participate in the EU institutions, such as the European Commission, European Council, Council of Ministers, European Parliament and the European Court of Justice.

6. Qualified majority voting: at least 55% of EU Member States representing at least 65% of the total EU population. Enhanced qualified majority voting: at least 72% of EU Member States representing 65% of the EU population.

7. Treaty on European Union, Article 50.



## To obtain the most favourable terms of access to the EU Single Market after Brexit, the UK would need to comply with the terms of EU regulations, but without any influence over making them.

7 There is no precedent for withdrawal from the EU under Article 50, which has never been tested.<sup>8</sup> The four main options most frequently cited as precedents for countries outside the EU seeking access to the EU Single Market through a new agreement with the EU are as follows:<sup>9</sup>

- *Norwegian option:* If the UK followed the Norwegian option, it would apply to join the European Free Trade Association (EFTA), which consists of Iceland, Liechtenstein, Norway and Switzerland, and also to join the European Economic Area, which includes the EU Member States and EFTA except for Switzerland. (It is not possible to become a member of the EEA without being a member of the EU or EFTA, and the EU and all four EFTA members would need to agree to UK EEA membership.) Under this option, the UK would not participate in the EU's common agricultural and fisheries policies, judicial affairs and foreign policy, but the UK would continue to have unrestricted free access to the EU Single Market. In order to do so, the UK would have to comply with the EU's Single Market regulations under EU law without having a vote on them; free movement of labour to and from the UK across the EU would continue; and the UK would be expected to pay nearly as much into the EU budget as it does now.
- *Swiss option:* The Swiss option would involve the negotiation by the UK of membership of EFTA and a series of bilateral agreements with the EU. In the Swiss case, there are around 120 bilateral agreements with the EU covering a Single Market for goods, but not services in general or financial services in particular, apart from some forms of insurance; Switzerland needs to ensure that its regulations continue to be equivalent to EU regulations in future; and, like Norway, Switzerland also contributes to the EU budget. Since Switzerland voted in 2014 against unlimited immigration from the EU in contravention of the EU Treaties, the EU has renewed an earlier call for a new agreement under which Switzerland would automatically update its regulations to match EU rules within a time limit, and accept the jurisdiction of the European Court of Justice. So the EU might be reluctant

to adopt the Swiss model again in the UK case.

- *A customs union:* An alternative option would be for the UK to join a customs union with the EU, like Turkey. This would involve accepting the EU's external tariffs without having any say in setting them, with access to the EU Single Market in goods in exchange for adopting relevant EU regulations, but not access to markets for services, which would have to be separately negotiated with the EU.
- *A free trade agreement:* Another option would be for the UK to trade with the EU under World Trade Organisation (WTO) rules<sup>10</sup>, which would be subject to the EU's common external tariff, or to negotiate a comprehensive free trade agreement with the EU, under which tariffs would be lower than WTO tariffs. Most free trade agreements do not currently cover services.<sup>11</sup> Canada has negotiated a Comprehensive Economic and Trade Agreement (CETA) with the EU, which will eliminate tariffs on industrial products, but differences in regulations and standards will remain, and financial services are not covered. CETA took five years to negotiate; the negotiations were concluded in 2014; and, subject to agreement in the Council and European Parliament, could enter into force in 2017.

### Practical implications of the withdrawal negotiations

8 One of the practical issues in the run-up to the UK referendum is that it may not be clear which of these options will be adopted by the UK Government in its negotiations with the EU after a vote to leave, nor what the response from the EU would be. Indeed, the UK may want to negotiate its own tailor-made agreement with the EU which does not conform to any single one of the precedents but which is intended to deliver the most favourable terms of access to the EU Single Market. A common feature of the precedents is that, in order to continue to obtain the most favourable terms of access to the EU Single Market after Brexit, the UK would need to comply with the terms of EU regulations, but without

8. Algeria seceded from France in 1962, and Greenland, as an autonomous dependency of Denmark, withdrew from the EU in 1985, following a referendum in 1982. Both these withdrawals took place before Article 50 came into effect.

9. See Clifford Chance, *Britain and the EU*, August 2015; and Jean-Claude Piris, *If the UK Votes to Leave: the Seven Alternatives to EU Membership*, Centre for European Reform, January 2016.

10. Including the WTO General Agreement on Trade in Services (GATS).

11. However, in addition to the Transatlantic Trade and Investment Partnership (TTIP) negotiations between the EU and the US, the proposed Trade in Services Agreement (TiSA), which the EU is negotiating with the US, Canada, Australia, Turkey and others, may cover 70% of global trade in services.



## Leaving the EU would not be expected to lead to less capital markets regulation in the UK.

any influence over making them. In the case of some EU capital market legislation, provision is made for a third country regime allowing non-EU firms access to EU markets, provided that they are authorised in a third country with a regulatory regime deemed by the EU to be equivalent, and provided that the third country offers reciprocal access to EU firms. It is not clear whether the UK would be able to benefit from this, as it would depend on the outcome of the withdrawal negotiations.

9 The UK negotiations with the EU on withdrawal would be expected to take two years and could take longer.<sup>12</sup> Besides the time needed to agree with the EU on the terms of withdrawal, extensive changes in UK legislation would be required. In the case of the capital markets, the regulations affecting the UK at present are largely set at EU level. EU regulations take the form of Directives, which have to be transposed into UK law<sup>13</sup>, and Regulations, which apply directly in UK law without transposition. Although EU Directives have been transposed into UK law, the UK Government would need to take decisions about whether to keep, modify or discard them, if the UK decided to leave the EU. As EU Regulations apply directly in the UK, they would cease to apply if the UK left the EU and the British European Communities Act 1972, which gives legal effect in the UK to EU law, was repealed. The question would then arise whether to replace them, and if so on what basis. In the case of the capital markets, this question would not just relate to EU legislation at Level 1, but to Regulatory and Implementing Technical Standards proposed by ESMA (and the other ESAs) at Level 2. UK legislation might of course need to replicate EU Single Market legislation if the UK wanted to have continued access to the Single Market after Brexit on the most favourable terms. A potential complication is that an agreement between the EEA and the ESAs on passporting rights has been delayed.

10 Leaving the EU would not be expected to lead to less capital markets regulation in the UK, for three main reasons:

- *Global level:* While the detailed regulations affecting capital markets in the UK are set at EU level, the overall framework for capital markets regulation is set at global level by the G20, working through the FSB, BCBS and IOSCO. The UK participates in the G20, and would need to continue meeting these global standards even if it left the EU.
- *EU level:* The UK would need to continue to comply with the terms of EU regulations, if it wanted to obtain the most favourable terms of access to the EU Single Market after leaving the EU.
- *National level:* Since the international financial crisis, the national regulators in the UK – the PRA and FCA (and the FSA before them) – have been among the most prominent national regulators in promoting strict regulation.

11 Under none of the options for withdrawal would the UK benefit from free trade agreements between the EU and countries in the rest of the world. (They cover around 60 non-EU countries or organisations and represent around 35% of world trade.<sup>14</sup>) So the UK would need to negotiate new agreements with its trading partners in the rest of the world. Trade agreements are currently negotiated by the EU rather than individual Member States. There are obvious negotiating advantages in doing so, as the EU is a market of around 500 million people. In addition, the leaders of the UK's largest trading partners outside the EU, such as the US and China, have said that they would prefer the UK to remain in the EU rather than leave. It is not clear whether negotiations with trading partners outside the EU would in practice begin before the UK completed negotiations on a withdrawal agreement with the EU, or only afterwards. As the UK has not been directly involved in trade negotiations for over 40 years, it would also need to train officials or hire experts to conduct them.

### Implications for capital markets in the UK

12 There are a number of potential implications from Brexit for international capital markets, particularly in London as an international financial centre. By contrast, domestic UK financial business should not be directly affected by Brexit as such, though there would of course be an indirect effect on domestic UK financial business as a result of the impact of Brexit on the UK economy as a whole, particularly if Brexit led subsequently to Scotland leaving the UK.

13 *Uncertainty about the terms of the UK's withdrawal agreement with the EU:* First of all, the critical considerations for financial institutions in the capital markets would not only be the eventual outcome of the UK negotiations with the EU on the terms of Brexit, but uncertainty about the outcome in the meantime, and the

12. During the period before withdrawal, EU laws – including new laws – would continue to apply in the UK.

13. ie English and Scottish law.

14. Piris, *op. cit.*

length of time that might be needed to achieve this. In addition, during that period, the safeguards negotiated if the UK votes to remain would not be available if the UK votes to leave. Those financial institutions in the UK which are heavily dependent on EU business (eg fund managers in the UK with EU business and banks that operate their European capital markets business from the UK) would have the opportunity, if they wished, to reduce the uncertainty by shifting at least some of their EU business to other locations in the EU. Any such shift in EU business would not necessarily all be to the same location, and would no doubt vary from one financial institution to another.

14 *Foreign direct investment in the UK:* Second, Brexit could also have implications for foreign direct investment in the UK, as the UK would not be as attractive a location for access to the EU Single Market, if the UK votes to leave, as it has been until now as part of the EU Single Market. Many foreign financial institutions currently use London-based subsidiaries as their “single passport” to the rest of the EU. If the UK votes to leave, they would have the opportunity, if they wished, to establish subsidiaries in the rest of the EU and conduct business from there.

15 *Location of staff in the UK:* Third, Brexit could lead to changes affecting the location of staff. It seems likely that the UK would either need to accept free movement of labour or, if EU citizens required permission to work in the UK in future, UK citizens would require permission in future to work in the EU. (There are currently around two million British citizens living, working or retired outside the UK in the rest of the EU, while around two and a half million EU citizens live in the UK.<sup>15</sup>) The outcome of the negotiations on free movement of people – and uncertainty about the outcome – might also affect the decision by financial institutions where to locate their EU business after a UK decision to leave.

16 *Euro business in London:* Fourth, when the euro was introduced in the euro area in 1999, the UK was well placed to carry out euro-denominated business in London as an international financial centre, despite the fact that the UK was not a member of the euro area, for two main reasons: first, it was well prepared; and second, it remained in the EU and continued to have unrestricted free access through the “single passport” to the EU Single Market. By contrast, in the case of Brexit, it would be difficult to be well prepared, as it would not be clear what form Brexit would take, at least until a UK withdrawal agreement with the EU was reached; and the UK would no longer be a member of the EU Single Market if the UK were to leave the EU.

17 *Euro market infrastructure in London:* Fifth, it is not clear to what extent it would be possible for euro market infrastructure to remain in the UK if the UK decided to



**The critical considerations for capital markets would not only be the eventual outcome of the negotiations, but uncertainty about the outcome in the meantime, and the length of time that might be needed to achieve this.**

leave the EU. A recent court case involving the UK and the ECB tested whether euro clearing houses dealing with large euro-denominated transactions needed to be located in the euro area or could be located anywhere in the EU, such as the UK. In 2015, the European Court of Justice found in favour of the UK. The basis for making this judgment in favour of the UK could change if the UK decided to leave the EU. (It is not clear whether the proposed merger between the London Stock Exchange and Deutsche Börse would affect this, if it goes ahead.) Of course, financial business denominated in euro could still be conducted in London, in the same way as it is feasible to conduct dollar business in London. But London’s competitive position as a financial centre for EU business might change in relative terms as a result.

18 *Stability of financial institutions:* Sixth, given the uncertainties relating to Brexit and its implications, it would be prudent for financial institutions in the UK – and in neighbouring states, such as Ireland – to ensure that they would be well prepared for any financial instability (eg as a result of market illiquidity) that could arise: eg by checking their capital adequacy, their liquidity and their access to funding against the risk of capital flight. The Bank of England announced on 7 March that it would provide additional liquidity to the market, if needed, before and after the EU referendum on 23 June.

19 *Financial contracts:* Finally, financial contracts, especially between parties in the UK and the rest of the EU, would need to be reviewed and might need to be amended (eg to take account of changes in UK legislation after Brexit). In addition:

15. Piris, *op. cit.*



- it is not clear to what extent English law would continue to be used for financial contracts in future (eg between the UK and the rest of the EU);
- large companies in the UK would be expected to set out the risks of Brexit to their business in their annual reports; and
- there is a question whether Brexit might need to be considered in prospectuses as a risk factor. To be meaningful, risk factors in prospectuses should be as specific as possible. But it would be difficult to be specific about Brexit as a risk factor, given the level of uncertainty about its implications, unless an issuer could point to specific implications from Brexit for its business.

### Implications for the rest of the EU

20 Apart from the impact of Brexit on the UK, there would also be an impact on the rest of the EU. For example, there could be an impact on the EU economy, which is the UK's main export market. It is also clear that the future of the euro area will affect the UK, even if it leaves the EU.

21 A UK decision to leave might lead to calls in some other EU Member States for renegotiations and referenda of a similar kind. In deciding on the terms for UK withdrawal, one of the questions which the other 27 Member States would need to consider is whether the grant of favourable withdrawal terms to the UK would encourage any other Member States to leave.

22 If the UK decided to leave the EU, there would be additional questions with implications for capital markets, including:

- whether Brexit would fragment capital markets between the UK and the rest of the EU, at a time when the EU's project for Capital Markets Union is designed to integrate them;
- whether new EU regulations after Brexit would in future be as favourable to international capital markets as at present: while the UK can influence the outcome of negotiations on new EU regulations at present, after Brexit they would be negotiated by the remaining 27 Member States without any UK influence;
- whether the euro-area authorities would take steps to encourage more euro business to be conducted within the euro area; and if so, whether they would be able to agree on a single financial centre for the euro within the euro area and where it would be (eg Frankfurt, Paris, Luxembourg or Dublin).

23 Finally, if the UK as a whole voted to leave the EU, but Scotland voted to remain, that would lead to uncertainty in capital markets about whether Scotland would then hold a second referendum (after the referendum in September

2014) on leaving the UK, with a view subsequently to applying as an independent country to rejoin the EU.<sup>16</sup>

### Contingency planning for Brexit

24 Contingency planning for Brexit in the capital markets is likely to be difficult ahead of the UK referendum, because of the uncertainty about what Brexit would involve. But contingency planning by financial institutions in the UK might include, *inter alia*:

- taking steps as a precaution to ensure their continued financial stability;
- reviewing their future investment and staff location plans; and
- checking whether their financial contracts would be affected by Brexit.

Similar considerations could arise for financial institutions outside the UK in relation to their UK counterparties.

25 As a result of contingency planning, financial institutions in the UK would incur costs, particularly where they have extensive international business. To the extent that contingency plans need to be made before the referendum takes place, these would be sunk costs if the UK votes to remain. If the UK votes to leave, subsequent planning would be complicated by uncertainty about the terms of the UK's withdrawal. The uncertainty would be likely to last for two years, and could last longer, until a withdrawal agreement was reached with the rest of the EU. And the expectation of uncertainty, if the UK votes to leave, might itself lead to decisions about where financial institutions with international capital markets business, particularly in the EU, would plan their future investment and the location of their staff.

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16. Nicola Sturgeon, First Minister of Scotland, is reported as saying on 24 January 2016 that a vote in favour of Brexit would result in an "overwhelming demand" in Scotland for a second independence referendum.