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Brexit and the Financial Services Sector

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Britain has decided on Brexit in a referendum. However, there is a lot of uncertainty about the steps to come. The UK has not yet formally notified the European Commission of its intention to leave the EU and no one knows when this will happen.

In the EU there are voices pressing for a fast Brexit and others who favor allowing more time. There is further uncertainty over the negotiations that will follow the UK's formal exit notification (invocation of Article 50) and especially on their result. Full details of the UK's new relationship with the EU are unlikely to be settled for several months, and may even take years to agree.

One of the most important questions is whether the UK will succeed in preserving access for companies in the financial services sector to the EU market under the freedom of establishment and freedom to provide services. This would be extremely important both for financial entities established in UK and for those established in the EU (assuming that a reciprocal arrangement can be agreed). An equally important consideration will be the extent to which service providers established in UK, other than financial entities, will continue to have access to the EU internal market.

So at present very little is certain, but here we set out some of the likely effects on the financial services sector.

Bank of England

What does Brexit mean for the Romanian financial sector?

Many financial entities are likely to be affected by the general uncertainty on capital markets and the macroeconomic situation. More specifically, entities in the Romanian financial sector (e.g. banking, insurance, investment, payment services) must assess what will happen if the Brexit agreement to be reached between the EU and the UK does not preserve the UK's access to the EU's internal market.

From the perspective of UK financial entities on the Romanian market, few are operating in Romania based on the freedom of establishment but many others have notified the relevant supervisory authorities that they carry out business in Romania under the freedom to provide services. We expect them to assess the implications of Brexit and decide on contingency plans (e.g. obtaining licenses in another EU Member State).

Romanian financial entities are likely to be affected by the following issues:

Passporting

Depending on the outcome of the negotiations between the EU and the UK, Brexit could have a significant impact on the applicability of one of the fundamental freedoms which are currently conditions of EU/EEA membership and which bring particular benefits to the financial services sector – the free movement of services and freedom of establishment.

For Romanian financial entities, this could affect their ability to 'passport' services into the UK. In addition, dealing with UK firms, group companies and partners (e.g. risk participation/sub-participation arrangements;

technology and other service contracts) on a cross border basis may become more difficult, to the extent that the freedom of UK companies to provide services in the EU (including Romania) will be affected.

Depending on the scale of their business carried out in the UK or the services or products sourced from UK partners, Romanian financial entities will have to consider the implications, including costs, deriving from the potential need to obtain new licenses or implement new business structures or arrangements in order to overcome the effects of Brexit on the free movement of services and freedom of establishment.

Funding arrangements

Depending on the exact terms under which Brexit takes place, the free movement of capital between the UK and the EU could also be affected. Romanian financial entities would have to consider the possible impact on potential funding arrangements involving UK financial entities, resulting from any limitations on parties' ability to move capital freely across borders (e.g. increased funding costs etc.).

In addition, the potential implications for existing financing agreements concluded by Romanian financial entities with UK financial institutions should be considered and assessed on a case by case basis (e.g. possible activation of increased costs provisions, if, for instance, lenders proceed with the recovery of the additional costs incurred as a result of legislative changes triggered by Brexit; possible implications relating to the enforcement of certain clauses, such as choice of law and jurisdiction clauses etc.).

Assets located in the UK

Brexit could also trigger changes with respect to the legal regime applicable to various assets located in the UK, especially in the context of the potential implications that Brexit could trigger in relation to the free movement of capital currently applicable in the EU/EEA. Consequently, Romanian financial entities could encounter possible implications from holding or investing in assets located or traded in the UK. For example, there are requirements certain Romanian financial entities (e.g. UCITS) must observe in relation to investment in shares and other financial instruments, depending on whether they are traded in an EU or a non-EU state.

Data Privacy

The flow of personal data between Romania and the UK may become problematic if the UK is not subject to the same data protection rules as the EU. Romanian financial entities which currently transfer personal data to the UK (e.g. to UK partners or to outsourcing or data processing centers with IT systems located in the UK etc.) would need to keep these issues under scrutiny.

Tax, immigration and social security

Directives will no longer apply. After Brexit, the UK will no longer be able to apply EU Directives, and this could generate additional tax costs and/or cashflow issues. The most relevant Directives for the Financial Services sector are:

- The Parent-Subsidiary Directive, which allows dividends from a subsidiary in one EU country to be paid to a parent company in another without being subject to withholding tax, under certain conditions.
- The Interest and Royalties Directive. This allows interest and royalties between affiliated parties in different EU Member States to be paid without withholding tax.
- The Merger Directive, which allows EU companies to carry out tax neutral reorganization transactions, under certain conditions.

Consequently, post-Brexit, unless an agreement is made with the UK to maintain the provisions of the Directives, Romanian companies within the financial services sector which have financing structures in place from mother-companies established in the UK might face higher financing costs by not being able to apply the Interest and Royalties Directive. Interest and royalties paid between Romanian companies and affiliated EU companies (by means of having a common UK parent company) will also be affected. Any distributions of profits from Romania to the UK mother company could also become taxable. Cross-border reorganization transactions would also be affected from a fiscal point of view.

Free movement of people

Free movement of people is one of the four fundamental freedoms guaranteed by the EU. This issue has generated considerable discussion, both before and after the UK referendum, and is quite likely to be curtailed post-Brexit. Consequently, there may be implications for directors and employees of Financial Services companies, whether they are Romanian nationals in the UK, or UK nationals in Romania.

Furthermore, there could be social security implications for mobile employees. The EU has common rules on social security designed to facilitate free movement between member states. These could be in jeopardy post-Brexit, thereby generating potential additional costs both for employers and employees and reduced benefits, unless the U.K. and EU agree to maintain some or all of the existing arrangements.

Prudential implications

In the longer term, financial services entities with exposures towards the UK may face more onerous regulatory capital requirements, depending on whether third party equivalence will obtained by the UK after Brexit. A more immediate impact may be triggered by the downgrades in credit ratings for European sovereigns, which may result in fair value losses from mark-to-market of sovereign exposures in the case of increasing yields, as well as in higher risk weights for these exposures.

With market pressures intensifying for EU financial groups with a local presence, we may also witness new strategies to optimize allocation of capital at group level, with an impact on availability of funding and liquidity on the local market.

Given the heightened uncertainty and increased volatility of financial and foreign exchange markets, financial institutions should closely monitor how the Brexit scenarios unfold and should make sure that their internal stress testing framework adequately captures these scenarios to demonstrate the soundness of their capital and liquidity position under adverse conditions.

A few more questions…

Though Brexit's impact will differ according to the profile and nature of each business, management should ask themselves:

- Who are our customers, suppliers, and outsource providers? What impact does Brexit have on them and our business interactions with them?
- What impact might future political or economic volatility have on our business?
- What impact will this have on our workforce, in terms of immigration, working hours, employee availability, etc?
- What impact will Brexit have on our current financing arrangements? What about other direct financial implications, such as transfer pricing, tax, jurisdictional issues, exchange rate differences, etc?

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