

Julia: Hello and welcome to a DerivSource podcast.

I'm Julia Schieffer, the founder and editor of DerivSource.com.

The referendum on the European Union, which is fast-approaching, has produced a plethora of papers, articles, forums, tweets and debates. They're not always of the highest calibre and it is often difficult to cut through the grandstanding.

However, a paper published by thinktank JWG, '*Brexit, Changing Out of the Engine of Finance*' shows if the UK exits, the country will enter a long period of uncertainty and the bureaucracy could become greater rather than less.

In this podcast I'm speaking to PJ Di Giammarino and Aoife Quinn about the findings of this paper.

Welcome to the podcast.

Aiofe: Thank you, it's good to be here.

PJ: Thanks, Julia, it's good to be here.

Julia: So, before I begin, I want to ask both of you to introduce yourself briefly, starting with you Aoife.

Aiofe: I'm a research analyst here at JWG. I've helped write this paper; I've studied European Law so I have quite a keen interest in it, so it was a good project.

Julia: Sounds like you're well-equipped to comment on this, then. Perfect. And, PJ, would you like to do a brief introduction?

PJ: Sure, Julia. I'm not a lawyer, I started this think-tank 10 years ago on the back of something called the MiFID Joint Working Group. We look at all G20 regulation globally; how it affects the infrastructure in ops and tech in particular. We took a keen interest in this particular topic because if it does happen we wanted to know what it would mean for our membership.

Julia: Okay, great, thank you.

So, the first question I have for you is: according to the paper there is a popular belief that if the UK chooses to leave it will be

free of the current rule-making environment. So why would the red tape become worse if the UK leaves?

PJ: It's a common misconception. It's something that when we started digging into it we just realised how much more red tape there would be. It really comes from a couple of different levels; one is at a global level, there are a number of commitments that have been taken among the G20 that would still need to be maintained. There's a certain amount of red tape just with those, and understanding how the UK stays equivalent with the rest of the G20, but then there's also in the drafting of the legislation in Europe there's a lot of equivalence rules that in order to be able to play on the continent you still need to be able to meet a lot of the obligation.

So, the real challenge then for the red tape becomes anything that's a delta between what you do on the continent or in the G20 and what you do in the UK, and that's really the fundamental driver which is any of the rule book tinkering that would occur.

Aoife: In terms of the exit process, we're looking at something which has never been used before. The Lisbon Treaty brought in Article 50 of the Treaty of the European Union, so this is a brand new mechanism which was set up to allow countries the option to formally exit the European Union.

The process for that is as soon as a country votes to leave, formal notice has to be given to the European Community. Once that formal notice is given there's up to two years before formal withdrawal needs to take place. During that period there's negotiations happening, however the UK would lose its seat in these formal negotiations concluded by the Council.

This means that it doesn't have a seat in terms of discussing its future, so this is quite a big thing because not only does the mechanism set in stone how the UK will leave, it also is the basis for setting how the future relationship between the UK and the EU will continue to function once withdrawal takes place.

As we said before, the only example that we have to date of a country voting to leave the EU is Greenland, and it never utilised this Article 50 protocol and so there's so many uncertainties in the process and they'll basically just have to be ironed out along the way as the withdrawal process takes place.

Julia: Thank you Aoife. My next question is about the rule book. So much of the rule book and what type of rules will have to be rewritten?

JW: We took a hard look at the rule book, Julia, and I think ultimately it came down to roughly 60% of the rules in the UK are derived from European law and this is due to the fact that since 1972 a lot of what has been put on the books here comes directly from regulation which under treaty then makes it directly applicable.

What this means is that there's an enormous backlog of regulation, anything that ends in an 'R' effectively; MiFIR or EMIR or CRR, anything like that that people might be familiar with will need to get put onto the UK books. In that process obviously we can expect a bit of tinkering. I don't think we've ever seen an environment where we didn't have the UK didn't tinker with rules. It does it a lot on the continent; it would be unreasonable to assume they'll just be copied and pasted as they are. This could mean very big business swings with one change of a paragraph. Things like Exchange-traded derivatives, or things like how FX is treated, or things like recordkeeping requirements, those could all change.

Ultimately then, what that will do is introduce an awful lot of uncertainty about when and how as Aoife was saying, the actual decisions will be made about what the rules are applied and that then falls to the courts. One of the big things I think that became clear, as we read in this paper, is that when the European Courts of Justice rulings can no longer be relied upon here, you then have another dynamic of what are the UK courts going to do, and how are the UK courts going to weigh-in?

There will be an awful lot of uncertainty about the rule book, and people will be making decisions based on partial assumptions and a bunch of very busy legal experts trying to advise everybody on what they think is likely to happen.

Aoife: Just to stress the issue with the Court of Justice of the European Union. Currently countries have the option to refer a question of uncertainty to the Courts in terms of interpretation. We're talking about here if the UK votes to leave and suddenly they've no longer have access to refer questions to the Court, understanding the basis of the laws which we're trying to re-write becomes a huge obstacle. You have no reference point and that could create huge difficulties.

Julia: Sounds complicated indeed. Now, for the DerivSource audience who tend to be derivatives professionals who work in

operations, risk, compliance, regulation (of course), as well as technology, so one thing I noted is that the paper notes that it will mean there's a huge operational undertaking, costing an additional spend of potentially between £14billion - £20billion in regulatory change management, with a median estimate of a total cost reaching to £17billion by 2026.

These are scary numbers, so what are some of the biggest changes firms will have to do in terms of a Brexit?

PJ: I think just to break those numbers down just a tiny bit. We looked at the cost model in terms of three different waves. The first wave was the UK regulators reshaping their rules and establishing how they'd like finance to work here. The second wave being where the UK has to then get wired back up to any kind of European structure which will then be dependent on treaties. And then the third, final wave where the G20 picture would have to be sorted out again.

It's not like one wave of change; there will be multiple changes. The kinds of changes we're most concerned about would obviously be anything that affected the way trading is actually done, any sales, trade or workflow, any risk calculation, any margining, any client controls and repapering, anything to do with distributors, or potentially even your vendor agreements. So, these are all very big variables, and a lot of those definitions as we talked about earlier, tied up regulation so they would have to be modified and holed out into a UK context, whatever the UK treaty negotiation status might be.

Julia: So we've talked about some of the impact and operational costs potentially. What about action plans? What would you tell your potential clients or financial institutions what their action plan should look like and what the key items really should be on their checklist going forward?

PJ: I think one of the things we need to hit hard, and we cover this in detail in the paper in a bit more depth, but there is enormous irrational component to this change program. It will be the mother of all change programs, no one will ever have seen anything this large before. One of the biggest issues will be the irrational component of the human response to what this means to the red entity, anyone's day-to-day life is framed by 'I go to an office and work with a team'. That office might move, your team might change, people may no longer have rights to work here. There will be changes to the way people are able to support their families or even travel across borders. There will be an enormous destabilising effect really to everybody, and especially to financial services, and yes a number of people will obviously be able to stay

under skilled visa programs etc, but it may tip the balance for a number of them and they may choose to go elsewhere.

So there will be a huge organisational gap, and I think that's one of the first things to really get to grips with. Who can you count on in terms of actually continuing to run the bank, or be able to conduct the business, and how are you thinking about making some of those decisions? Obviously for a group outside Europe it will have some choices about whether to make, where to go, and some of those decision-making processes may change as well.

Fundamentally, the biggest thing we think people will need to come to grips with is tracking their overall regulatory change portfolio and having the ability to spot, know and eventually be able to do the changes in a better, faster and cheaper manner. And those firms that are really on top of knowing what they need to do and deploying the right kind of tech or big advocates of regtech and they would really need to be defining a consistent repeatable way of getting to how they define, what are their infrastructure and operational targets to beat. They need to be able to make that a very flexible, nimble and robust capability.

Aoife: The current industry estimates and the current estimate from the government suggest that this is a 10-year project. Getting your plans together now, and getting them together early is going to be crucial. So, yes, I just wanted to stress the fact that this is a 10-year project, it comes with a 10-year bill, firms need to be prepared to get in there early with their proprietary measures.

Julia: **So let's talk a little bit about the impact again. What will the impact be on business models; will there be any winners or losers in this situation?**

PJ: I think obviously the passporting rights will be one of the biggest variables in this whole discussion. Those that have access to the bigger market via other ways may choose to then remain in the UK or not, and there's a lot of speculation about how that would actually work.

Ultimately, there will be winners and losers based on those that are on top of this kind of massive change program and are thinking about how do they de-risk it across their value chain, ie. all the way up to clients, and then all the way back down their supply chain, ie. all the way down to the data vendors and everybody else that they're relying on.

That's a giant risk management exercise, so from a business model point of view you've got to be thinking about how are you going to keep

those clients? How are you going to look and position yourselves better in front of the competition, just as much as how do I then lock-in the right kind of service providers (lawyers, consultants, auditors etc) that really know what's going on and are able to help manage through all this. They will be in very short supply, and we all know the change management pool for reg is a large number of people but the good ones that can piece all of this complexity together are few in number. So it's critical to think about locking down those arrangements now. Let me say, this is not me being a consultant, not being a lawyer, but obviously that's going to be a large part of the game and ultimately the winners are going to focus on the total cost of ownership and how can they get the right kind of end-to-end change management support that they need over the next decade.

Julia: We've talked about this already, you've mentioned it already, about the psychological impact or behavioural change. Can you tell me a little bit more about the psychological impact or this behavioural change that will be required?

PJ: I think anyone involved in the regulatory agenda now suffers a bit of regulatory burnout. It's not new. Those of us that have been at it since Pittsburg in 2009... I have seen an Eiffel Tower's worth of paper already, and we had to pick through it, had to fight about what this clause and footnote means, and then tie that back to an ISDA agreement and figure out what we're going to do about repapering the client.

So the prospect of going through this all again is a bit daunting, and I think there is a... especially for the DerivSource audience there is a real potential issue of people just not having the will to fight this fight out. And I think in that optic, anything that firms are doing to make this more palatable for people at home and to be able to make it easier to come into the office and realise they need to apply their two decades worth of experience yet again for another decade can only be help. Ultimately those people you're relying on are your biggest asset and ultimately if you're going to be out of compliance because they missed something and you didn't have them on board.

So that's really I think the biggest angle to stress is that we are already in a very high stress environment, we already have huge demands, this will just be ratcheting it up a few extra degrees but in doing so may well break the current organisation and the operating model that you have in place.

Julia: It sounds like a Brexit would really be quite complicated and would greatly impact the financial services sector at a time when really this industry is already dealing with significant regulatory change and cost related to that.

Thank you to PJ and Aoife for sharing their insight and the findings of this paper with our audience today.

I want to thank Aoife and PJ for joining us today and sharing the findings of this report in this DerivSource podcast. Thank you both.

Aoife: Thank you.

PJ: Thanks a lot Julia.

Julia: Listeners, let us know your thoughts in the comments section on either DerivSource's Podcast show notes page, or on iTunes - we'd love to hear your thoughts on this topic. We will also share a link to the JWG paper on the Podcast Show Notes so please go that page for more information on the paper itself as well.

Thank you for listening, join us next time.

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