REPLY
AVANTAGE

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BREXIT

THE IMPACT OF BREXIT ON FINANCIAL INSTITUTIONS

REPLY AVANTAGE

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Established in 2004, Avantage Reply (a member firm of Reply) is a pan-European specialised management consultancy delivering change initiatives in the areas of Compliance, Finance, Risk and Treasury.

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1. Introduction

On the 29th March 2019, the United Kingdom will leave the European Union after 46 years of continuous membership. Disentangling of the UK from the various European institutions into which it has become woven will not be a trivial task; arguably it will be the most complex de-merger ever contemplated. Impacts include the potential disruption to the lives of millions of European nationals living outside their home country, the disruption to complex supply chains in industries such as automobiles and aviation, and the disruption on capital flows and the financial services industry.

This paper is focussed primarily on Financial Services firms, with particular reference to Banks, which will no longer be able to 'passport' licences from the City of London to the EU and vice versa. This paper will try to determine what exactly Brexit will mean for a Financial Institution, and what actions will need to be taken as a result. The exact answer to this question depends of course on the result of UK-EU negotiations, which will likely not be truly concluded until the last minute, by which time, there will be limited time for action.

The approach taken in this paper is one of scenario analysis. We cannot predict the future, but we can discern the different possible outcomes – for example 'soft' Brexit, 'hard' Brexit, or 'no-deal' Brexit - and identify for each the impact on the industry. Certain specific impacts are considered in detail, including for example those relating to contractual continuity, clearing, and licensing. Given that in any non 'soft' Brexit scenario, some degree of FI relocation is likely to be required, we consider the requirements for such a mission. Finally, we conclude with a few thoughts regarding the likely direction of travel, the associated risks, and the required planning and risk management.

2. Political and Economic Background

In this chapter, we consider the range of likely outcomes from the UK-EU negotiations regarding the nature of the future relationship, and consider the implication of these outcomes for the financial services industry.

2.1 Six scenarios for political negotiations

Any analysis of the likely future state for the UK post-Brexit logically begins with an analysis of existing relationship between the EU and its neighbouring non-Member States. Countries such as Norway and Switzerland are arguably prosperous, successful states, with defined and understood framework agreements governing their EU relationship. Other states have a less intricate, and less open relationship. Broadly speaking, there are six possible outcomes to the negotiations currently underway in Brussels. These may be characterised thus:

Soft Brexit:

1. The Norway / EEA Scenario.

Hard Brexit:

2. The Switzerland / EFTA Scenario.
3. The Turkey / Customs Union Scenario.
4. The Canada / Free trade agreement Scenario.

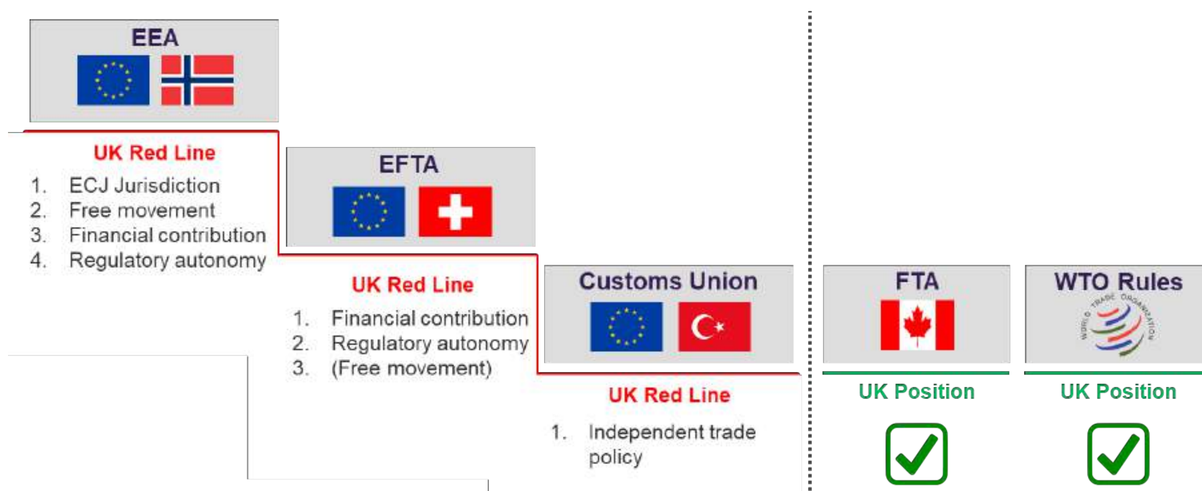
No Deal:

5. The WTO Scenario.

No Brexit:

6. The Revocation / No Brexit Scenario.

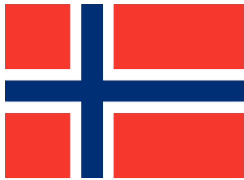
Below a graphical representation of the different options, include the UK's position on these, based upon the Barnier 'staircase' diagram[1]:



1 European Commission (2017), Future Relationship: https://ec.europa.eu/commission/publications/slide-presented-michel-barnier-european-commission-chief-negotiator-heads-state-and-government-european-council-article-50-15-december-2017_en

REPLY AVANTAGE

NORWAY / EUROPEAN ECONOMIC AREA



The first option would be for the UK to elect to join the European Economic Area (EEA), the current members of which are the Member States of the EU, plus Norway, Iceland and Lichtenstein.

The 1994 EEA Agreement provides its members with access to the EU Single Market and is subject to European law and jurisprudence in respect of the 'four freedoms', namely the free movement of goods, services, persons and capital. Members also pay a financial contribution to the EU. In addition, the EEA Agreement also covers cooperation in policy areas such as research and development, education, social policy, the environment, consumer protection, tourism and culture. Policies outside the scope of the EEA agreement include the Common Agriculture and Fisheries Policies, Customs Union, Common Trade Policy, Common Foreign and Security Policy, Justice and Home Affairs, and European Monetary Union.[2]

Economically, the transition from full EU membership to EEA membership would be slight with minimal need for complex transition projects. Politically, it would require the UK to become a 'rule taker', that is, to implement EU regulations on which it had not participated, something that is unlikely to be sustainable in the longer term. However, if the UK where to choose this option, financial services would not be impacted, as the UK would remain part of the Single Market.

SWITZERLAND / EUROPEAN FREE TRADE ASSOCIATION

Upon exiting the EU, the UK could elect to join the European Free Trade Association (EFTA). This is an inter-governmental organisation focussed on facilitating free trade between its members (Iceland, Liechtenstein, Norway, and Switzerland), the EU, and various third countries via various Free Trade Agreements.

All EFTA states except Switzerland belong to the EEA (see above). Switzerland is therefore not part of the EU Single Market: instead, it has a series of bilateral treaties with the EU, each covering a different policy domain or industry sector. Each of these treaties has a bilateral commission to manage changes to rules, as well as its own dispute resolution mechanisms. Practically, this means that trade in goods (but not services) is subject to these agreements, typically in accordance with EU rules. This means that financial services would not be within the scope of such an agreement.

In theory at least, the use of a framework of treaties instead of a single comprehensive agreement provides some degree of flexibility for the Swiss government regarding the scope of coverage of EU-Swiss relationships, whilst enabling on-going trade in goods. It has thus been cited in some quarters as a possible template for future UK-EU relationships. Whether such an agreement would be acceptable to the EU is another matter: the EU considers the current framework to be overly cumbersome and complicated, with continued conflict over Swiss arrangements for EU regulatory alignment and jurisprudence.

CUSTOMS AGREEMENTS (TURKEY)

Turkey is outside the single market, but inside a customs union for manufactured goods (rather than "the" customs union). Such customs unions can function selectively, applying only to certain sectors of the economy: the microstate of Andorra has a customs union with the EU which excludes agriculture. This arrangement means Turkey must set the same tariffs on manufactures as the EU does and cannot make its own separate trade deals covering tariffs. It could theoretically make special deals that covered only regulations, and EU tariffs on manufactures are very low anyway. But in practice Turkey has no real control over its manufactured goods trade policy, which severely curtails its ability to do other, multi-sector deals.

2 Source: efta.int

FREE TRADE AGREEMENT

The next option the UK and the EU could decide on is a Free Trade Agreement (FTA), the commonly used example of this is the CETA agreement, which the EU and Canada recently signed. An FTA usually includes tariff free trade for most goods. However, (financial) services are excluded. By signing an FTA, the UK would still be able to sign other agreements with other countries, but trade with EU would be more burdensome, because a proof of origin for all goods would be required and firms exporting to the EU would still have to comply with EU standards and requirements related to these goods.

WORLD TRADE ORGANISATION (WTO)

If the EU and the UK do not decide on any form of preferential trade agreement the fall back would be the WTO Trade regime. In effect the trade between the EU and the UK would become comparable to trade between the EU and China. The impact of this would mean that there would be trade tariffs and no access for (financial) services, but also no obligation to comply with EU law in any way, shape or form.

REVOCATION

In a logically complete set of scenarios, the final scenario that one must consider is a revocation of the Brexit decision. At the time of writing this scenario is considered unlikely, given that it is contrary to the official policy of the two major political parties in the UK. A substantial deterioration in the political climate in the UK could, however, lead to a change of government and so policy. This would imply limited economic change to the UK, with completely unknown political consequences.

2.2 General Implications for the Financial Services Industry

The amount of required change in the financial services industry is clearly dependent upon the nature and scope of the political agreement. Broadly speaking, there are four possible outcomes: these are presented below.

PASSPORTING

At present, a Financial Institution licenced in one EU Member State can in principle conduct business throughout the EU by ‘Passporting’ its licence across national borders. If the UK post Brexit elects to remain in the EEA (see above), then Passporting of licences may continue and the impact on the industry is limited. At the time of writing, EEA membership is not a stated UK objective, however one should not completely rule out scenarios where the UK seeks temporary EEA membership to smooth the exit path from the EU.

MUTUAL RECOGNITION

For much of the early Brexit negotiation phase, the preferred outcome of the British government was to establish a system of ‘mutual recognition’, this being an agreement whereby both parties would agree to maintain comparable rules and accept each other’s findings as binding in their own territory. Within the context of financial services, this would have required the establishment of a bilateral body to jointly agree objectives, such as financial stability and consumer protection, and to manage disputes. Each party would typically have different procedures for achieving the agreed objective: the goal would be to ensure consistency of outcome. Such an approach would differ from Equivalence (see below): it would have had a much broader scope, and would be based on a partnership of equals, as opposed to a more one-sided, Brussels-centric decision model. These are arguably the reasons why this was seen as both desirable by the UK, and less so by the EU.

EQUIVALENCE

In theory, Equivalence offers a simple way of facilitating cross-border business. The EU examines the regulatory and supervisory framework in place in a given country for a given business activity and determines whether the rules in said third country are equivalent to those in the EU. If they are, then Financial Institutions from said third country are permitted to conduct cross-border business. Given that the UK and EU are, by definition, starting at a point of perfect regulatory convergence, this provides on paper at least a means by which firms established in the City could continue to operate cross-border, post-Brexit.

It should be recognised that in practice there are many practical obstacles for the ongoing use of Equivalence. It is not a single route to cross-border business, but rather is a patchwork of measures, individually defined on an ad-hoc basis per Regulation and Directive. The scope is extremely limiting, covering approximately one-third of financial services activities. The below table[3] illustrates the current scope and limitations of Equivalence in key banking and investment activities.

Furthermore, the equivalence framework is somewhat one-sided in application, with decision power balance tilted towards the EU. There are very few procedural safeguards: the EU is permitted to withdraw equivalence with as little as 30 days' notice. This means that use of equivalence for cross-border finance is subject to inherent political, regulatory and legal risk, which increases with the complexity and maturity of any transaction.

In short, equivalence provides a cross-border solution for a limited number of activities, and within that scope, is suitable for transactions that are both simple and short-dated. It does not, in its current design, provide a sufficient basis for a comprehensive cross-border business portfolio.

The UK's Chequers Proposal[4] acknowledges that Equivalence is likely to be the foundation of future UK-EU financial services agreements, with the UK seeking a declaration that the City of London is Fully Equivalent to the EU, by reference to a common legal and regulatory framework. This means that a deep understanding of both the functioning and limitations of this framework is a pre-requisite for post-Brexit regulatory management.

Passporting and equivalence compared: five key EU banking frameworks

	Service, Product or Activity covered	Single market access via passport?	Single market access via equivalence?	Who decides equivalence?
CRD IV	Core bank services such as lending and deposit taking and corporate banking advisory services.	Yes, cross border rights across the single market and local treatment for branch operations.	No, While the EU recognizes third countries as equivalent with CRD IV for certain reasons, this confers no market access rights for non-EU banks.	No equivalence regime.
MiFID II	A range of investment and market services, including the design, sale and trading of securities and the provision of investment advice.	Yes, cross border rights across the single market and local treatment for branch operations.	In principle, MiFID II creates cross border market access rights for non-EU firms, once authorized by ESMA, but only covering some MiFID services. However, this system has not yet been activated.	A combination of: ESMA, the European Commission and EU Council.
PSD II	Payments services.	Yes, cross border rights across the single market.	No, PSD II has no market access framework for non-EU service providers	No equivalence regime.
UCITS Directive	The design, management and distribution of collective investment products.	Yes, cross border rights across the single market.	No, UCITS funds can only be managed and marketed from inside the EEA	No equivalence regime.
AIFMD	The marketing, and management of alternative investment funds. Yes, cross border rights across the	Yes, cross border rights across the single market.	In principle, AIFMD creates cross border rights for non-EU firms, with equivalence and once authorized by ESMA, but no country has yet been recognized as equivalent.	A combination of: ESMA, the European Commission and EU Council.

3 British Bankers Association (2016): BBA Brexit quick brief: What is 'equivalence' and how does it work?, https://www.bba.org.uk/wp-content/uploads/2016/12/webversion-BQB-4-1.pdf

4 HM Government (2018): The future relationship between the UK and the EU, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/725288/The_future_relationship_between_the_United_Kingdom_and_the_European_Union.pdf

RELOCATION

Another option for financial services firms conducting cross-border activities is Relocation. An international firm with its European headquarters in London could elect to open a licenced EU headquarters in an EU-27 Member State; similarly, a European firm wishing to conduct business in the UK may elect to establish a licenced office in London. If the backbone of the future UK-EU agreement is Equivalence, then those activities for which equivalence is not permitted (see above) would be subject to relocation, possibly with legacy book transfer.

There are substantial challenges for any firm contemplating this route. Quite aside from the logistical challenges implied in establishing operational readiness, there are numerous challenges in ensuring that these new entities conform to the high standards increasingly demanded by regulators. Many of these challenges are explored in the next section in greater detail.

2.3 Conclusion

Assuming the UK leaves the EU (and the EEA), and that Passporting ceases to be a valid tool for licensing of cross-border business, one can either look to existing models in other countries, such as Switzerland and Canada, or consider future negotiating objectives.

A key negotiating objective of the UK is to secure a Free Trade Agreement with the EU, which would ideally include financial services. Given that no existing free trade agreements are known which feature financial services, this is an ambitious goal: building a treaty-based relationship ultimately requires credible arrangements which enable the management of financial stability and systemic risk, especially in crisis situations, and these are matters which national governments are typically unwilling to share with foreign jurisdictions.

The realistic best-case scenario for the City of London is therefore a future framework comparable to existing EU-US arrangements, based on bilateral supervisory relationships, and agreed equivalences of key regulations in many specific areas. This, however, implies the permanent loss of much of the City's EU27, non-institutional business, much of which would – given the restrictive nature of Equivalence – need to (re-) booked in an EU entity.

3. Drill-down: Several Practical Implications

In this chapter, we consider some of the practical implications of Brexit for Financial Institutions, both from a continuity of business perspective and from a relocation perspective.

3.1 Contractual continuity for derivatives

As for all other activities in the financial sector, the impact of Brexit on derivatives will depend on the shape and form that Brexit will take. The various scenarios are summarised in the previous chapter. The Bank of England's Financial Policy Committee (FPC) has identified the likely issues relating to contractual continuity as a key Brexit risk[5]. At the heart of the matter is the contractual disruption likely to occur in the event of the UK leaving the EU (and the EEA) without a comprehensive Free Trade Agreement in place. This is because some derivative contracts will be arranging for the provision of services that will become a legal impossibility due to the UK's loss of its Passporting rights[6].

"Grandfathering" contracts could help mitigate part of this issue. Under grandfathering, a provision stipulates that old, legacy, rules, still apply, in parallel to the implementation of a new rule. This would mean that legacy derivatives contracts could be let to mature even under a new legal and regulatory regime, provided no changes are made. However, this does not come without challenges and a primary one is that there would need to be recognition by both the UK and the EU of those grandfathered contracts.

5 Bank of England (2016-8), Financial Policy Committee (FPC) minutes: https://www.bankofengland.co.uk/record/fpc-records

6 Ashurst (2016): Brexit: The impact on derivatives regulation: https://www.ashurst.com/en/news-and-insights/insights/brexit-the-impact-on-derivatives-regulation/

Collateral and counterparty management systems would need to be updated accordingly.

BREXIT, THE GREAT RE-PAPERING EXERCISE

In the event of a 'hard' Brexit (outside the EEA without compensating FTA), there is scope for significant contractual disruption. For example, several existing termination clauses within the ISDA agreement could be automatically triggered post-Brexit, for example:

- Force Majeure;
- Impossibility or Illegality Termination Event;
- Tax Event Termination;
- No violation or conflict with applicable law;
- Consents; or
- Breach of agreement or Maintains Authorisation (judged unlikely by ISDA)[7].

Concern over such possible triggers would in many cases call into question the legal certainty required to enable a Financial Institution to be able to benefit from a netting agreement in its exposure and capital calculations. Many derivative contracts will therefore need to be amended to reflect new legal and regulatory frameworks. This is in many cases a practical infeasibility for firms to do this on their own.

Overall, it is important to note that none of the ISDA Master Agreements (1992 or 2002) include a construction clause that would help to "automatically" update the agreement. Such a clause can, for example, be found in lending documentation such as the standard LMA document, in which the provisions states that "a provision of law is a reference to that provision as amended or re-enacted".

7 ISDA (2018): Brexit FAQ, https://www.isda.org/2018/04/10/brexit-faq/

In the past, ISDA has dealt with such industry-wide issues by issuing 'online protocols' to which parties can adhere, thereby updating all their existing documentation in the process[8]. However, no such Brexit protocol has been issued so far.

CHOICES OF JURISDICTION

The enforcement of derivative contracts depends, among others, on the choice of jurisdictions by counterparties. English Law, with London as a jurisdiction, is a favourite (along with New York) for most derivative contracts. In financial contracts, the jurisdiction of choice for the contract often differs from the domicile of the parties.

In the case of a hard Brexit, the UK would likely also exit the Recast EU Brussels Regulation (Recast Regulation). The general position under this regulation is that proceedings against a party must be brought in its place of domicile unless the contract in question contains a clause conferring jurisdiction on a named country. The Recast Regulation also allows for the mutual recognition of jurisdictions within the EU. The UK would also exit the Rome I and Rome II Regulations. In brief, in matters concerning contractual obligations, Rome I give effect to the parties' choice of law and provides rules to determine the applicable law where no choice has been made. Rome II provides a similar mechanism for ascertaining the applicable law for disputes arising out of non-contractual obligations, for example, claims in tort[9].

Hence, theoretically, without the Recast Regulation, there could be some uncertainty as to whether the English courts would have jurisdiction to hear a specific case in which the parties are not domiciled in the UK, or whether an English law judgement could be enforced elsewhere in the EU, and vice-versa.

However, several international conventions could remediate this, such as the Lugano Convention. The UK would have to join and adhere to these post-Brexit[10]. The UK could also consider integrating Rome I and Rome II into its domestic body of law, e.g. as part of the Withdrawal Agreement.[11]

UNCLEARED OTC DERIVATIVE IN A CATCH-22

There is an existing category of contracts that is already a 'grandfathered' type of contracts, allowed to mature despite the implementation of a new regulatory requirement: those are the uncleared OTC derivatives that pre-date the implementation of EMIR and its Article 4 on the obligation to clear any new or novated[12] derivative contract (with exceptions and conditions). It is estimated that about a quarter of OTC derivatives are not currently cleared[13].

For those uncleared OTC derivatives, the grandfathered contracts, lifecycle events such as novation and compression would still be considered as regulated activities in most EU Member States[14], and the resulting new contract would have to comply with any existing (i.e. new) legal and regulatory regime.

Assuming a hard Brexit, or a minimal Free Trade Agreement without mutual recognition and delayed equivalences, consider the following two outcomes for an EU firm dealing with a British counterparty, with an uncleared contract under English law:

1. A firm could, under a grandfathering agreement, retain a legacy portfolio of derivatives in the UK, but they would not be able to actively manage it as any lifetime event, such as novation or compression, would be a regulated activity for which passporting or equivalence is required; and
2. The uncleared OTC contract could be transferred to an EU legal entity (instead of a UK one), in which case, it would lose its "grandfathering right" (only given to cross-border contracts UK-EU) and fall under EU regulatory scope and EMIR clearing obligations.

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8 Ashurst, ibid

9 Bird & Bird (2018): Brexit: cross-border dispute resolution implications, https://www.twobirds.com/en/news/articles/2018/global/brexit-cross-border-dispute-resolution-implications

10 Ashurst (ibid)

11 Bird & Bird (ibid)

12 Derivative contracts go through lifecycles, during which they undergo transformations. Two main transformations are 'Compression' (some (or all) offsetting contracts are replaced by an equivalent derivative) and 'Novation' (an existing contract is transferred to a new legal entity). Both would give rise to a new contract, subject to any existing regulatory requirement.

13 The Economist (2017), Standing novations, https://www.economist.com/finance-and-economics/2017/10/12/brexit-will-give-the-derivatives-market-a-nasty-headache

14 ISDA (ibid)

Even if the choice is to transfer uncleared derivatives contracts to an EU legal entity, this process of novation requires the agreement of all counterparties on any given contract, which could become a logistical hurdle. A more 'generous' grandfathering law, which would take those constraints into account is maybe possible, but it would be complex and require close cooperation between the EU and the UK.

COUNTERPARTY RISK EXPOSURES

A key purpose of master agreements such as the ISDA is to reduce counterparty risk exposures. Prudential regulations, such as Basel III / CRR recognise the mitigating benefit of such agreements, provided that they are supported by current legal opinions appropriate to the jurisdictions involved. Post-Brexit, legal opinions for UK-EU transactions will need to be renewed, to take account of the terms (if any) under which the UK has left the EU. Where these opinions are qualified, the eligibility of netting for regulatory reporting purposes would be drawn into question, thus substantially increasing Banks reported counterparty exposures and therefore capital requirements. Matters such as those discussed in the sections above would influence whether or not positive opinions are available to support these capital influencing decisions.

IN CONCLUSION

- Absent Treaty agreement to provide appropriate contractual continuity, novation of existing contracts with material counterparties should take place, to mitigate the risks of discontinuity. Contracts which are currently uncleared would thus become subject to mandatory clearing requirements.
- With grandfathering agreements in place, automatic novation would not be required, but transactions in a designated legacy portfolio of uncleared trades would not be eligible for inclusion in compression agreements without prior novation and clearing.
- Financial institutions should at the very least have stand-by planning in place to enable these novations and possible associated clearing requirements, together with critical path analysis to identify the latest plausible moment for starting these transfers.

3.2 Euro Clearing

Since its launch, the Euro-clearing market has been sustaining consistent levels of growth with the significant share of that growth taking place in the UK. In 2017, less than 5% of the Euro-clearing was undertaken in a Eurozone country and just last year, LCH.Clearnet, in London, cleared more than GBP 175tn of euro-denominated derivatives or about 75% of that market.

However, the location of this Euro-clearing hub that is now London has more than once ruffled the EU's feathers. This was notably the case during the euro-crisis, in 2011, when LCH.Clearnet decided to increase haircuts for margins for Irish and Portuguese government bonds. In 2015, the British Government won a court case at the European Court of Justice (ECJ) against the ECB, which sought to have Euro-clearing activities located exclusively in the Eurozone. Concerns within the EU regarding Euro clearing outside the Eurozone have increased since the start of the Brexit process, and thus reflect various regulatory proposals, including:

- Future modifications to EMIR, to limit the volume of Euro clearing conducted in non-EU CCPs; and
- New ESMA standards, increasing scrutiny on the use of non-EU CCPs by EU domiciled firms.

Furthermore, all CCPs in the UK will need to renew their authorisation to operate under EMIR via Equivalence, a process which cannot be assumed to be painlessly delivered.

The EU's views on Euro-clearing are in principle about managing regulatory and political concerns, although some suspect a more mercantilist motivation. Robust clearing houses can be, among others, an effective barrier to threats of contagion during a financial crisis. The EU is keen to maintain a regulatory oversight over systemically important CCPs for Euro-denominated derivatives and the capacity to intervene if that were to be needed. This explains the desire of the EU to extend regulatory power and oversight over Financial Market Infrastructure located in a third country.

WHAT ARE THE POSSIBLE OUTCOMES UNDER THE VARIOUS BREXIT SCENARIOS?

CCPs operate under the European Market Infrastructure Regulation (EMIR) on over-the-counter (OTC) derivatives, central counterparties (CCPs) and trade repositories (TRs), or EMIR.

The possible regulatory outcomes of various Brexit scenarios are listed below:

1. Soft Brexit (EEA), with continuation of Passporting: Limited transition required. In the short to medium-term it would be business as usual. However, potentially there could be continued reluctance regarding UK Euro clearing from the EU over time.
2. Hard Brexit, with Mutual Recognition agreement: The mutual recognition of UK regulatory framework for CCPs could work because the current setup will be largely inherited from EMIR, which is now transposed into domestic law through the Great Repeal Bill. In the short-term, there could be potential uncertainty during the negotiation and a new way forward must be established. In the medium and long-term there would be much regulatory convergence and potential stability.
3. Hard Brexit – Equivalence: The UK becomes a third country and there is no automatic recognition in the EU of the equivalence of its regulatory framework. London-based CCPs must apply for equivalence rights under EMIR. Equivalence is granted based on the assumption that a third-party regulatory regime will deliver outcomes deemed desirable by the EU, hence some degree of regulatory convergence is likely. Timings are problematic as discussed below, but the free trade agreement could contribute to expedite the process.
4. No Deal: The UK becomes a third country, there is no recognition of its regulatory framework. In the short-term, London-based CCPs could still apply for equivalence under EMIR, but the lack of an FTA would hamper that process. Pending resolution of political agreement, London based CCPs would cease to be 'Qualifying' CCPs, with undesirable capital consequences for their clients.

The British governments official position is that the UK seeks to leave the single market (EEA) and therefore leave EMIR. It also seeks an FTA, with a financial services framework based on either mutual recognition or (possibly enhanced) equivalence. Such an outcome would provide a mechanism for continued EU approval of UK-based CCPs, albeit with the potential for significant short-term uncertainty and upheavals but solutions for minimised disruptions in the medium-term and at least some degree of regulatory convergence in the long-term, even if accompanied by dissensions.

THE ROAD TO EQUIVALENCE

As illustrated above, various scenarios could see London-based CCPs apply for equivalence under EMIR, under Art. 25 and 13. A high-level overview of the process is provided below. The road to equivalence, as defined under EMIR by ESMA, is thus:

1. the European Commission needs to have adopted an Implementing Act determining, amongst other things:
    a. That the legal and supervisory arrangements of the jurisdiction in which the CCP is established are equivalent to the requirements laid down in EMIR (Article 25(2) (a) of EMIR); and
    a. That the jurisdiction in which the third-country CCP is established needs to have equivalent systems for anti-money laundering and combating the financing of terrorism to those established in the EU (Article 25(2) (d) of EMIR).
2. Application to ESMA under Art. 25.

The road to equivalence is however arduous and long. Scarpetta and Booth (2016) have estimated that such equivalence application process could last anywhere between two and a half and four years, with two years being a low boundary, mostly reached by countries that were also in negotiation for Free Trade Agreements with the EU. This contrasts unfavourably with the 21-month transition period anticipated by the UK and EU. Hence, timing will be of the essence and much political, legal and regulatory uncertainty are likely to prevail.

CONCLUSIONS

Given the UK objective of leaving the EU and EEA, and the EU objective of using CCP control to better manage financial stability, the most likely outcome appears to be one which is based upon equivalence: UK CCPs will need to re-apply for permission to operate (with EU counterparts) under EMIR, and this permission is likely to be subject to both thresholds and joint UK-EU oversight. Short term, this will create uncertainty, with the attendant risk of mandatory novation of clearing contracts to Eurozone CCPs. Medium term, the trend is likely to be one which encourages the growth of these Eurozone CCPs, with regulatory steering of EU firms in this direction. Longer term, this may precipitate a secondary, offshore market in Euro clearing for non-EU counterparties, outside of this regulatory framework.

WHAT TO DO TODAY?

Market participants should have two objectives of:

1. Managing uncertainty today, and
2. Developing contingencies and options based on 'bad' and 'worst'-case scenarios.

For both, preliminary impact-assessments of various scenarios are vital, and data generated will be a key input to any Brexit programme:

- Develop specific scenarios for the entity / what is the worst scenario / sensitivity analysis.
- Develop options to manage the entity's activities in a 'Brexit-proof' manner:
  - » For any new or modified derivative, consider alternative clearing arrangement. Could this derivative be cleared elsewhere and not be subject to Brexit-related uncertainty?
  - » Do new or modified contracts include specific clause that could soften the disruption of Brexit by providing guidance for various Brexit-related outcomes?
- For existing derivatives and clearing arrangements: could a re-papering exercise already provide safeguards against disruption? Or is not worth the re-papering cost quite yet?
- Engage with stakeholders and the industry to refine understanding of options and current context.

DEVELOP CONTINGENCY PLANS

- For each specific scenario developed, identify triggers that would flag the "moment to act" to implement contingency plans. This should at a minimum include establishing appropriate agreements with EU domiciled CCPs (as well as other Financial Market Infrastructure providers), to ensure continuity of service for new transactions. One should also closely monitor cross-border trading volumes, and stand ready to novate where exposures breach pre-determined risk levels.

3.3. Data protection and Brexit

The European Union's new General Data Protection Regulation (GDPR) came into effect on the 25th of May 2018. The Regulation significantly changes and extends existing rights of data subjects in the EU and obligations of entities processing and transferring personal data in the EU and in third countries. This is particularly relevant for international firms whose European HQ is operationally located in the UK, with EU offices accessing systems and data held in the UK.

Given that GDPR has already been fully implemented into European law, it is binding in the UK and will (assuming a transition period) continue to be binding until the end of 2020[15]. The key question is how Brexit will impact financial institutions transferring data from the EU to the UK and vice versa, e.g. between a UK data centre and an EU hub. In order to determine the impact of this issue, three different scenarios are described below.

SCENARIOS

There are, broadly speaking, three scenarios with different outcomes on the transfer of personal data as a result of the current Brexit negotiations between the UK and the EU. As can be seen below, these are:

15 Council of the European Union, XT 21004/18 ADD 1 REV 2, Brussels 29 January 2018, §22

1. A 'soft' Brexit, which would result in the UK maintaining GDPR compliance through the membership of the European Economic Area (EEA);
2. A 'hard' Brexit, but with an agreed framework for future relationships in place – Here, the UK would seek to be recognised as an "adequate country", such as Switzerland or Canada, in order to be able to transfer data on this basis; or
3. Limited or no deal, in which case the UK would become a third country and financial institutions would have to resort to using appropriate safeguards to continue the transfer of personal data.

Figure 1 – Data transfer Scenarios

SOFT BREXIT

The first scenario is a soft Brexit deal, under which the UK retains EEA-like membership. Since the GDPR is an EU Regulation, it has direct applicability and direct effect in all EU Member States (incl. the UK). For EEA countries the system is slightly different. Once the GDPR has been deemed to be an EEA-relevant EU legal act, like the Data Protection Directive before it, all EEA members are also required to transpose the GDPR into their national law.[16]

This scenario would not impact the transfer of personal data. For financial institutions this means nothing will change. The UK would go from being an EU Member State to being an EEA member and maintain access to the Single Market. This means all transfers of personal data would continue to take place within the Single Market and no additional measures to ensure the transfer to a third country would need to be taken.

16 The GDPR has been evaluated as EEA-Relevant according to: https://planit.legal/blog/en/the-applicability-of-the-gdpr-within-the-eea/

HARD BREXIT - ADEQUACY

In the scenario that the UK decides to leave the EU and not to join the EEA, this does not have to mean there will be an impact on the transfer of personal data. The GDPR allows for the option of transferring data to third countries, which have the status of 'adequate', as decided on by the European Commission.[17] In assessing whether a country is adequate the Commission looks at criteria relating to the rule of law, the functioning of the supervisory authorities and the international commitments into which the third country has entered.[18, 19] Current countries which are deemed to be adequate to the EU include Canada and Switzerland.[20]

17 Article 45(1) GDPR

18 Non-exhaustive summary of the requirements for article 45(2 sub a) GDPR

19 Article 45(2) GDPR

20 https://ec.europa.eu/info/law/law-topic/data-protection/data-transfers-outside-eu/adequacy-protection-personal-data-non-eu-countries_en

If the UK receives the status of adequate, transfers of personal data between the EU and the UK remains possible using normal GDPR compliant contracts. If adequacy is not applied (immediately) it might be the case that the UK and the EU sign a separate treaty with regards to the transfer of personal data, similar to the US-EU Privacy shield agreement.[21] One should however caution that adequacy decisions take time, and Privacy Shield doesn't automatically apply to the UK post-Brexit[22].

NO DEAL

In the scenario that the UK and the EU do not reach a deal (on data protection, or at all), there is one final option to ensure that transfers between the UK and the EU remains viable. Article 46 of the GDPR allows for the transfer of personal data in the case where both the processor and the controller have put in place appropriate safeguards.[23] According to the latest notices from the EU, the following safeguards seem to have the highest success rate[24]:

1. Standard data protection clauses.
2. Binding corporate rules (BCR).
3. Approved Codes of Conduct.
4. Approved certification mechanisms.

For these suggested safeguards, we suggest the following approaches: For Intragroup transfers BCR approved by the competent data protection authority, would provide the best option.[25] These have to be approved: this takes time, and the wait times are likely to increase in the event of a no-deal Brexit, so companies may wish to apply now as a precaution[26].

For transfers from a Controller to a Processor, the standard data protection clause provides the best safeguard. Currently there are three types of standard data protection clauses approved by the European Commission, of which one is focused on data transfers between EU controllers to non-EU or EEA processors. These clauses could be used to ensure continued transfers in the case of a no deal.[27] Transfers based on standard data protection clauses approved by the European Commission, or on binding corporate rules, will not be subject to a further specific authorisation from a supervisory authority. Note that data transfers are constrained not only by the negotiations between UK and EU but also by a large number of agreements and notices between Data Controllers, Data Processors and Sub-processors, and Data Subjects themselves. Many of these agreements and notices are based on optimistic assumptions about the status of the UK after Brexit, and could therefore become invalid under certain scenarios, with consequent uncertainty about the legal liability for any privacy breaches or other adverse incidents.

It is important to realize however, that these standard data protection clauses should be implemented on top of additional requirements from the GDPR regarding data transfers. This means that if there is a no deal scenario, additional work is required to maintain GDPR compliance. In addition, it is deemed to be best practice to apply for approved codes of conduct and certification (once these become available) when transferring personal data to third countries.

CONCLUSION

To summarize, the Brexit impact on data transfers depends on the nature of the UK-EU withdrawal agreement.

Depending on the outcome of the negotiations one of three scenarios may occur after the transition period:

- The UK joins the EEA which would mean it will still apply the GDPR,
- The European Commission decides the UK is adequate with regards to data protection and transfers of personal data can continue unhindered, or
- If neither of the previous scenarios happen financial institutions can decide to put in place appropriate safeguards in addition to their normal processing contracts, which would allow the continued flow of data.

21 However, given the uncertainty surrounding Privacy-shield this option will not be further explored in this paper

22 https://www.lawfareblog.com/no-privacy-shield-no-parachute-brexit-cliff-edge-and-data-regulation

23 Article 46(1) GDPR

24 Directorate-General Justice and Consumers, Notice to Stakeholders, Brussels, 9 January 2018

25 List of companies which can implement a BCR: https://ec.europa.eu/info/law/law-topic/data-protection/data-transfers-outside-eu/binding-corporate-rules_en#listofcompanies

26 https://ico.org.uk/about-the-ico/news-and-events/news-and-blogs/2017/11/blog-changes-to-binding-corporate-rules-applications-to-the-ico/

27 European Commission decision 2010/87/EU

Of the different outcomes mooted, a baseline for planning would be an exit from the EEA, but with an agreement in place which enables inter alia the transfer of personal data via an Adequacy ruling: such an outcome would not materially impact data management. The tail, or political risk however remains, namely that a ruling on Adequacy would be either denied or withdrawn at short notice: these risks require the maintenance of detailed contingency plans, addressing extreme scenarios under which UK-EU data transfers become restricted in law.

3.4 Re-Licensing and Authorisation

Any scenario in which the UK leaves the EU/EEA implies a loss of passporting. In certain alternative scenarios, such as equivalence, partial market access can be continued in those areas specifically defined by regulation (see above). However, even in the most generous of such scenarios, there is a substantial loss of market access. Firms currently conducting such activities will need to review the viability of these activities post-Brexit, and for those businesses which are to be continued, ensure that appropriate licensing exists within the EU.

In practice, this means that many firms will need to either increase the scope of an existing EU licence, or seek a new one altogether. How this will work is discussed below.

ECB LICENSING

A central feature of the EU model for the post-crisis financial services regime is the requirement for firms to be authorised within an EU Member State. The conditions of authorisation impose a number of obligations - such as operational or transparency requirements - on firms irrespective of the Member State in which they are established. Authorisation in a Member State under such model is to a great extent a pre-requisite for being able to conduct business in the EU. Once authorised, a firm can use relevant passports to provide services and/ or market funds cross-border into other Member States without additional registration, authorisation or licensing obligations being imposed by that host Member State.

PRE-APPLICATION DISCUSSIONS

Whether it is necessary for a bank to apply for a new or additional authorisation will depend on several factors, such as for example local requirements or the form and extent of the current banking authorisation. When a bank does intend to expand its business activities, the ECB and local regulators should be contacted to clarify whether a new or additional authorisation is needed.[28] When applying for a licence it is important to consider the following information:

- The ECB and the national supervisors (known as National Competent Authorities or “NCAs”) see value in having preparatory discussions with banks interested in establishing or increasing their presence within the Euro area. Such discussions are encouraged on issues around applications as soon as the fundamental elements have been defined, and the firm has narrowed down any options of the proposed transformation or reorganisation plan. In particular, a firm needs to be able to demonstrate that it has sufficient systems and controls in place to manage the new business.
- The information requirements for the authorisation of credit institutions were further specified by the European Banking Authority in draft regulatory technical standards[29].
- Banks are expected to include in their applications a detailed business plan for all Euro area operations envisaged over the medium term (i.e. three years ahead), as well as full details on the long-term target operating model. Furthermore, the bank should also communicate in the authorisation process when they plan to commence operations, i.e. they need to provide a strategy that clearly sets out how they intend to implement the business plan and build up an adequate risk control system.

28 Significance can be determined using the following criteria: https://www.bankingsupervision.europa.eu/banking/list/criteria/html/index.en.html

29 EBA: Standards specifying information requirements for the authorisation of credit institutions https://www.eba.europa.eu/-/eba-publishes-final-standards-specifying-information-requirements-for-the-authorisation-of-credit-institutions

"COMMON PROCEDURES" FOR AUTHORISATION & EXTENSION

The procedure for granting authorisation or extending a banking licence if relevant, is one of what is known as "common procedure"[30], since local supervisors and the ECB work closely together on the authorisation of banks. The ECB and the national supervisors are involved in different stages of these procedures yet the ECB is responsible for these procedures with regard to all Eurozone institutions, i.e. for both Significant Institutions (SIs) and Less Significant Institutions (LSIs); it ends with the ECB taking the final decision.

All licensing applications are processed according to the 'common procedure', regardless of the Member State in which the application is filed. In a common procedure, a licence application or licence extension should be submitted directly to the relevant national supervisor of the Member State where the bank will be located, irrespective of whether the significance criteria are met or not.

All requirements in relation to authorisation will need to be met on an ongoing basis. Hence one can submit an application for authorisation even if the legal entity to be authorised is not yet established. Yet the documentation certifying the existence of the undertaking expected to be authorised needs to be submitted during the assessment period.

Finally, local supervisors may withdraw the authorisation granted if the authorisation granted is not used, i.e. the firm does not start its business operations within 12 months of the authorisation grant date[31]. However, this timeframe may vary per Member States.

THE AUTHORISATION PROCESS ITSELF

For those banks wishing to, relocate to, or expand activities in the Euro area and needing an authorisation for their expanded activities post-Brexit, the ECB and NCAs expect to receive authorisation applications as soon as possible but at the very latest by mid-2018, with a view to obtaining the required authorisations before 29 March 2019.

It should take 6 months for a decision to be taken regarding a licence application, once an application is complete. But this period may be shorter where the request is for an extension of an existing licence, provided that the national framework allows for such an extension and that there are no supervisory concerns over the existing SSM entity. Nonetheless, the ECB decision must be taken within 12 months of the date of the application.

The ECB have indicated that they will focus on five key areas when assessing license applications, namely: to ensure that subsidiaries have adequate local management capabilities, some access to financial market infrastructures, some hedging and trading capabilities, do not fully rely on intra-group booking and hedging strategies, and can provide accurate data on their local activities.

The ECB has issued a stern warning that relocating banks should have robust risk management capabilities in the Eurozone. This reflects their rejection of some of the early licence requests from global financial institutions, which gave rise to fear with the ECB that many systemic banks sought to establish 'brass-plate' operations in the Eurozone, without management substance. ECB officials say that if banks are lending to individuals and businesses in the Eurozone, they must manage that risk from inside the region and not London.

This theme is expanded upon in the next section.

3.5 ECB expectations for relocating firms

In establishing an EU hub within the Eurozone, the fundamental principle is that a firm is expected to ensure that the new entity is a robust, independent Institution, capable of standing on its own two feet without parental support. In assessing this resilience, supervisors are expected to pay particular attention to governance and organisation, market access, booking models, intragroup dependencies, and IT strategy. These expectations

30 For detailed information on the common procedures, see Articles 14/15 of the SSM Regulation, and Part V of the SSM Framework Regulation.

31 CRD IV, Article 18a.

were recently set out by the ECB in a paper on booking models.[32]

3.5.1 GOVERNANCE AND ORGANISATION

The aim is to ensure that an EU hub is correctly governed, implements robust risk management, and allocates appropriate resources to the execution of the risk management plan throughout the organisation.

GOVERNANCE

The key guiding principle here is very simple: everything that happens within the entity should be a consequence of a conscious decision taken by the Board of Directors of the local entity. In particular:

- The local Board approves the local business mandates, defining the nature of commercial activities that may be undertaken by staff in the first line, and the type of transactions that may be booked on the local firm's balance sheet.
- The local Board approves the risk management framework, including policies, controls, and reporting requirements, to ensure that the local firm's risk exposure remains within its approved appetite.

There are many implications of this governance statement. Fundamentally, it means that banks in the Eurozone should have control over their balance sheet and all their exposures. The local firm cannot be used as a booking centre for transactions managed from another location: establishing an "empty shell" company would not be acceptable to the ECB.

The local EU firm must also be capable of managing all material risks potentially affecting them. Therefore, the Board should devote sufficient time to the consideration of risk issues, and must ensure that adequate resources are allocated to ensure appropriate outcomes. Institutions must also have their own locally-based risk management function, independent of the operational functions, and with sufficient authority, stature, resources and access to the Board.

RISK MANAGEMENT

In developing the operating model for the EU entity, a number of risk management questions must be considered. Here, a number of conflicts may arise between a Group view of what constitutes an efficient operating model, and the ECB's objective of ensuring the financial stability of banks located in the Eurozone. An EU subsidiary might, for example, take the view that market and liquidity risk can best be managed through various intra-Group hedging and funding transactions. The regulatory concern is that this may create significant dependence upon a single entity, with unacceptable concentration risks. In discussions such as these, a prudential supervisor invariably focuses on tail risk: is a firm sufficiently firm to withstand a future financial crisis? What happens if there is a shock event, which means that (say) the London market is not operating normally? – what would the impact of such a shock be on an EU entity? – and what impediments might there be regarding local management's ability to implement recovery plans?

ORGANISATION

The definition of both the target operating model and the risk management plan imply the required level of local staffing. The general requirement is that a firm should ensure that sufficient staff are located in the local entity - as opposed to group staff utilising delegated rights - including both risk management and the front office. The ECB pays particular attention to whether the bank's local governance framework and staffing infrastructure, as well as risk management capabilities, are appropriate and commensurate with its business model and trading strategy.

- If the ECB accepts a business model whereby a bank carries out business in the Euro area, including capital market transactions, while it continues to use group-wide infrastructure, expertise and arrangements (e.g., a centralised risk management function) in a third country this would be following a strict assessment.

[32] ECB Banking Supervision (2018) : Supervisory expectations on booking models. https://www.bankingsupervision.europa.eu/banking/relocating/shared/pdf/ssm.supervisoryexpectationsbookingmodels_201808.en.pdf

- There is a strong expectation that an EU firm should also be in a position to respond directly and independently to potential enquiries by the ECB or national supervisors on all activities affecting the bank and provide information swiftly.
- If a firm plans on giving more than one role to staff on a temporary or permanent basis, i.e. with staff working for several group entities ("dual hatting"), the ECB and national authorities will carry out a thorough assessment to ensure that sufficient time is spent carrying out such functions in the supervised banks. Certain key roles should not be part of a dual hatting arrangement.[33]

The core requirements for a well-functioning bank must be in place before an institution takes up any banking activities in the Euro area. These can be developed over time, for example with some of the additional local capabilities and arrangements being built up in parallel. Such arrangements may be permitted by the supervisor on a case-by-case basis where aligned with the bank's business plan. Any arrangement must be based on a realistic and detailed business plan for the development of such capabilities, which should be included in the authorisation application.

3.5.2 BUSINESS ORIGINATION & FMI ACCESS

The risk management plan should describe carefully the EU Bank's business model, and the means by which the associated risks are to be managed. This should describe, amongst other items:

- The scope and scale of planned Financial Market activities.
- Proposed hedging and funding strategies, both for trading and balance sheet management purposes.
- The planned and required level of access to financial market infrastructure, for example clearing houses, exchanges and custodians.
- Ability to access multiple market sources and counterparts, to be able to respond to failure in one location through increased activity in another.
- The scope and size of internal arrangements of intragroup transactions and exposures.
- Counterparty concentrations and other large exposures.

The fundamental aim here is to ensure that an EU entity has continuous access to FMIs and a diversified set of counterparties, especially in times of crisis, and sufficient local front-office staff to execute on its business plan. In particular, plans for crisis management and resolution should be addressed, to allow e.g. for the possibility of being unable to access the UK market, either due to a hard/no-deal Brexit, or due to some future unknown crisis.

3.5.3 BOOKING & HEDGING STRATEGIES

The aim here is to ensure that there are strong controls around hedging and risk management practices together with managed concentration on hedging providers. Whilst market risk can be hedged via back-to-back transactions, the complete transfer of counterparty risk is much harder, and the compliance risk associated with sales cannot be hedged. Back-to-back firms are therefore expected to have adequate resources to identify and fully manage their counterparty credit risk, and any material risks that they have transferred in the event of the failure of their counterparty. Regulators are expected to pay special attention to large exposures or concentration risk to some counterparties, as resulting from systematic use of back-to-backs.

The ECB therefore expects that the risk generated by material product lines should be managed and controlled locally, with possible transitional arrangements allowed on a case-by-case basis. It expects banks to have permanent local trading capabilities and risk-management operations.

Since banks are also expected to be able to operate on a stand-alone basis, i.e. independently of group support, the ECB is expected to assess the extent to which banks meet (or plan to meet) these supervisory expectations when assessing booking models. Supervisory expectations vis-à-vis booking models will be applied proportionately according to the materiality and complexity of each individual institution's activities. This means that large banks, with a high level of interconnectedness and

33 This quarterly supervisory update warned about "double-hatting": https://www.bankingsupervision.europa.eu/press/publications/newsletter/2017/html/ssm.nl171115_2.en.html

complex capital market operations, will be subject to higher supervisory expectations and assessments. The specific requirements and possible transitional periods will depend, among other things, on:

- The structure of the booking model.
- The materiality and complexity of the business.
- The level of intra-group exposures.
- The underlying contractual relations and internal arrangements.

This will, for many firms, mean that they are expected to eventually establish a permanent local trading capability and local risk committees, including the trading and hedging of risks with a diversified set of external counterparties.

3.5.4 INTRAGROUP

Given the need to EU banking hubs to be able to operate independently, the ECB will check that they are able to independently monitor and manage risks arising from intragroup exposures and independently price and evaluate intragroup transactions.

OUTSOURCING ARRANGEMENTS

Banks are expected to have robust risk control mechanisms in to ensure that the implementation of outsourcing agreements (whether within or outside the group) is properly monitored and fully compliant with regulatory requirements. This also means that the operational independence of the supervised bank should not be compromised as a result of the outsourcing of functions or services; appropriate contingency procedures must be in place and regularly tested to ensure continuity in the entity's business operation.

It is also crucial that outsourcing contracts provide for local management and that supervisors have access to full information and the ability to inspect the entity providing the services. Generally, outsourcing arrangements will be reviewed and assessed by ECB and national supervisors on a case-by-case basis. Note that, after Brexit, it is assumed that the UK will be a 'third country' (i.e. outside the EEA) and thus activities outsourced to institutions in the UK prior to Brexit should be assessed with regard to the ability of the institution to adapt to this possible scenario.

LONDON BRANCHES OF AN EU ENTITY

The ECB considers that the purpose of branches in third countries is to meet local needs, and therefore does not expect that branches in third countries perform critical functions for the bank itself, or provide services back to customers based in the EU. A proposed EU bank is therefore expected to clarify the role (if any) of branches in third countries and the UK in their Brexit plans. This means providing detailed information on the branch's activities, organisational structure and geographical distribution of customers, as well as on the persons responsible for managing the branch and any proposed arrangements for dual hatting involving other group entities.

The longer-term implications of this ECB policy statement are likely to have significant impact on the long-term allocation of business between London and the EU-27. In particular, this implies that EU headquartered banks with a significant trading business based in a London branch can expect to receive challenge from the ECB regarding the ongoing role of said London branch in their operating model, with a possible repatriation of activates mandated.

3.5.5 IT STRATEGY

The ECB's key objective is to ensure that all EU based hubs are able to deliver all required regulatory reporting to the required quality and deadline. More generally, there is an implicit expectation that the EU hub complies with the principles set out in the Basel standard BCBS 239 for risk reporting[34].

Given the increasingly complex nature of ECB reporting, with new requirements such as AnaCredit creating significant burdens for regulated firms, this is a non-trivial goal. Whilst the ECB is focussed on the objective

34 Basel Committee for Banking Supervision (2013): Principles for effective risk data aggregation and risk reporting, https://www.bis.org/publ/bcbs239.pdf

– timely delivery of quality reporting – Banks must determine how this is to be achieved, and to what extent it can be achieved via systems located outside the EU (e.g. in London, North America or Asia), where the local configuration reflects a different set of regulatory objectives. Significant reconfiguration and/or relocation of management information systems is likely to be required.

4. Conclusion

International banks are currently in the process of finalising their Brexit strategy, including location, booking model, resources, business model, and permissions. The challenge faced by many is uncertainty: how will the political negotiations end, and what will this mean for business?

Banks increasingly use scenario-based planning for planning and forecasting exercises. Applying this approach, one would develop the following core scenarios:

- A base case, based upon reasonable assumptions regarding most likely outcomes. This forms the basis of planning.
- A negative case, based upon key risks to the base case. This forms the basis of contingency preparations.

In this final chapter, a base case is proposed. Clearly, each firm will have its own view as to what constitutes a base case, but the general principle of the approach is easily modified.

4.1 Withdrawal Agreement

Whilst the end state is not yet known with certainty, much less agreed by the respective parliaments, the broad contours of the UK-EU Withdrawal Agreement (WA) are emerging. The complexities of Northern Ireland border may yet delay or even derail negotiations – this is a problem which has plagued British politics for centuries – but is unlikely to materially impact the long-term direction of any discussion regarding financial services.

Key points of the Withdrawal Agreement are expected to include:

- Formalisation of a transition period (to end 2020), for which period the UK continues to benefit from EU market access and be fully subject to EU law. The key risk relates to the approval process, with a non-trivial likelihood of non-approval and political crises. Contingency planning is essential for such an eventuality.
- The UK will exit the EU Single Market for services on 1st January 2021. It is expected to seek a Customs Agreement[35] with the EU to facilitate the free movement of and trade in manufactured goods. Regulatory alignment would in this scenario be maintained in certain areas, facilitating Equivalence Agreements in selected areas, but the UK will no longer enjoy the full benefits of EU membership. The risks here relate to the details of the equivalence process: will all equivalence agreements be approved, and on what terms? - or will political disharmony prevail?
- The Withdrawal Agreement will not include a Free Trade Agreement. Instead, the Withdrawal Agreement is expected to be accompanied by a Political Declaration, which will commit both sides to the negotiation of a future Free Trade Agreement. Such a future FTA is unlikely to include Financial Services within its scope: here, concerns regarding financial stability and crisis management will likely over-rule any commercial considerations.

4.2 Impact on Financial Services

The base case starts with expiration of cross-border UK-EU passporting of licences at the end of 2020. UK proposals to establish a system of 'Mutual Recognition' are unlikely to be acceptable to either the ECB (concerns regarding financial stability) or those Member States with aggressive mercantile policies. The basis of future UK-EU finance will therefore likely be the Equivalence regime, under which

35 Ref e.g. UK Government policy paper ('Chequers Proposal'): https://www.gov.uk/government/publications/the-future-relationship-between-the-united-kingdom-and-the-european-union

the EU grants partial market access to firms licenced in jurisdictions with fully aligned regulations, subject to strict conditions.

Given the global importance of the City of London, a future framework could be one which - in some respects - is comparable to existing EU-US arrangements, based on bi-lateral supervisory relationships, and agreed equivalences of key regulations in certain specific areas. As alluded to above, the key risks relate to the complexity of the equivalence process. There are many different regulations in scope for this (for example, EMIR, MiFID, GDPR), and many different supervisory discussions will be required before the final scope of equivalence is agreed. This uncertainty is likely to be a key feature of the next phase of the Brexit negotiations, taking place during and after the transition period.

If one assumes that equivalence, where permitted, is granted, then the bones of the future framework become clear. This framework, however, implies the permanent loss of much of the City's EU27, non-institutional business, much of which would – given the restrictive nature of Equivalence – need to (re-) booked in an EU entity, with booking and operating models updated accordingly for Eurozone banks. Those future activities not covered by the Equivalence regime will therefore be subject to mandatory relocation, with financial institutions required to establish substantive operations within the Eurozone.

4.3 Planning Considerations

An oft-expressed concern is the amount of time needed to fully establish a fully operational EU hub, given the high standards set out by ECB/EBA/ESMA. Firms therefore need to define a roadmap, which includes both the key Brexit milestones, as well as the implementation schedules for regulatory initiatives, such as the Targeted Review of Internal Models (TRIM) and "Basel 4". Key objectives for such a roadmap include:

- Ensuring that all required authorisations are in place in time for Brexit day (29th March 2019). Given that detailed documentation regarding the future business model and plan is a sine qua non of these authorisations, it is therefore expected that all decisions regarding the future booking and operating model have been made by this data, and that comprehensive implementation planning is available.
  - » This is supplemented by contingency planning to enable a rapid management response to an unexpected, 'crash' Brexit without transition period. Such a plan should be fully aligned to an Institution's recovery plan and address amongst others the topics raised in this paper, such as continuity of derivative contracts, access to financial market infrastructure, ability to transfer data cross-border, and availability of required financial authorisations.
- Delivery of a viable entity no later than end 2020. The transition period is intended to be the period in which implementation (not planning) occurs, and the many complex and challenging operational and technology related challenges are addressed[36].
- Many international firms have (substantial) IT systems and data in London. This creates numerous challenges in terms of being able to demonstrate an independent regulatory reporting capability, and being able to mitigate possible future GPDR risks.
- Integration of relocation with other regulatory milestones, such as TRIM and Basel 4. A relocating firm will need to have a clear view regarding its long-term strategy for deployment of internal models, coupled with a sense of short-term pragmatism: for example, given the forthcoming changes to the regulatory model landscape, a short period on CRR Standardised Approach may be preferable to a (costly, lengthy) internal model application ahead of the transition to the new rules. Recognising the challenges, the ECB has flagged an indication to 'grandfather' internal models in a number of cases, for example, where the model to be transferred has an existing PRA approval under CRR, does not have material performance issues, and is to be transferred to a comparable portfolio.

36 Source: ECB Supervision newsletter, May 2018: https://www.bankingsupervision.europa.eu/press/publications/newsletter/2018/html/ssm.nl180516.en.html

4.4 Longer-Term Considerations

Brexit is not a merely one-off relocation project. With future UK-EU trading relationships based on some form of equivalence, each new European Regulation or Directive with financial services relevance will require a corresponding change to rules in the UK, and not all of these changes will necessarily be forthcoming from the UK authorities. The scope and applicability of Equivalence cannot be assumed to remain constant over the course of the next decade, as both parties adjust to the new normal. Each change to the size and scope of equivalence will imply additional changes in UK-EU financial services, with the EU hub assuming greater responsibility with each regulatory change.

It is sometimes said that we tend to overestimate the effect of a change in the short run and underestimate the effect in the long run. Brexit is precisely one of those occasional, seismic events for which this remark is suited: the longer-term implications are likely to be far-reaching.

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