“Brexit means Brexit“– but what does it mean for companies in the financial services sector?

The Brexit process poses many outstanding questions and major uncertainties. The United Kingdom (UK) will be leaving the EU in March 2019, but a detailed schedule for implementation in the financial services sector is still open.

Financial entities will therefore be forced to consider restructuring options and strategic alternatives.

This article provides an overview of the current situation, implications, and potential responses. Regarding to the high level of complexity, and various possible options financial entities have to prepare for Brexit:

Act now rather than reacting later!

The starting position: uncertainty all over

The UK decided to leave the EU in a referendum held on June 23, 2016. The communication to the EU Council as well as the official request followed in March 2017. Article 50 of the Lisbon treaty specifies a two-year separation period to conduct the negotiations between UK and EC.

The first conversations between the European Commission (EC) and the UK started in July 2017. The EU will only accept further negotiations about future relationship with the UK once Brexit is completed.

The current lack of political clarity coupled with a great deal of speculation is characteristic of the mood in recent months. Uncertainty is rife.

Brexit: Process and Timeline

Brexit is scheduled for completion on March 29, 2019. On this date the UK will officially be leaving the EU. To start off, negotiations regarding withdrawal from the EU will follow the 2017 guidelines issued by the EC. Further negotiations relating to the future relationship between the EU and the UK will take place afterwards, and shall be completed by October 2018. It should be noted here that comparable negotiations for trade agreements usually took six to nine years to complete. Moreover these agreements did not cover financial services… so Brexit negotiations enter uncharted territories.

It is expected that the remaining 27 EU member states (EU 27) will host a joint Brexit-summit in October 2018 to establish a final framework for the exit.

Banks, financial services providers, insurance companies, asset managers as well as the European Banking Authority (EBA) – which is currently located in London – will be severely affected by the impending exit. It is the EBA's purpose to set or implement common European standards for the Banking Supervisory Law.

As a consequence of Brexit the EBA is planning to leave London. Until now eight European countries (Belgium, Ireland, Germany, France, the Czech Republic, Luxembourg, Austria and Poland) have applied to become the future location of the EBA. The ministers of the EU 27 member states will determine the relocation of the EBA in November 2017.

Fig. 1 – The Brexit process – The three most important phases:

Negotiations

The delegations of the EU and UK will be getting together for several rounds of negotiations.

- Initial talks started in June 2017
- Most of the negotiation process will be taking place in a period of only 10 months – between January 2018 and October 2018

Ratification

Expected for October 2018: Brexit summit meeting – Alignment within EU 27

- All ratifications/votes by national and regional parliaments have to take place until March 2019
- A possible Scottish referendum could occur could occur after Brexit

Brexit

UK will be leaving the EU on March 29, 2019

- All ratifications of the Brexit negotiations take effect on this day
- If no agreement is reached by then, the UK-EU trade relationship will fall back to WTO rules

At the moment neither politicians, nor affected supervisory authorities or the financial institutions know what the future banking landscape will look like. It is for this reason that in the first half of 2017 financial institutions in the UK have been requested by the Bank of England (or more specifically the Prudential Regulation Authority (PRA)) to provide information on how they are implementing their Brexit plans. The ECB asked a similar question to financial institutions in the Euro area which are conducting business in the UK. The PRA has announced in early August that it has received more than 400 answers by market participants, but these remain to be evaluated. With its request of "contingency plans" the PRA is hoping to foster a frictionless transition for financial markets. One special focus is on a Brexit-scenario with no contractual arrangements between the UK and the EU at the time of the exit.

Possible Brexit-scenarios and the possible courses of action rising out of each one of them are shown in Figure 2.

For the sake of completeness, political scenarios also include the possibilities of an "Exit from Brexit" as well as a "Cherry Picking" scenario. Though many possible scenarios are being discussed, most experts consider "Hard Brexit" the most likely outcome. The different Brexit-scenarios will affect the alternative actions of individual market participants.

The Brexit-scenarios

Exit from Brexit

Even though Britain's exit from the EU is already declared in accordance with Article 50 of the Lisbon treaty, backing out cannot be completely excluded.

Hard Brexit

There are different forms of a "Hard Brexit": It is possible to reach a free trade agreement between the EU and the UK in time or the separation will be executed without the establishment of such an agreement. An uncontrolled exit would have significant consequences for both the European and the British economy.

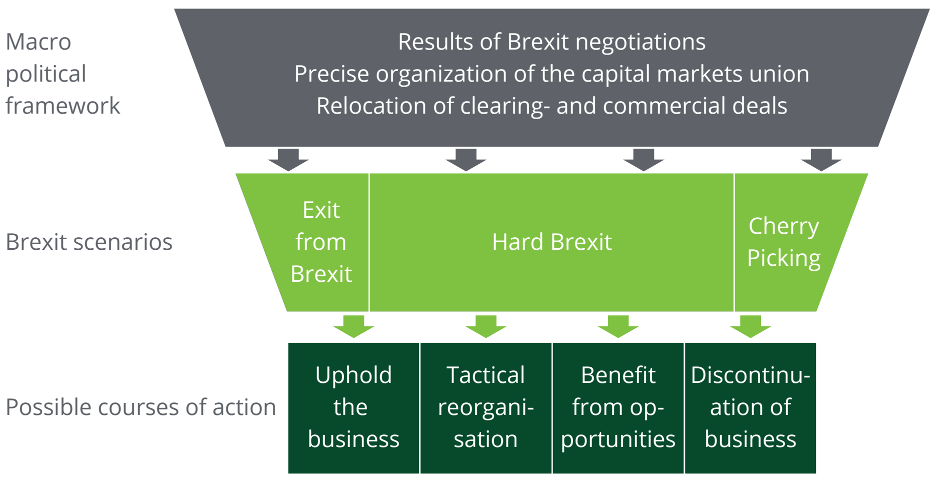
All previous free trade agreements have only covered the exchange of goods and such have not so far provided a framework for financial services. An agreement between the UK and the EU, which will have a positive impact on the financial services sector, is not expected to be completed due to the tight timeline of negotiations.

Cherry Picking – the best of both worlds

An arrangement providing the UK with nearly all privileges of a membership and at the same time without taking on the obligations of such a membership would be interpreted as an impressive negotiating success for the UK. However, this is not likely to happen because of the possible "copycat effect". Further considerations of this scenario are not helpful because the preconditions to enable such a scenario are simply not there. These preconditions include: access to the internal market to provide services, the recognition of the European Court of Justice, and co-regulation.

In light of the aforementioned and recent developments, other options and alternatives for financial institutions in light of a "Hard Brexit" scenario will now be presented in more detail.

Fig. 2 – Scenarios



How should financial institutions act considering (the likelihood) of the scenarios mentioned

There is an urgent need to adapt to the consequences of a "Hard Brexit". Waiting for a political decision is not an option, as the time that remains will be insufficient to take appropriate action.

No matter which scenario actually transpires, financial institutions have already taken on enormous costs analyzing and projecting the situation. According to a study by Deloitte conducted in April 2017, 40 percent of the interviewed financial institutions have already drawn up an internal Brexit task force for evaluating possible impacts.

Besides the increased expenditures, the situation is also made more difficult by the time pressures described above. Unfortunately, these have been increasing with the ongoing uncertainty and waiting period.

Current developments for financial institutions acting out of the UK

It can currently be observed that in response to Brexit more and more financial institutions are planning to shift parts of their business activities away from London to the EU 27. They will try to obtain a banking or financial services license in another EU country to be able to continue their activities within the EU or the European Economic Area (EEA) via affiliates or subsidiaries. If an affiliate has received the license, it can use the EU passport in order to establish branch operations or to offer cross-border services.

Besides location decisions for Paris, Dublin, Madrid or Luxembourg many financial institutions have already announced to transfer their EU business operations to Frankfurt. Infrastructure, talent pool, the tax system as well as the being close to customers, other market participants and the ECB are the main factors considered while deciding on the location.

Many institutions have to consider carefully which license to apply for. Whereas a full banking license (deposit-taking bank/ CRR credit institution) will allow them to perform all kinds of banking operations, many institutes take more restricted licenses such as a securities trading license or a financial services license into consideration. Licenses for investment firms are not subject to decisions made by the ECB. These companies are exclusively supervised by local regulatory authorities, i.e. BaFin in Germany, and are not part of the Single Supervisory Mechanism (SSM) in which the ECB supervises CRR-deposit institutes.

Investment firms in general expect a faster licensing process. At the European level however a regulatory "race to the bottom" is feared, which puts various countries in competition in order to attract the investment firms with comparatively flexible requirements for the implementation of regulations. Having said that, if a company still opted to form a CRR[1]-deposit institute, the question arises whether it will become a Significant Institution (SI) or a Less Significant Institution (LSI).

Therefore, choice of location is of central importance as the significance of an institution is, inter alia, measured by its size in relation to GDP. In smaller EU countries this threshold is significantly lower than in larger economies.

Furthermore, it is possible to run several subsidiary companies to ensure that individual subsidiaries do not meet the relevant thresholds. Further in discussion are structures comprising a small subsidiary and simultaneously setting up a branch in a third country operating as a Booking Entity which currently is not subject to direct supervision by the ECB.

[1] CRR – capital requirements regulation, (EU) No. 575/2013

Financial industry UK

24%
of all Financial Service activities in the EU

GDP 2016
£124.2 bn
representing 7,2% of the economy as a whole

£65 bn
fiscal revenues per year

1.1 million
employees

With 46%
of the **EU equity capital**, being acquired in Great Britain
and 41%
of all currency business, taking place in London, the UK is one of the **most important financial markets in the world**

Currently, it is mainly the UK (comprising 24 percent of all financial service activities) that guarantees a fully functioning and efficient capital market in the EU. With 46 percent of EU equity capital being raised in the UK, as well as 41 percent of all foreign exchange transactions being carried out in London, the British capital is not only one of the most important financial centers in the EU, but the world.

Besides London being the world's largest financial center and a matter of prestige, the financial market sector is a significant part of the British economy. In 2016 it contributed £124.2 bn to British GDP (Gross Domestic Product), representing 7.2 percent of the overall economy.

In addition, the financial sector generates £65 bn of tax revenue per year, and employs 1.1 million people. Apart from London, Edinburgh has evolved into an important financial center in the UK.

The ongoing CRR-II/CRD-V consultation has addressed this topic by introducing the idea of so-called Intermediate Parent Undertakings (IPU). The proposal provides that in the future, institutions part of a group of at least two group entities domiciled within the EU, and whose joint parent company is based in a third country, are required to open an intermediate company in the EU. Exempted from this are those groups where the total value of assets within the EU does not exceed €30 bn. Not exempted are globally systemically relevant groups, whose parent institution or (mixed) financial holding company is not based within the EU.

Groups containing a CRR-deposit institution are currently most affected by this regulation. Therefore, the ECB has been repeatedly calling for an extension of this proposal to cover CRR investment firms and subsidiaries in third countries. In addition, the ECB demands that its supervisory competencies should be extended to CRR investment firms as well as subsidiaries in third countries.[2]

Even though it is very likely that the EU will aim for a "Level Playing Field" for the entire financial sector, this leaves little time to take into account these considerations. On the one hand, it is unclear how the final requirements will be specified, on the other hand the rapid approval of the license needs to be the focus. As the licensing process takes six months after submission of the relevant documents, and the setting up of a subsidiary after receiving the license takes another six months, there is not much time for strategic considerations. This is why tactical solutions will need to be pursued. Note here however, that setting up a small "offshore company" is viewed critically by the supervising authorities (see Sabine Lautenschläger, ECB director[3]).

Other aspects of the "Level Playing Field" such as national regulations regarding outsourcing, subsidiaries in third countries and exemptions are generally viewed critically by the ECB and EBA as well.

Since the submission to withdraw from the EU, we have observed an increased demand for founding banks in Germany. Therefore, BaFin – in coordination with the ECB – has created a "new checklist".[4]

The media already picked up on this trend and is reporting about the increased demand for banks founding. For example, BaFin has stated that it is in dialogue concerning Brexit with more than 20 different banks.[5] The ECB highly recommends all Brexit-banks to seek a banking license as quickly as possible, as the process needs a lot of time. The current atmosphere within this group of banks is perceived as being too relaxed.[6]

Forecast for EU 27 financial institutions with a subsidiary in the UK

For German and all other institutions based in the EU 27 the attainment of a UK-license and the fulfillment of UK-specific requirements constitutes the key challenge for being able to continue business activities in the UK. Due to the expiration of the EU passport, subsidiaries have the following options:

1. Discontinuation of business in the UK
2. Relocation to another country within the EU
3. Possibility of UK-licensing of the present subsidiary
4. Transformation into a licensed subsidiary in the UK

The choice of the right option will be influenced by the results of the exit negotiations with regard to the EU passport, transitional arrangements and the free movement of people.

It is expected that each alternative will entail extensive efforts and needs to be planned and implemented ahead of time.

2 https://www.bankingsupervision.europa.eu/press/speeches/date/2017/html/ssm.sp170425.en.html.
3 http://www.zeit.de/wirtschaft/2017-03/brexit-europaeische-zentralbank-eu-bankenlizenz-geschaefts-verlagerung.
4 https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2017/meldung_170720_Erlaubnisverfahren_en.html.
5 http://www.handelsblatt.com/finanzen/banken-versicherungen/brexit-mehr-als-20-banken-bekunden-interesse-an-deutscher-banklizenz/19985858-2.html.
6 https://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp170613.en.html.

Scenarios for all banks and financial service providers

Based on the aforementioned, all financial institutions should evaluate the following four options, and prepare for realignments. The following considerations apply to both financial intuitions based in the EU and those based in the UK:

I. Upholding the business

The first option includes upholding the business by aiming for a continuation of business activities in their current scope. The advantage of the approach lies in the extensive continuity of the business model.

Primary challenges are:

1. Receipt of the banking license or the EU passport in the target country
2. Fulfillment of specific requirements of the regulator and supervisor, as well as compliance with standards in the country of business activity (e.g. local GAAP, law and taxation rules etc.)
3. Specific organization of the legal entity (differences in corporate law)
4. Timely recruitment of high quality personnel and overcoming language barriers, where applicable
5. Consistent review and monitoring of potential outsourcing, or shifts of business as well as the possibilities to transfer existing processes and systems
6. Preservation of profitability under modified conditions

The main condition for the option of "upholding the business" is the result of negotiations with regard to the transitional arrangements, the free movement of people and the labor and real estate market. The setup of an appropriate IT infrastructure is one further very important topic that should be considered.

II. Tactical reorganization

The second option is a tactical reorganization, which ideally can be adapted to a changing framework and accordingly optimizes the target business model. With this customized and time-optimized business orientation, the following main points are to be considered based on challenges 1 through 4 of the first scenario:

1. Orchestration of the overall approach with respect to the recently high regulatory uncertainty on a maximally time-sensitive implementation path
2. Development of target operating models in parallel for different markets
3. Arrival on the market as a supplier and buyer on a particularly late stage

While acting according to the option "tactical reorganization" it is important to observe how other institutions proceed. Furthermore, the financial institution has to consider the dependency on the highly dynamic developments in regulation and negotiation results, as well as the process for obtaining the banking license.

III. Benefit from opportunities

The third option aims at growing market share and/or complementary business sectors to reap a sustainable benefit from increased market dynamics. Furthermore the following critical points arise in addition to challenges 1 through 4 of the first option above:

1. Identification of the potential for suitable expansion combined with the right timing of market entry
2. Conception of a new target operating model including its specific supervisory requirements
3. Arrangement of the necessary means for an expansion

The option "making use of opportunities" especially depends on the behavior of other institutions, specific market entry barriers, as well as the receipt of the banking license through cooperation with the supervisor. Because the positioning of the financial institution choosing this option will be quite late when compared to the other options already mentioned, there is a high interdependency with the labor and real estate market as well as a timely set up of an IT infrastructure.

IV. Discontinuation of business

This last resort implies the complete discontinuation of business operations in either the UK or the EU 27. The clarity of this decision and the reduction of regulatory induced expenditures as well as an elimination of political uncertainty constitute the central advantages of this approach.

Actions to be taken when choosing this option are on the one hand the management of liquidation or transfer of business (here the legal situation of remaining in business needs to be considered), the timely sale of the business, the release and relocation processes and customer management. On the other hand, the loss of present contribution margins needs to be compensated for and alternative business models need to be developed. Significant dependencies stem from the clarification of the legal situation as well as the approach of other institutions which will have an impact on market demand and prices.

What do financial institutions need to do today?

The various Brexit scenarios presented above and the options derived thereof show that the affected financial institutions need to focus intensively on the topic. The hazy uncertainty surrounding the modalities of individual regulations on the part of politics and the supervisory authorities as well as dwindling time needed for implementation complicates and fogs the decision making process needed for necessary adjustments within the financial institutions.

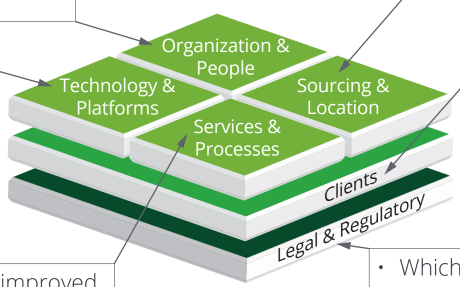
Deloitte has already engaged in extensive analysis on Brexit before the referendum, and is now furnishing financial institutions with tailor-made approaches across projects of every kind. Not only have we helped develop strategies, but analyzed and quantified concrete and actionable options. We have helped businesses focus on costs; from relocations, to setting up start-up projects for institutions throughout the UK and the EU 27. Deloitte has extensive experience founding financial institutions and has supported everything from the first strategic considerations to the final implementation of the overall project.

A clear and structured approach to set up the target operating model (s. Figure 3) is the base needed to identify relevant questions relating to Brexit for financial institutions and to develop an efficient solution. On the basis of the legal, in particular the supervisory framework conditions, all relevant ideas will be analyzed and incorporated in an implementation project. Here, we support our customers with our international network of business consultants, lawyers, tax consultants and auditors, as well as the specifically established "Deloitte Brexit Task Force".

We would be glad to support you and your team with our analysis, and to help you implement your plan in face of this impending challenge. We offer a multidisciplinary project team to determine the functional, procedural and organizational aspects which will best suit your needs. As leading experts, Deloitte is here to assist you implement your plan in a professional and timely manner.

Please contact us with your questions regarding Brexit so we can deepen your understanding together. For a personal appointment, please contact one of our team members listed below.

Fig. 3 – Deloitte Target Operating Model (TOM) for Brexit



- Which skills and employees are necessary to achieve the expected results?
- What determines the current Operating Model?
- Can the current organisation cope with future challenges?

- Which processes are outsourced and which are not?
- How are operational entities organized and where are they located? (onshore, offshore, near shore)?
- How is the vendor management set up?

- Which systems and instruments support the operating model?
- How well are these aligned with processes?

- How does interaction with the costumer work?
- How well do goals and operations harmonize?
- How are business relations managed?

- How should processes be improved to deliver constantly good results?
- Who should be the process owner based on economic profit, skills and risk?

- Which regulatory decrees do exist?
- Which steps/requirements are necessary for business establishment in Germany?
- Which legal form and which leadership skills are needed?
- Which obligations to report etc. do exist?

Contact for additional information:

Hans-Jürgen Walter
Partner | Banking Lead EMEA und FSI Lead Deutschland
Mobile: +49 (0)175 5882 651
hawalter@deloitte.de

Dr. Alexander Börsch
Director | Lead Brexit Initiative Deutschland
Mobile: +49 (0)151 5800 5081
aboersch@deloitte.de

Dr. Mathias Hanten
Partner | FSI Brexit Legal
Mobile: +49 (0)175 7234 496
mhanten@deloitte.de

Tilmann Bolze
Director | FSI Brexit Consulting
Mobile: +49 (0)172 2073 783
tbolze@deloitte.de

Thomas Peek
Director | FSI Brexit Risk Advisory
Mobile: +49 (0)179 6913 428
tpeek@deloitte.de

Claudia Sendlbeck-Schickor
Director | FSI Brexit Tax
Mobile: +49 (0)172 8644 669
csendlbeck@deloitte.de

Deloitte.

Issued 10/2017