Responding to Brexit in the Financial Services Industry

Banks and investment firms relocating business to the EU will need to adjust their operating models to adapt to the national legal framework. Based on the example of Germany we demonstrate that a “one size fits all” approach does not work in every case.
While almost all topics and requirements apply to banks and investment firms alike, regulatory expectations may differ in detail based on the business model of an institution.
Introduction
At the end of March 2019 the United Kingdom's membership of the European Union will end ("Brexit"). Whether or not the EU and the United Kingdom will be able to agree the terms for withdrawal and the future relationship in time for the March 2019 deadline is still an open question. The negotiations on this issue have been so difficult that no one yet knows the extent to which British companies will have access to the European single market and how long European law will be applicable in the United Kingdom after the exit. In an opinion dated June 25, 2018, the European Banking Authority (EBA) therefore warned financial services providers – for the second time – that they must take adequate precautions for Brexit.¹

Banks and other financial services providers are especially affected by Brexit because the laws currently in effect allow them to offer financial services across national borders ("passporting"). Whereas branches of banks domiciled in third countries need a separate license, credit institutions domiciled in the member states of the EU can operate in other EU states with relatively little effort. Similar provisions apply to other financial services providers such as insurance companies. What this means in practice is that a credit institution with a UK license is currently able to operate throughout the EU. Conversely, French or German banks (for example) can offer banking and financial services in the United Kingdom.

However, it is likely that the UK will lose this automatic cross-border market access as a result of Brexit. Therefore, the affected banks ("Brexit banks")² will be obligated either to apply for a third-country license to operate a branch or to form a new bank and transfer the relevant business to the new entity. Financial enterprises currently domiciled in the United Kingdom that wish to continue operating in more than one EU country may choose to found a new bank to enable continued operation across borders within the EU. The other option – obtaining a third-country license – is equally complex as founding a new bank, but it is likely that this has to be done separately in each affected country.

In general, the major regulations are applicable for CRR credit institutions as well as for investment firms, although in some specific areas there might be differences. In this paper we will not focus on the possible specific differences in regimes for CRR credit institutions and investment firms, but rather give a general overview of challenges for Brexit institutions.

Since it is not yet clear whether the UK will qualify for the enhanced third-country equivalence, the vast majority of banks are planning to set up a new EU legal entity to ensure market presence and to be able to continue to use the EU passport regime.

² For the purpose of this document, “Brexit bank” or “Brexit institution” shall refer to a bank or financial services institution transferring business from the UK to Germany or another EU-27 country in response to the UK Brexit decision.
In the following we will address typical topics, point out potential problems and discuss possible solutions in the context of founding a new bank or investment firm. Ultimately, it will be seen that it is usually not possible to employ the same exact operating model as in the UK due to local requirements. This white paper addresses the typical issues that will necessitate adjustments, based on experience in Germany.

Such a country-specific approach involves several key fields of action. Depending on the specific business model, other issues may need to be considered. In addition, new regulatory developments could necessitate further adjustments.3

Figure 1: Relevant key fields of action

As the business models and products and services offered vary, this paper cannot describe all relevant fields of action. An individual analysis should thus be carried out in order to develop an appropriate mitigation plan.

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3 Current regulatory developments are the subject of Deloitte Regulatory Insights, see https://www2.deloitte.com/de/de/pages/financial-services/topics/regulatory-blog.html.
1 Supervisory practice
A comparison of current supervisory regimes in some cases reveals significant differences between EU member states. Although these differences have been reduced by the Single Supervisory Mechanism, national particularities can still be observed in practice.

A typical feature of the German market is a kind of division of labor between the supervisory authorities, the auditor of the annual financial statements and the auditor conducting the audit prescribed by the German Securities Trading Act (Wertpapierhandelsgesetz, WpHG). Essentially, the German central bank (Bundesbank) is responsible for the ongoing supervision of financial institutions. Insofar as the European Central Bank (ECB) exercises direct supervision, the Bundesbank participates in Joint Supervisory Teams.

In the case of smaller banks in particular, on-site audits by the supervisory authority are somewhat of an exception because the independent auditor also performs a very extensive review of compliance with regulatory requirements as part of the audit of the annual financial statements. The topics to be audited include reporting obligations, the requirements prescribed by the German Banking Act (Kreditwesengesetz, KWG) – and therefore indirectly such minimum requirements as the Minimum Requirements for Risk Management, etc. – and the minimum capital according to the Capital Requirements Regulation (CRR).

The independent auditor also reviews the safeguards implemented to prevent money laundering and the capital market-related requirements prescribed by the German Securities Trading Act, the European Markets in Financial Instruments Regulation (MiFIR) and the European Market Abuse Regulation (MAR). In addition, the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin) may order that other matters be audited or initiate additional special audits. Such special audits are conducted either by the German Bundesbank or an outside auditor appointed by the supervisor.

Further audits should be expected from the applicable Deposit Insurance Scheme for banks planning to take customer deposits. Membership in such a scheme is mandatory and the scheme will audit every member frequently to assess the default risk of the member and determine the membership/insurance fee.4

Due to the involvement of external experts in financial supervision, the bank’s internal documentation is especially important because it must regularly prove to the auditor that the requirements have been met. Therefore, the bank must not only ensure that its actual processes are “correctly” designed, but also that its organizational directives are aligned with these processes.

Due to the fact that the supervisory authorities do not always perform the audit themselves, as described above, the consistent treatment of comparable issues is an important aspect. In practice, this is done by means of circulars and interpretations of the supervisory authority, which must be observed in the design of the bank’s structural and procedural organization. Moreover, various regulations are accompanied by commentaries and

4 The first Deposit Insurance Scheme audit should be expected at an early stage, assessing the business plan and organizational procedures.
pronouncements that must be applied in the evaluation of many issues. Authors of these publications include professors, audit firms or banking associations but also employees of the supervisory authority.

Whereas the commentaries are useful for the interpretation of supervisory requirements, the Auditing Standards of the Institute of Public Auditors in Germany (Institut der Wirtschaftsprüfer in Deutschland e.V., IDW) de facto impose additional requirements to be met by financial institutions because the auditors regularly apply the IDW Auditing Standards to determine whether the requirements are properly met. In the Brexit context, it must be noted that the commentaries and guidelines – like many publications by the national supervisory authorities – are usually not available in English.

2 Minimum Requirements for Risk Management
2.1 MaRisk Overview
The United Kingdom is currently subject to the harmonized European banking regulations and the risk management requirements of the national supervisory authorities are basically comparable with the BaFin’s requirements. Nonetheless, the implementation of specific national requirements is sometimes a labor-intensive task for a financial institution characterized by UK supervision due to the different legal systems and regulatory practices. With respect to Germany, these include various regulations and regulatory interpretations such as the Minimum Requirements for Risk Management (MaRisk).

In this respect, the challenges for banks involve both the substantive requirements of the MaRisk and most notably the corresponding documentation requirements. The complete written documentation of all business activities and controls required by bank regulations in Germany is usually more extensive than the existing documentation of “Brexit banks” relocating from the UK, leading to a considerable increase in implementation costs.

The legal foundation for MaRisk – which have been issued as a circular to all German banks – is section 25a KWG. This section of the German Banking Act requires all institutions to have a.o. an appropriate business organization and a suitable risk management system that ensures the risk bearing capacity on an ongoing basis. The MaRisk consist of several modules, grouped in the General Part (Allgemeiner Teil, AT) and the Special Part (Besonderer Teil, BT). As the MaRisk specify the legal requirements set out in section 25a KWG, they apply to all institutions established in Germany.

Commentaries and guidelines for the interpretation of supervisory law

National differences and specificities

5 The supervisory authorities of the United Kingdom are the Financial Conduct Authority (FCA, https://www.fca.org.uk/) and the Prudential Regulation Authority (PRA, https://www.bankofengland.co.uk/prudential-regulation).
6 See section 25a (1) sentence 4 no. 2 KWG in conjunction with AT 5 MaRisk.
7 The MaRisk have been updated several times to reflect changes in regulatory expectations. The most recent version was published in October 2017.
2.2 Regulation in the context of outsourcing

Operating on the assumption of a “hard Brexit" and the corresponding loss of EU market access, the affected institutions are currently attempting to contain Brexit-related costs while complying with the regulatory requirements by continuing to use their existing processes and expertise in London by means of outsourcing. However, this balancing act between cost efficiency and compliance with regulatory requirements could mean that the regulatory requirements for outsourced processes and activities will only be implemented slowly. Therefore, banks could increasingly come under time pressure as they strive to keep their options open.

To preserve access to the European single market after Brexit, banks must therefore quickly establish a definitive definition of their future business model and implement the corresponding regulatory requirements, particularly including the requirements for the necessary documentation and the outsourcing of processes and activities.

Since it might not be possible to set up an entirely independent operating model in the remaining time frame until the Brexit date, many newly founded entities plan to outsource some or large parts of the processes to the UK entity.

When doing so, banks and investment firms must pay particular attention to the implementation of the regulatory requirements for the outsourcing of activities and processes within the meaning of section 25b KWG in conjunction with AT 9 MaRisk. Given the likely substantial scale of outsourcing plans of “Brexit banks” and the growing regulatory requirements that can be expected at the European level, the correct implementation of the MaRisk outsourcing requirements is imperative.

Although the FSA requirements set out in SYSC 8 are essentially comparable with the MaRisk requirements, the risk analysis of planned new outsourcing activities with AT 9 Para. 2 MaRisk and the definition of future outsourcing monitoring and evaluation measures present great challenges for “Brexit banks”. This is usually due to the fact that the future business model of these banks after Brexit has not yet been defined in sufficient detail, making it difficult to delimit the outsourcing plans precisely.

Generally speaking, parts of the business organization may be outsourced as long as someone responsible for the outsourced activities remains in the bank. However, if business operations are to be outsourced in practice, the outsourcing provider must fulfill the German requirements, meaning that the relevant, up-to-date publications must be understood and interpreted. This fact usually necessitates an above-average understanding of regulatory issues in Germany. Therefore, it will probably be more appropriate that the German institution employs the competent specialists.

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9 The "Senior Management Arrangements, Systems and Controls (SYSC)" are part of the FCA Handbook.
The principle of avoiding the establishment of shell banks, which the BaFin and other European supervisors communicate quite clearly, must be observed with respect to all subject areas. What this primarily means is that the national supervisory authority expects an appropriate structural and procedural organization, appropriate personnel resources and, particularly, the retention of essential roles and functions. This also includes an appropriately designed “second line of defense”; in this respect, the term “appropriately” must be interpreted based on the circumstances of each individual bank.

The management of all outsourced activities is also important. The frequently discussed minimum size of a so-called “retained organization” (RTO) as a central element of outsourcing management\(^\text{10}\) undoubtedly allows for different interpretations. Nonetheless, it is undisputed that every institution must have a central outsourcing officer. Beyond that, it must be analyzed on a case-by-case basis what service exactly is outsourced, where the data is stored, processed and maintained, etc. Some aspects of these requirements, in fact, are still being discussed at the BaFin.

Specific requirements apply in the context of Anti-Money Laundering (AML). Based on the German legal framework\(^\text{11}\) a planned outsourcing has to be reported to BaFin in advance. BaFin is entitled to prohibit such outsourcing under specific circumstances, for example in case their monitoring rights will be negatively affected. Moreover, some duties are not allowed to be outsourced at all, e.g. the ongoing monitoring of transactions and business relationships.

3 BAIT – Bank supervisory requirements for IT

The BaFin published the “Supervisory Requirements for IT in Financial Institutions” (Bankaufsichtliche Anforderungen an die IT, BAIT) in November 2017. In this circular, it formulates its expectations for governance, processes and systems in IT. The circular was prompted by growing risks posed by increasing digitalization, the rising trend of outsourcing and other IT services purchased from third parties, and the volatile situation of cyber threats, among other things. The BAIT requirements are an important and mandatory component of IT supervision and must therefore also be observed in connection with Brexit projects. Some subject areas are especially important in the context of such projects.

The business plan, for example, which is a mandatory part of a license application, must describe the planned design of the IT organization depending on the intended business model, as well as the steps to be taken to ensure compliance with the applicable regulatory requirements. Different constellations must be considered in this respect.

In many cases, the financial institutions affected by Brexit already have mature IT structures (although usually not in Germany). Taken as a whole, all necessary IT operational structures are essentially already in place on the international level. The central question to be answered, therefore, is what additional functions must be established for the institution locally after Brexit to fulfill regulatory requirement and standards.

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\(^{10}\) See MaRisk AT 9, also in conjunction with BAIT Chapter 8.

\(^{11}\) See section 25h (4) KWG.
If the initial application for a banking license is pending, a new IT organization will need to be established in compliance with MaRisk/BAIT. The challenges here relate to the consideration and interpretation of the principle of double proportionality, meaning the type and/or size of business activity and the risk profile of the future bank, which can only be assessed on the basis of the specifically planned business model.

In our experience, the main focus is on topics like the organization of IT governance, outsourcing management/retained organization and the intensive local requirements for information security. Empty shells must be avoided as explained before.

The BAIT requirements for information risk management are more specific than global standards such as NIST\textsuperscript{12} or the requirements of the supervisory authorities in the UK. The requirement to maintain an overview of all components of the so-called information network, including all dependencies and interfaces, is currently a major challenge. The German supervisory authority uses the term “information network” in this context. In addition to this, the rules for the methodology to be applied in determining the protection requirements and the treatment of data or primary information values to be determined on that basis have put tremendous pressure on banks to take action in this respect. Institutions of all sizes are currently seeking to develop an appropriate solution for this problem.

4 Risk-bearing capacity and large exposure limits
Every credit institution licensed to operate in the EU must fulfill the CRR capital requirements individually and independently of its parent company. This requirement applies equally to banks with their own license and to branches of institutions licensed to operate in a third country. The risk-bearing capacity\textsuperscript{13} must also be demonstrated at the level of the individual institution and independently of the parent company.

4.1 Risk-bearing capacity
The internal capital adequacy assessment process (ICAAP) is an essential and integral part of the three pillar approach developed by the Basel Committee on Banking Supervision (BCBS). Both the EBA (via guidelines) and the ECB (as part of its Supervisory Review and Evaluation Process, SREP) have further elaborated on the regulatory requirements concerning risk measurement and risk management.

SREP is directly applicable to all banks under ECB supervision. For less significant institutions (LSIs), local requirements must be observed. For Germany the supervisory expectations deviate to some degree from a “typical” ICAAP approach, since several additional mandatory aspects must be implemented.

\textsuperscript{12} National Institute of Standards and Technology (national institute of the United States responsible for technological standardization processes, including encryption algorithms, for example).

\textsuperscript{13} In Germany, the requirements for risk-bearing capacity are implemented by section 25a (1) sentence 3 no. 2 KWG; in this respect, the MaRisk and the SREP and other EBA requirements must be considered in parallel.
The concrete requirements for the risk-bearing capacity are specified in AT 4.1 MaRisk and in a BaFin Guideline\textsuperscript{14} and they are different in part from the ICAAP requirements of the PRA. The German supervisory authority expressly requires that institutions base their risk-bearing capacity concept on two perspectives, a normative and an economic perspective.

Whereas the normative perspective is geared toward the totality of regulatory requirements, the economic perspective requires risk quantification on an economic basis. This risk quantification should also include all of those elements that are not (or not appropriately) captured in the financial reporting and in the regulatory capital requirements.

In terms of methodology, a “Brexit bank” can generally utilize the existing risk-bearing capacity concepts of the parent company. With respect to the normative perspective, however, the degree to which they cover the BaFin’s national specifications must be analyzed. Due consideration must also be given to specific national financial reporting rules, including the adjustment of regulatory capital to include nationally eligible capital instruments (e.g. reserves pursuant to sections 340f and 340g HGB).\textsuperscript{15}

By contrast, the required (parallel) implementation of an economic perspective is new in part for “Brexit banks” and entails considerable implementation costs. The BaFin also requires that the methods applied to ensure the risk-bearing capacity on the institution level be linked to the business and risk strategy and that suitable risk management and controlling processes be implemented for essential risks to ensure the implementation of the strategies and the risk-bearing capacity.

4.2 Requirements for large exposures
According to Article 395 CRR, exposures to one customer or group of connected clients may not exceed 25\% of eligible capital after taking eligible collateral into account. These large exposure regulations are identical in the UK. However, some challenges may arise in the Brexit context because some basic parameters will change. Furthermore, by national discretion, some aspects of the large exposure regime can deviate locally. One example in this context is the waiver for intra-group exposure, where the German requirements are slightly different to the UK.

First of all, it must be considered that eligible capital in the new entity is usually (much) lower than the applicable amount for the relocating company. For this reason, the capital base of the subsidiary to be founded must not only be oriented to the expected risk-weighted assets (RWA), but must also take into account the individual exposures of the portfolio to be transferred as well as any large exposures resulting from that. If large exposure limits were exceeded on the basis of the planned capital base of the new subsidiary, suitable measures must be taken to adjust either the capital base or the exposures that must be covered.

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\textsuperscript{14} See the BaFin Guideline “Regulatory Assessment of Banks’ Internal Risk-Bearing Capacity Concepts”.

\textsuperscript{15} HGB = Handelsgesetzbuch (German Commercial Code)
One conceivable solution for such a problem would be to substitute the exposure with a counterparty to which the large exposure limit does not apply – say in the form of cash deposits or sub-participations on the part of the parent company. Another conceivable solution would be contractual clauses that lead to a reduction of the applicable exposure value for undrawn facilities in accordance with section 1 No. 6 GroMiKV (Großkredit- und Millionenkreditverordnung, German Large Exposures Regulation) or the stipulation of conditions precedent, under which a credit facility may only be drawn if it does not cause the exposure limit to be exceeded.

Another conceivable solution in this context would be guarantees issued by the parent company, although it must be remembered that receivables from affiliated companies are also limited by the large exposure requirements. While there are various options to reduce the required capital charge, they are usually tied to certain conditions. As a zero-weighting is usually only possible by pledging collateral, the possible risk transfer is delimited.

5 Minimum Requirements for the Compliance Function

5.1 Regulatory content of the MaComp and affected institutions

In its “Minimum Requirements for the Compliance Function” (MaComp), BaFin specified various national and international regulations and provided interpretation aids. The MaComp combines the BaFin’s administrative practices with respect to individual regulations and must therefore – like the MaRisk – be considered by all affected institutions.

Particularly those institutions that are formed in Germany as a result of Brexit must familiarize themselves with the particularities of the MaComp and implement suitable measures to fulfill the many requirements, some of which do not currently exist in a comparable form or are handled differently in the UK.

The scope of application of the MaComp makes it clear that nearly every financial institution in Germany (with only few exceptions), or at least those that provide investment services, must comply with the MaComp. MaComp is applicable to all investment firms (pursuant to section 2 (10) WpHG), branches (pursuant to section 53b KWG) and capital management companies (but only if they provide services and ancillary services according to section 20 (2) Nos. 1, 2, and 3 and (3) Nos. 2, 3, 4 and 5 Capital Investment Code – Kapitalanlagegesetzbuch, KAGB).

Banks and financial services institutions that are not investment firms within the meaning of section 2 (10) WpHG are subject to the general organizational requirements of section 25a (1) KWG, but not to the requirements of section 63 et seq. WpHG and the MaComp.

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16 See section 2 GroMiKV. A central requirement in this context is the comparability of large exposure rules. It cannot be said with certainty at the present time whether the United Kingdom will continue to apply the CRR (permanently) after Brexit. Should the future UK regulation be deemed not equivalent to EU regulation, certain waivers would no longer be available.

17 The MaComp was published as Circular 05/2018 WA on April 19, 2018. The official title is “Minimum Requirements for the Compliance Function and Additional Requirements Governing Rules of Conduct, Organisation and Transparency”.

18 Specifically, the BaFin specifies the provisions of section 11 of the German Securities Trading Act (WpHG) and Art. 21 ff. of the Delegated Regulation (EU) 2017/565 in the MaComp.
5.2 Structure and core topics of the MaComp

Basically, the MaComp have a modular structure similar to MaRisk. The General Part (AT module) sets out the basic principles of the organization and conduct obligations of the WpHG.\(^{19}\) The Special Part (BT module) sets out very concrete and detailed provisions on specific aspects.

Although the national implementation of the MiFID II and other capital markets regulations are basically supposed to be identical with EU regulations, the German requirements differ in part from the EU rules or specify them due to the country’s specific legal framework. Brexit institutions are therefore faced with the challenge of performing a detailed analysis to determine the extent to which the German administrative practice goes beyond the already known UK requirements. As mentioned above, the clearly communicated principle of avoiding “empty shells” must be considered at all times.

For example, particular attention must be devoted to section BT 1, which deals very extensively with the organizational requirements and duties of the institution’s compliance function. In this regard, the experience to date shows that Brexit institutions that would currently like to build up their business in Germany are struggling to expand their monitoring activities and find suitably qualified personnel.

Other core topics of the MaComp that particularly involve German particularities include the rules for monitoring personal dealings (BT 2) and the special focus on the duplicate procedure (“Zweitschriftenverfahren”) in connection with the monitoring of employee dealings, the corresponding notification obligations and approval reservations as well as the incorporation of BT 9 regarding scaled commissions.\(^{20}\)

Another national specificity arises from BT 10 regarding the regulation of inducements: In this particular case, the regulator is partly departed from the MiFID II requirements and also recognizes an “extensive network of branch advisors” as a quality-enhancing measure.\(^{21}\)

Furthermore, the annexes to the MaComp play an important role. These include in BT 12.2 a template for the complaint report by which client complaints must be reported to the supervisory authority from 2020 onwards (reporting period: 2019),\(^{22}\) and in Annex AT 8 an extensive list of minimum requirements for records that an institution must provide to the BaFin upon request and retain for up to seven years.

The foregoing comments make it clear that the MaComp do not constitute an entirely new set of rules for Brexit institutions given that many of the specifications included in them are already known in the UK from MiFID II and other European regulations. However, other topics should be analyzed in more detail in order to determine those areas in which German administrative practices require adjustments to particular processes.

\(^{19}\) These basic principles involve the overall responsibility of the management (AT 4), the organization obligations pursuant to section 80 (1) WpHG (AT 6), record-keeping obligations (AT 8) and requirements for outsourcing (AT 9).

\(^{20}\) Scaled commissions must be expressly addressed in the institution’s conflict-of-interest policy.

\(^{21}\) See section 6 (2) no. 1 letter d) WpDVerOV (Regulation Concretizing Rules of Conduct and Organizational Requirements for Investment Services Companies).

6 Particularities of the deposit and safe custody business for investment services companies

The business model of broker-dealers in the United Kingdom is particularly limited to financial commission business.

In Germany, this kind of business model is generally only practiced by smaller institutions. Many larger investment services companies in Germany that provide or offer the above-mentioned investment services almost always also have a license to carry deposits and safe custody accounts.

In this context, however, investment services companies must observe extensive requirements for the proper provision of deposit and safe custody services. These requirements have been further specified on the European level in MiFID II and the Delegated Directive (EU) 2017/593.

On the national level, these requirements are specified inter alia by the Custody Account Act (Depotgesetz) and the planned corresponding BaFin Circular „Minimum Requirements for the Safe Custody Business“ (MaDepot). Particular attention is given here to general safeguards for protecting the financial instruments of clients, safe custody with third parties, safe custody accounting of investment firms and financial security in the form of title transfers. In addition, specific implementation questions related to clearing and settlement processes arise with respect to transactions involving different financial instruments.

If an investment services company does not have a license to take deposits and provide custody accounts, the funds and securities of clients must be deposited with a licensed institution. Even though the regulations on this subject are supposed to be harmonized across the EU by the MiFID II, processes and even IT systems need to be adjusted, in some cases substantially, to accommodate German particularities.

Given the different legal systems in Germany and the United Kingdom, it is therefore necessary to develop and evaluate adequate solutions that will enable the new investment services companies to continue their previous business activities in the EU-27. This process must also address the concrete design of the given business model and the necessary or reasonable licenses for this purpose.

7 Regulatory reporting

Regulatory reporting is especially important in the context of founding a new institution or expanding an existing institution. This applies not only to regulatory reporting, but also to statistical and foreign trade reporting. The range of relevant reports is initially determined by the planned scope of business and the licenses sought or already applied for as well as the regulatory approaches to calculating Tier 1 capital requirements. In the next step, the planned product catalogue is considered in determining what specific items must be reported.

When it is necessary to establish a completely new reporting system in the context of founding a new institution, some banks pursue the approach of transferring existing expertise and established structures and systems from London and building on them. This can make sense to a certain degree in the case of uniform reports on the European level such as COREP and FINREP. This is especially advisable when the plan is to continue using the parent company’s IT systems.
Generally speaking, for example, a bank can apply the existing technical concept for COREP and use established systems and software programs also in the new institution. However, because the accounting system also forms the basis for large parts of the reporting system, the limits of transferability can be quickly reached. The applicable financial reporting standards for the parent company in the UK are usually IFRS or UK-GAAP, whereas the subsidiary in Germany must prepare financial statements according to the regulations of the German Commercial Code (Handelsgesetzbuch, HGB). Therefore the introduction of HGB accounting is a particular challenge, and not only for finance or tax departments.

The differences between the two sets of accounting standards, including with respect to the capital components that qualify as the institution’s own funds, as well as deductible items, eligible components of risk provisions and fair value measurement, will probably necessitate a more or less extensive adjustment of the conception of the COREP report and its IT implementation. Because FINREP is based directly on the accounting system, this necessity is even greater with respect to the FINREP report on the basis of HGB accounting standards. Therefore, adequate resources and an appropriate time frame must be planned for adapting the reporting concept.

In terms of content, differences can arise between the previous practice in the United Kingdom and the implementation in Germany, particularly with respect to the COREP reports, because a number of national discretion options have been exercised differently. At any rate, local reports such as the million-euro exposure report will have to be completely redesigned and technically implemented.

If an existing institution is to be expanded, the transfer of business from London and the related expansion of business volumes and product lines may also necessitate a change in the Tier 1 methods from standard methods to internal models.23

In addition to methodology questions with respect to the design and implementation of internal procedures, a number of additional reporting requirements must also be observed in this case. In this context, the liquidity reports (LCR and NSFR) must not be forgotten because a finished technical concept is usually not available for newly added products. In addition, intra-group hedging transactions with the parent company or affiliated companies must also be incorporated into the reporting system, depending on the chosen booking model.

To be able to file reports, a suitable reporting software must be chosen and implemented. The questions to be answered in this context include standard software vs. internally developed software and whether the same system used by the parent company can be used by the affiliated company.

Depending on the chosen solution another question to be answered is whether sufficient implementation expertise and capacities are available internally, or whether external support should be utilized for this purpose.

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23 Because the use of internal rating methods or risk models must be approved by the supervisory authority, sufficient time must be planned for the approval process. The supervisory authority should be consulted at an early stage of such planning to ensure that on-site inspections can be performed on time.
In consideration of the aspects mentioned above, it is advisable to define the extent of the required reports first, based on the planned scope of business and licensing and the intended regulatory methods. This definition will determine the extent to which a new reporting system must be developed or an existing reporting system can be extended, which software solution is the most suitable, how costly the implementation of the various reporting requirements will be, and – last but not least – what capacities will be needed for ongoing operation.

8 Global booking models

Due to the expectation of new and stricter regulations and changes in business models, both the supervisory authorities and senior bank managers are increasingly focusing on the booking models of internationally active banks. The main question in this context is how different institutions (entities) of an international banking group trade with each other, which entity enters into the contract with the customer, and who is responsible for managing the risks that arise in this context.

Whereas economic considerations and process optimization were often the main factors considered in connection with the management of credit and market price risks in the past, the main issue today usually has to do with regulatory requirements that necessitate the proactive management of booking models. In connection with ongoing Brexit projects, questions related to the regulatorily permissible and/or optimal design of booking models are of crucial importance.

A detailed analysis of global booking models can be found in the Deloitte report “Maximizing and maintaining the business benefits”.

8.1 What booking models are used?

Booking models have developed over time. Each banking group is in a different situation with different entities, licenses, legal conditions and regulatory requirements. Basically, three different kinds of booking models are used:

- Global remote booking
- Global back-to-back
- Local risk control

Global remote booking

Under the global remote booking model, a bank acts through local branches or subsidiaries without managing risks from customer transactions in the local entities. The client’s trades are indeed concluded locally, but are posted to the books of the central entity. Due to the changed legal status resulting from Brexit and the anticipated status of the United Kingdom as a third country, this model represents an especially challenging option for Brexit institutions given that the German regulator considers “empty shells” as critical and expects local risk management capabilities to be established in Germany.

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Global back-to-back

The global back-to-back booking model is based on the idea that an entity exists with its own – partly limited – (IT) infrastructure and support functions (e.g. middle office or product control). Trades are booked in the local entity and the (market price) risk of the trades is transferred to the central entity by means of so-called back-to-back trades. This practice gives rise to cost synergies because the banking group only needs to make a limited investment in developing a separate local risk management capability. Central booking also makes it possible to take advantage of netting effects.

Despite the centralized risk management function, the local supervisory authority can influence the trades to be cleared and settled by defining minimum requirements. This can lead to considerable disadvantages for the banks, such as when the requirements for cross-border trades are tightened on the basis of a resolution scenario. From the standpoint of regulatory, competition and tax considerations, banking groups must also ensure that trades booked with another group entity are concluded at fair market prices.

In addition, it must be noted that a central entity based in London may end up with a third country status. This would mean that certain waiver options potentially are no longer available for intragroup trades, depending if and when UK will be granted equivalence status. Therefore, the planning scenario should assume the worst case, i.e. non-equivalent third country status.

Moreover, the supervisory authorities have repeatedly stated that a 100% back-to-back booking model will not be accepted in the medium or long term.

Local risk control

Under the “local risk control” booking model, the bank’s risk management is decentralized by establishing a comprehensive risk management function in the local entity. This arrangement is advantageous from the standpoint of bank supervision because all trades are booked and managed locally, putting them under the direct influence of the local supervisory authority.

However, it is to be expected that the application of such a model will increase the overall costs of trading due to decentralization of risk management and the loss of any economies of scale, netting advantages, loss of access to a number of liquid markets and more difficult client management.

Cost advantages and netting effects

Strict requirements for intragroup trades

Limited acceptance by supervisory authorities

Risk management in the local institution

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26 Noteworthy waiver options include the exemption of intragroup trades in the context of large exposures.
8.2 Challenges and solutions

Many institutions affected by Brexit currently prefer the global back-to-back booking model. This model is already being used in many cases and can therefore serve as the basis for an enhanced model that could potentially be accepted by the supervisory authority initially during a transition phase. In the medium term, however, increasingly stringent minimum requirements for local risk management can be expected. Thus, affected banks will be forced to decide between efficient risk and cost management vs. the growing demands of local supervisory authorities in a no longer harmonized European financial market (post Brexit).

Specific subject areas that banks must consider with respect to their booking models in the Brexit context include the following:

- Responsibilities and governance with respect to the management of the remaining credit risk and other risks
- Quantification of the margin implications for hedged trades in both the local and the central entities and the organization of the related operational margining processes in the local entities
- Development of solutions related to potentially limiting large exposure limits with respect to both the central entity and local clients
- The different ways that the chosen booking model affects internal funds transfer pricing
- Set-up of local entities with respect to risk management capabilities and the necessary IT infrastructure. In this regard, the supervisory authority would mainly like to prevent the formation of so-called “empty shell entities” and will therefore seek to make the above-mentioned minimum requirements even more stringent
- Adequate mapping of the capital and liquidity requirements resulting from the booking model
- Extensive, early-stage documentation of booking models; the expectation of the supervisory authority at booking models has been increased, and requirements are expected to tighten considerably\(^\text{27}\)

Therefore, “Brexit institutions” should perform an intensive analysis of their planned booking models in order to meet the essential regulatory and economic requirements. Ultimately, the necessary resources, capitalization and liquidity funding of local entities will very much depend on the choice of booking model. In addition, “Brexit institutions” should prepare to introduce the local risk control booking model in the medium term in view of the regulations that can be expected in the future.

\(^{27}\) Refer to recent publication on booking models published by the ECB: “Supervisory expectation on booking models”, see footnote 24.
9 Governance

9.1 Responsibility of the management

Crucial questions to be answered when founding a new entity in Germany include the degree to which processes must be performed in the local institution and the areas in which already established processes within the group, especially in the existing UK entity, may be utilized.

The same applies to the integration with the group’s management system vs. the assurance of the independent responsibility of the management of the German entity. What decisions must be made by the management of the new unit and what decisions can still be made, also for the German institution, in the UK or another location of the group?

Institutions in Germany must maintain appropriate governance structures and an effective risk management function regardless of whether they are organized as an independent company or a legally dependent branch. In particular, the ultimate responsibility of the management for the legally compliant business organization of a German institution according to section 25a KWG may never be compromised.

With respect to one managing director exercising a dual function (“double hatting”), factors such as available time, mandate limitation and the existence of conflicts of interest must always be reviewed. Due consideration must be given to the prohibition of concurrent management and supervision, meaning that a managing director is not permitted to be a member of the institution’s board of directors or supervisory board simultaneously.\(^\text{28}\)

Within corporate groups, there is always a legitimate interest in making strategic decisions on a group-wide basis. This will still be permitted subject to the condition that the independence of the German institution must always be assured. It must be assured at all times that the institution is not in fact managed by persons who do not belong to the senior management of the local institution. Directives to managing directors, which are permissible under corporate law, are limited by the regulatory requirement of autonomous and independent management.\(^\text{29}\)

9.2 Design of the risk management function

The design of the risk management function is to be determined on the basis of the nature, scope and complexity of the business activity of each institution. Regardless of the size of the institution and the complexity of the business model, the supervisory authority requires appropriate organizational and personnel capacities within the local institution. In particular, this requirement applies to the control function, internal audit, risk controlling and compliance.

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\(^{28}\) See section 25c (2) Sentence 2 No. 1 KWG.

\(^{29}\) The managing directors of the German institution are responsible to the supervisory authorities for compliance with all relevant regulations. Violations are punishable by fines and in extreme cases imprisonment, pursuant to section 25c KWG in conjunction with section 54 ff. KWG.
Even if the use of established, group-wide risk management processes can make sense for banks, transactions must be booked in the unit in which they originated so as to avoid the formation of “empty shells.” As pointed out above, the European supervisors have repeatedly made clear that “letter box banks” and “empty corporate shells” will not be permitted within the European Union.

With respect to the outsourcing of essential activities, it must be remembered that this term also covers intragroup outsourcings, which are therefore subject to all the requirements applicable to outsourcing in general. Consequently, neither the responsibility of the management nor any core banking activities may be outsourced. Control functions may be outsourced only under strict conditions.

Due to the (deemed) single institution status defined in section 53 (1) Sentence 1 KWG, the above-mentioned outsourcing requirements are applicable not only to legally dependent entities, but also to branches located in Germany, namely in the case of cross-border outsourcings.

10 Other legal aspects

10.1 Choice of legal form
UK institutions intending to found subsidiaries in Germany must choose the appropriate legal form from a range of possibilities. Supervisory law does not impose restrictions on the legal form to be chosen, so that both corporations and commercial partnerships can be formed. Depending on the choice of legal form, different corporate law obligations must be fulfilled and certain governance bodies must be established (e.g. obligatory Supervisory Board). The establishment of such governance bodies may in turn give rise to additional regulatory requirements, so that the choice of legal form can certainly also be influenced by regulatory requirements.

10.2 License application
Newly founded institutions must file a license application with the national supervisory authority. Licensing procedures for CRR credit institutions are handled by the national supervisory authority together with the ECB, while the BaFin and the German Bundesbank prepare one vote. This vote and all of the documentation are then submitted to the ECB, which makes the final decision on the application. All other institutions located in Germany fall under the jurisdiction of the BaFin, which handles the procedure together with the German Bundesbank.

The formal requirements for a license application are stringent. In addition to a sound business plan, which must include detailed information on capital, the business organization and all planned business activities, numerous other documents must be submitted on the subject of the new institution to be founded, the companies and natural persons behind it, and the managing directors.

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30 See section 8 on booking models.
31 See section 2.2 on outsourcing.
32 The licensing requirements for CRR credit institutions are set out in sections 32, 33, 1 (1) Sentences 1 and 2 KWG in conjunction with Art. 4 (1) SSM-VO and those for financial services institutions are set out in sections 32, 33, 1 (1a) Sentences 1 and 2 KWG.
The time required to prepare an adequate business plan and compile all other required documents should not be underestimated. The same applies also for the total duration of the procedure after filing the application. It usually takes about one year for an application to be processed, assuming that it meets all formal requirements at the time of initial submission. Supervisors are currently seeking to speed up the process for Brexit-related applications.

10.3 Labor law
Labor law issues must also be considered in addition to the corporate law and supervisory law. If the intention is to transfer the business of an existing branch to a new institution in Germany, this will usually constitute a transfer of undertakings pursuant to section 613a German Civil Code (Bürgerliches Gesetzbuch, BGB). Under such a transfer, the new unit automatically enters into the employment relationships with the previous employees. In such a case, a notification letter must be prepared and signed in order to ensure the legally compliant transfer of employment relationships. In addition to this transfer, organizational measures must also be considered in every case, including (for example) the relocation or restructuring of business operations or employee relocations.

The cost of transferring existing contracts to the new entity should not be underestimated. One question to be answered in this context is whether the contracts may only be transferred with the consent of the other party in every case or whether they can also be transferred without such consent. Because the United Kingdom has thus far opted not to introduce the instrument of spin-off, meaning the transfer of divisions to another entity by way of partial universal succession, the consent of the other party will usually be required in such cases.

10.4 Managing directors and staff
In deciding on a new location, the general availability of suitably qualified employees has usually been a key decision factor. However, it takes some time to build up the necessary resources because suitable candidates must be found and hired or relocated from other locations.

Management functions are especially important because the planned managing directors must already be indicated when filing the license application.33 They must be professionally qualified and personally reliable.34 Therefore, the selection of future managing directors – if not done already – takes the highest priority.

Although the requirements for staff below the senior management level are not as formal, qualified employees are required particularly with respect to the “3 lines of defense.”35 It would also seem advisable to fill these positions early so that those persons who will ensure the adequacy of processes after commencement of business operations can be consulted with regard to the decisions to be made in the course of the project. The local requirements of the German Regulation on Compensation in Financial Institutions must be considered when drawing up the employment contracts.

33 See section 32 (1) Sentence 2 No. 2 KWG.
34 See section 33 (1) Sentence 1 No. 2 KWG in conjunction with the BaFin Guidance Notice of January 4, 2016.
35 In addition, general requirements such as the EBA Guidelines for Corporate Governance must be observed.
Because the supervisory authority will not accept empty shells, as mentioned above, a comprehensive outsourcing of processes is not possible. For this reason, fallback scenarios that mainly rely on outsourcing are to be viewed in a critical light. An appropriate staffing level must thus be maintained in the new entity.

In this context, it must be considered that notice periods for termination are often shorter in the United Kingdom than in Germany. Therefore, several months can pass between the decision for an applicant and the earliest possible starting date. German labor contracts often state that a termination can only take effect at the end of a quarter. Therefore, contract offers must be made to applicants in due time so as not to further lengthen the notice periods for termination.

Ultimately, personnel planning should be performed based on day 1 requirements: Upon the commencement of business activities, sufficient personnel must be in place to conduct the business properly while maintaining the necessary segregation of functions. Employees must also be adequately trained and familiarized in this regard, meaning that new employees must be hired with sufficient lead time.

Employees delegated from London will be familiar with the processes and IT systems used, assuming they are to be transferred. However, they must be familiarized with the particularities of local supervision as described in this paper. Therefore, training on this subject must be planned as well. In addition, reference must be made to the fact that unresolved questions regarding freedom of movement also affect the employment of British citizens in the EU. Barring a political agreement, it may be necessary to apply for work permits, etc.

Based on the German two tier system, the supervisory board (non-executive directors) is separate from the executive board. In many cases, members of the supervisory board will be staff from the UK entity. While members of the board need no approval from the regulator, they must possess sufficient knowledge, e.g. concerning the local regulatory requirements. Therefore, training sessions also for non-executive board members should be planned.

11 Tax aspects

Potential tax repercussions have been discussed ever since the UK’s Brexit decision. Since it is not foreseeable at the moment whether there will be a transition solution, it is particularly important for companies in the financial services sector to react to any possible changes as early as possible because tax requirements and repercussions must always be considered when planning corporate restructuring measures.

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36 The notice periods to be observed can vary widely because the statutory periods often only represent minimum times in practice, whereas collective bargaining or individual contract provisions may stipulate longer notice periods for termination.

37 See section 25d KWG.
If it has been decided to form a new entity to conduct business within Europe after the UK's departure from the EU, a wide range of tax questions must be answered in relation to both the transfer of business to the new entity and the general set-up of the new entity.

Because business activities in the financial services sector have often been conducted for Europe from the United Kingdom by way of foreign business establishments, more than one jurisdiction will often be affected when business is transferred after Brexit. This requires a coordinated, cross-border analysis of the potential tax implications, also in view of the planned future business dealings between the individual entities.

One challenge among others to be overcome when attempting to transfer business on a tax-neutral basis concerns the resulting corporate-law structure. In practice, many banking groups did not want the transferring company to hold shares in the receiving company after the transfer because it is intended in many cases for an overarching holding company to hold both the shares in the British transferring entity and in the German receiving entity. This must be taken into consideration when contemplating any restructuring measures.

If a new German institution is to be founded, due consideration must be given not only to the tax registration obligation of the new institution, but also its obligation to report the formation of foreign business establishments. In addition, care must already be taken at the time of formation to implement appropriate procedures and processes to ensure that the new institution is tax-compliant.

This situation also raises questions related to the location and storage of electronic bookkeeping and tax-relevant data, the implementation of the German required principles of proper electronic bookkeeping and storage of books, records and documents, and the assurance of data access in relation to bookkeeping, etc.

Companies operating in the financial services sector often use uniform bookkeeping systems for all domestic and foreign group companies. Moreover, such companies often intend to perform at least parts of the electronic bookkeeping and/or storage of electronic tax-relevant data centrally in the UK, even after Brexit. In this case, the company in question must file an application for approval of electronic bookkeeping/storage in a foreign country pursuant to section 146 (2a) German Tax Code (Abgabenordnung, AO) in a timely manner because the approval of the tax authority must be issued before the relocation, i.e. before commencement of business activities. It should also be remembered that the performance of services such as bookkeeping activities, for example, on behalf of another entity must always also be reviewed on the basis of the regulatory outsourcing requirements.

To summarize the foregoing comments, it can be noted that the high degree of complexity of tax planning considerations is not solely the result of individual tax requirements, but also the interplay of many different kinds of requirements, including those arising from tax law, commercial law and supervisory law. In practice, therefore, it is critical to analyze all planning considerations and requirements in relation to all areas of the law on a coordinated basis. Thus, continual consultations among the members of the different project teams is also indispensable for tax purposes.
12 The Deloitte approach to Brexit and the founding of new institutions

Should an organization determine that part of its Brexit strategy is to establish a new entity, a highly structured approach should be followed when founding an institution in Germany. Besides implementing global corporate approaches and systems, the necessary processes must be adapted to the statutory and supervisory requirements in the target country. In principle, the Brexit approach is not different from the "normal" formation of an institution, but it must be done according to a strict timetable given the established time periods resulting from the UK’s departure from the EU. The failure to meet all statutory and supervisory requirements by the exit date could lead to a business interruption. It must also be remembered that the processing of license applications could be delayed as a result of the high number of license applications and the ever longer coordination process with the ECB in the age of Brexit.

The new entity must be compliant with the core regulatory requirements when starting its business ("day 1") but no later than end of March 2019, when the UK’s membership of the EU ends. Full compliance with local requirements is not required immediately but must be achieved within a reasonable timeframe ("day 2").

![Structured approach for the comprehensive consideration of all relevant subject areas](image)

Figure 2: The Deloitte Approach

Upon commencing licensed business activities in Germany, a smooth transition is planned for part of the business. In other words, only new business shall be conducted in the new institution, while the previous business in place at the time of the UK’s departure will mostly remain with the existing UK entity.\(^{38}\)

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\(^{38}\) "Contract continuity" is an issue in this context as some of the contractual arrangements might not be permissible after the Brexit date. Existing contracts must be checked to determine whether any adjustments are required to reflect the post-Brexit legal framework.
Given the fact that business is only just beginning, such an arrangement can alleviate the implementation work for “day 1”, but it also means shifting the implementation work for the necessary target processes and systems to “day 2”. Additional work may be required during this transition period to establish the business and risk units because the supervisory authorities, particularly including the BaFin and the ECB, have repeatedly said – depending on the business model – that the complete transfer of risks to another group entity, such as one in London, for example, will not be accepted.

In this respect, the degree to which a combination of regulatory requirements and necessary group-wide processes, systems and booking models will necessitate the transfer of considerable resources and decision authorities to the newly formed German institution cannot yet be determined. It is likewise still unclear how the supervisory authorities will deal with “undesirable” solutions and permit any outstanding requirements to be fulfilled only after the commencement of business activities in the new institution.

Regulators have put a lot of emphasis on what they call “the glidepath”. While the regulators may accept solutions, which are not yet fully compliant on day 1, a plan must be available that demonstrates how the newly founded entity will achieve acceptable compliance within a reasonable timeframe after day 1. It seems unlikely that regulators will accept a glidepath that needs more than 24-36 months to achieve full compliance. This sets the latest tolerable date for “day 2”.

Therefore, the goal must be to have achieved a sufficient degree of compliance in the relevant subject areas by “day 1” and coordinate any foreseeable delays with the supervisory authorities at an early stage in order to arrive at a consensual solution. Regular consultations with other parallel projects will help everyone involved gain a sense of the expectations of the supervisory authorities and develop arguments for prioritization.

The stringent time constraints leave very little room for unsound solutions. Therefore, approaches that are not likely to be accepted by bank supervisors should be discarded at an early stage. Also in this respect, regular consultations or the engagement of outside experts can help avoid time-consuming and costly aberrations.

For the Brexit-related projects, failure is not an option. Banks must thus ensure that the new entity is up and running by March 2019. This will likely require additional resources in the period just before and after day 1. Deloitte’s highly qualified staff will be able to fill any eventual gap both on the project side as well as in running the bank, for instance in risk management, finance or regulatory reporting.

Our rapid response teams will align with bank staff and project resources to achieve regulatory compliance in all relevant areas while leveraging on the experienced gained in numerous bank foundation/Brexit projects.

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Best compliance on day 1 is desirable

No time for unsound approaches

Deloitte rapid response teams
## 13 Overview of regulations and abbreviations

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<th>English</th>
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<td>AO</td>
<td>Abgabenordnung</td>
<td>Tax Code</td>
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<td>AT</td>
<td>Allgemeiner Teil (der MaRisk und MaComp)</td>
<td>General Part (of MaRisk and MaComp)</td>
</tr>
<tr>
<td>BaFin</td>
<td>Bundesanstalt für Finanzdienstleistungs-aufsicht</td>
<td>Federal Financial Supervisory Authority</td>
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<td>BAIT</td>
<td>Bankaufsichtliche Anforderungen an die IT</td>
<td>Supervisory Requirements for the IT</td>
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<td>BGB</td>
<td>Bürgerliches Gesetzbuch</td>
<td>Civil Code</td>
</tr>
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<td>BT</td>
<td>Besonderer Teil (der MaRisk und MaComp)</td>
<td>Special Part (of MaRisk and MaComp)</td>
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<td>Depotgesetz</td>
<td>Custody Account Act</td>
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<td>GroMiKV</td>
<td>Großkredit- und Millionenkreditverordnung</td>
<td>Regulation on large exposures</td>
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<td>HGB</td>
<td>Handelsgesetzbuch</td>
<td>Commercial Code</td>
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<tr>
<td>IDW</td>
<td>Institut der Wirtschaftsprüfer in Deutschland</td>
<td>Institute of Public Auditors in Germany</td>
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<tr>
<td>KAGB</td>
<td>Kapitalanlagegesetzbuch</td>
<td>Capital Investment Code</td>
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<td>KWG</td>
<td>Kreditwesengesetz</td>
<td>Banking Act</td>
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<tr>
<td>MaComp</td>
<td>Mindestanforderungen an die Compliance-Funktion</td>
<td>Minimum Requirements for the Compliance Function</td>
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<td>MaDepot</td>
<td>Mindestanforderungen an das Depotgeschäft</td>
<td>Minimum Requirements for the Safe Custody Business</td>
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<td>MaRisk</td>
<td>Mindestanforderungen an das Risikomanagement</td>
<td>Minimum Requirements for Risk Management</td>
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<tr>
<td>WpDVerOV</td>
<td>Wertpapierdienstleistungs-Verhaltens- und Organisationsverordnung</td>
<td>Regulation Concretizing Rules of Conduct and Organizational Requirements for Investment Services Companies</td>
</tr>
<tr>
<td>WpHG</td>
<td>Wertpapierhandelsgesetz</td>
<td>Securities Trading Act</td>
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