Maximizing and maintaining the business benefits
Global bank booking models
The banking sector faces considerable challenges in preserving the business benefits of global booking models in an increasingly fragmented regulatory environment. In the coming years, the industry will need to navigate what will likely be a highly contested boundary between two booking hubs: London and the Eurozone. What’s more, decisions need to be made just as supervisors ramp up their baseline expectations of what “good” booking model capabilities should look like. Banks need to focus on comprehensive documentation, integrated governance, and strong trading controls, while identifying opportunities for optimization.
Contents

Glossary 02
1 Executive summary 03
2 The evolving supervisory landscape 08
3 Adopting a booking model mindset: practical implications 14
4 Where does this leave us? 18
Appendix 1: EU regulatory developments 19
Appendix 2: From IHCs to IPUs 23
## Glossary

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>BRRD</td>
<td>Bank Recovery and Resolution Directive</td>
</tr>
<tr>
<td>CCPs</td>
<td>Central counterparties</td>
</tr>
<tr>
<td>CFTC</td>
<td>Commodity Futures Trading Commission</td>
</tr>
<tr>
<td>CRD</td>
<td>Capital Requirements Directive</td>
</tr>
<tr>
<td>CRR</td>
<td>Capital Requirements Regulation</td>
</tr>
<tr>
<td>Dodd-Frank Act</td>
<td>The Dodd-Frank Wall Street Reform and Consumer Protection Act</td>
</tr>
<tr>
<td>EBA</td>
<td>European Banking Authority</td>
</tr>
<tr>
<td>ECB</td>
<td>European Central Bank</td>
</tr>
<tr>
<td>EEA</td>
<td>European Economic Area</td>
</tr>
<tr>
<td>EPS</td>
<td>Enhanced prudential standards</td>
</tr>
<tr>
<td>EMIR</td>
<td>European Market Infrastructure Regulation</td>
</tr>
<tr>
<td>ESMA</td>
<td>European Securities and Markets Authority</td>
</tr>
<tr>
<td>FBOs</td>
<td>Foreign banking organizations</td>
</tr>
<tr>
<td>FCA</td>
<td>Financial Conduct Authority</td>
</tr>
<tr>
<td>FINMA</td>
<td>Swiss Financial Market Supervisory Authority</td>
</tr>
<tr>
<td>FMIs</td>
<td>Financial market infrastructures</td>
</tr>
<tr>
<td>FRB</td>
<td>Federal Reserve Board</td>
</tr>
<tr>
<td>FSB</td>
<td>Financial Stability Board</td>
</tr>
<tr>
<td>G-SIB</td>
<td>Globally systemically important bank</td>
</tr>
<tr>
<td>IHC</td>
<td>Intermediate Holding Company</td>
</tr>
<tr>
<td>IPU</td>
<td>Intermediate Parent Undertaking</td>
</tr>
<tr>
<td>ISDA</td>
<td>International Swaps and Derivatives Association</td>
</tr>
<tr>
<td>MAS</td>
<td>Monetary Authority of Singapore</td>
</tr>
<tr>
<td>MI</td>
<td>Management information</td>
</tr>
<tr>
<td>MiFID</td>
<td>Markets in Financial Instruments Directive</td>
</tr>
<tr>
<td>MREL</td>
<td>Minimum requirement for own funds and eligible liabilities</td>
</tr>
<tr>
<td>OCC</td>
<td>Office of the Comptroller of the Currency</td>
</tr>
<tr>
<td>PRA</td>
<td>Prudential Regulation Authority</td>
</tr>
<tr>
<td>RPA</td>
<td>Robotic process automation</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SM&amp;CR</td>
<td>Senior Managers and Certification Regime</td>
</tr>
<tr>
<td>SMFs</td>
<td>Senior management functions</td>
</tr>
<tr>
<td>SRB</td>
<td>Single Resolution Board</td>
</tr>
<tr>
<td>SSM</td>
<td>Single Supervisory Mechanism</td>
</tr>
</tbody>
</table>
1. Executive summary

1.1 Global bank booking models in 2018 and beyond

Since we published our last paper on global bank booking models in 20151 a great deal has happened. Booking models have moved further up the supervisory agenda for four main reasons. First, supervisors have in the last few years delved deep into the complexity of global banks’ booking structures, particularly in the UK and US, and their expectations continue to evolve and strengthen as they learn, with the PRA in particular having finalized its expectations of booking arrangements in early 2018.2 Second, the IHC requirement for certain large, non-US banking groups operating in the US became effective on July 1, 2016, drawing further attention to the role of global booking models. Third, and more urgently, the UK’s decision to leave the EU threatens to disrupt global banks’ European operations, creating a new regulatory and supervisory fracture in the EU’s Single Market where currently none exists. Fourth, the business benefits from a robust and clearly articulated booking model remain significant, in terms of making best use of capital and liquidity, effective risk management, and satisfying client preferences. Less immediate, but no less important, is a series of regulatory changes in the EU which will unfold over the next five years and will likely fundamentally overhaul the way in which international banks operate in the region.

All that said, supervisors’ overall objectives with respect to booking models remain much the same now as when we wrote on the subject last: they want transparency, simplification, robust governance, risk and financial controls, and practices that improve resolvability and self-sufficiency. Various historical practices that were accepted in the past are now generally seen to be undesirable for resolvability or supervisory reasons (such as split hedges and unjustified, opaque or ad hoc revenue transfers and cost allocations). But supervisors’ expectations of banks’ capabilities are clearly a notch above where they were a few years ago, given that industry has had time to digest and address earlier supervisory interventions.

“Some of these changes will cut across banks’ ongoing work to upgrade their booking model capabilities, and may also create significant resource pressures.”

Of particular note is a shift of focus towards more preventative control frameworks, designed to restrict the ability for individuals to book trades which do not comply with the bank’s booking model authorities, policies and practices. Work has included hard-wiring of controls and the construction of “rules” libraries of acceptable booking practices.

---

2 See the PRA’s supervisory statement on the authorization and supervision of branches, available online at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2018/ss118.pdf
1.2 Challenges in meeting baseline supervisory expectations and leading practice

Despite the evident business benefits and the significant investment that some banks have made to bring their booking models closer into line with these heightened supervisory expectations, many are not there yet. And meeting what might be considered leading practice has proven particularly challenging for the industry. Some banks have not moved as quickly as supervisors may have anticipated to address their concerns, while others have struggled to make their booking models more efficient. We still observe a range of challenges for banks across a number of key areas:

1.2.1 Documentation and articulation

- Most large banks – particularly their front office staff and legal entity management – can describe booking practices for individual products and individual trading desks. While a number of banks have aggregated their global booking practices into a comprehensive macro view, few have so far constructed a systematic framework to ensure that documented booking practices are updated and maintained on a regular basis. Fewer still have a fully functioning attestation framework to demonstrate bank-wide understanding of and compliance with the agreed booking model.

- Front office staff can typically explain the products they trade, but not the legal entities they use for origination or booking and where they manage risk. This is becoming increasingly problematic given that supervisors want to understand business models within legal entity boundaries.

- Booking policies tend not to be systematically linked to resolution planning or legal entity governance or legal entity simplification programs.

- “Booking policies tend not to be systematically linked to resolution planning or legal entity governance or legal entity simplification programs”

- This lack of an up-to-date, centrally maintained macro view (spanning both the business and legal entity dimensions) makes it difficult to deal with multiple requests for information from supervisors in different countries.

- Some banks have struggled to ensure that existing booking documentation is globally comprehensive, regularly maintained, and sustainable, and have therefore been unable to demonstrate to their supervisors’ satisfaction that documentation is not just a “one-off” exercise for the bank.

- The granularity with which booking practices are documented varies across banks, and is typically high level. Supervisors increasingly expect that the documentation of booking practices describes the “why” and “how” of booking activities in addition to the “where”.

- There is often no common language or taxonomy to discuss booking models, both within and between banks and regulatory or supervisory authorities (for instance for key terms such as “remote”, “back-to-back” or “intercompany booking”).
1.2.2 Governance

• There remains a lack of defined principles and policies around booking model decision making. This has resulted in a distinct lack of clarity around individual roles and responsibilities for adhering to booking model principles, and the processes and reporting required to evidence the ongoing management and monitoring of the booking model.

• For some banks, booking practices which were initially developed for a specific client for a limited period of time may subsequently be offered to other clients without a prior cost-benefit analysis of the practice. Such scenarios are often linked to new product processes, in which historical decisions which may have been intended as one-offs under specific circumstances are later used to justify new and unrelated types of business.

“Some banks have struggled to document and codify the governance procedures in place to ensure that their framework for making decisions about booking practices is followed.”

• Many policies tend to focus only on the most heavily scrutinized jurisdictions and product types (e.g. derivatives), and do not offer a comprehensive framework for all booking practices.

• Some banks have struggled to document and codify the governance procedures in place to ensure that their framework for making decisions about booking practices is followed, including:
  – legal entity governance systems and how these are tied to booking model governance;
  – the ways in which booking practices are factored into new product approval processes;
  – the procedures for altering booking models outside the new product approval process, and the governance systems in place to oversee any changes;
  – linkage of booking practices to the legal/compliance requirements for individual products, which may vary according to the jurisdiction of the activity;
  – linkage to existing corporate governance, risk and compliance management frameworks;
  – linkage to recovery and resolvability strategies, frameworks and documentation in global and local recovery and resolution plans;
  – identification of who is responsible for ensuring that booking model governance is adhered to (with some additional complexity for banks operating under the UK’s SM&CR);
  – the ways in which booking model governance is monitored and managed, what the escalation processes in the event of non-compliance are, and how these processes are embedded in existing reporting/controls frameworks;
  – the mechanisms for ensuring that booking practices are kept up-to-date; and
  – the veto powers held by the boards and/or senior management teams of legal entities, particularly for those entities into which risk is remotely booked by other legal entities in the group.
1.2.3 Monitoring, controls and reporting

• Many banks lack an integrated control environment from the trading floor through to the legal entity governance process. Front office controls often only serve one purpose (e.g. to meet a specific regulatory requirement), and often do not use the same systems reference data and hierarchies, creating MI that is interpreted in different ways across the first and second lines of defense.

• MI is often in need of development, particularly in order to develop a globally consistent view which can be shared with regulators in different jurisdictions.

• Due to the often piecemeal development of booking models, the corresponding controls do not always comprehensively, coherently and efficiently demonstrate effective control. Divergence in regulatory regimes can also create challenges in developing an end-to-end control framework. For example, the UK’s SM&CR has meant that banks have had to define controls on the basis of individual senior management functions, while the Volcker rule in the US has required trading mandates for individual trading desks, covering their mission, financial instruments, and limits.

• A key supervisory focus has been on the ability of individual legal entities to control the on-boarding of risk from transactions originated and managed by personnel in different legal entities and jurisdictions. The extent to which a bank can screen and veto trades coming in from other jurisdictions depends on an integrated and transparent controls framework, with an emphasis on the existence of preventative controls, of which we have seen few examples.

1.2.4 Efficiency and business drivers

• Effective and robust booking models can yield a number of business benefits, including legal entity, tax, capital and funding efficiencies resulting from managing risks at a portfolio level, and operational efficiencies through the concentration of risk management activities.

• The fragmented development of booking models over time has meant that these benefits are not always realized. Entrenched culture around what and where certain trading desks have historically been allowed to book trades may pose a challenge in developing a more comprehensive and efficient model.

• Banks require both a thorough understanding of their booking model (transparency) and an integrated framework to guide how business should be booked and monitored (governance and controls). These are necessary to enable them to identify and realize fully any opportunities to optimize their booking model, including business strategies, legal entity usage, and financial resources efficiencies.

• Technological advancement has meant that banks have access to analytical tools to leverage capital, business and risk management data in order to document and manage booking practices more efficiently and effectively.

• Banks should assess their current booking models against future developments in regulatory and market expectations, whether certain or expected, and seek to provide impact analyses for decision-making and the futureproofing of documentation.

1.3 Where does this leave us?

In our view, banks need, at a minimum, to be able to demonstrate to supervisors that their booking model is well documented and governed; that documentation is durable and evolves with the business, rather than simply being a one-off compliance exercise; that integrated risk and financial controls are in place; and that the booking model does not represent an obstacle to resolvability. In instances where banks have fallen short of the expected standards, we have seen regulatory enforcement of remedial actions to enhance the current state booking model and governance and controls frameworks, particularly through detailed data requests, which has led in some instances to banks setting up large booking model review programs to address supervisory concerns. In future, we may see an escalation of interventions by both home and host supervisors, such as capital and liquidity add-ons, mandatory restructuring to improve resolvability, limitations on inter-affiliate transactions or even (temporary) restrictions on new business for specific entities. For global banks, booking model issues can be expected to be discussed and debated actively among supervisors, boards, and senior management.
“Banks need, at a minimum, to be able to demonstrate to supervisors that their booking model is well documented and governed; that documentation is durable and evolves with the business, rather than simply being a one-off compliance exercise; that integrated risk and financial controls are in place; and that the booking model does not represent an obstacle to resolvability.”
2. The evolving supervisory landscape

The practical challenges that banks face in meeting baseline expectations and in working towards leading practice are significant. Even in the absence of competing priorities, of which there are plenty, the remediation work required is operationally complex and the remedial actions are too often designed to deal with a legacy issue rather than to provide a durable, ongoing control. To complicate matters further, for those banks operating in the EU, the general supervisory attention on booking models sits alongside a major overhaul of the regulatory and supervisory framework for cross-border banking. There are a number of threads relevant to booking models:

1. **Brexit:** most obviously, Brexit requires cross-border banks to contemplate the prospect of relocating a variety of activities from the UK into EU27 countries in order to guarantee continuing access to the Single Market. There are several important supervisory developments relating to Brexit, including:
   - the changed regulatory status of branches and subsidiaries of UK and EU27 entities which passport between the two territories, and the associated impacts on market access;
   - the ECB’s development of an approach to booking models delivered through speeches, Q&As, and industry workshops;

   “To complicate matters further, for those banks operating in the EU, the general supervisory attention on booking models sits alongside a major overhaul of the regulatory and supervisory framework for cross-border banking.”

2. **The IPU:** the EU is developing a requirement that would force large third-country groups with more than one bank or investment firm in the EU to structure themselves under EU IPUs, similar in intent to the US IHC requirement for large foreign banks operating in the US.

3. **Investment firm supervision:** the EU is overhauling the way in which investment firms are regulated and supervised. The largest investment firms are likely to be required to gain authorization as credit institutions, bringing them under the direct supervision of the ECB’s SSM.

4. **Resolvability:** the SRB continues to build its operational capacity, and will be looking to apply its resolvability assessment framework more assiduously in the coming years, creating another avenue through which regulators may intervene in group structures and intragroup transactions. Resolvability is also clearly influencing Brexit restructuring conversations.

3 See Appendix 1 for further detail on these initiatives.
4 See Appendix 2 for a review of lessons learned in the implementation of US IHCs.
5 Credit institutions and investment firms are the two main categories of entities in which banking and investment activities are carried out in the EU. Broadly speaking, credit institutions are authorized under the CRR to accept deposits and extend credit, while investment firms are authorized under MiFID for activities such as executing transactions in financial instruments, portfolio management and underwriting activities. Certain categories of investment firm are subject to the prudential rules set out in the CRD and the CRR. Negotiations are ongoing which would overhaul the prudential regime for investment firms. For more details, see Appendix 1.
When these pieces are put together, the trend seems clear: with the UK’s exit from the EU, the ECB will become a far more significant player in the supervision of cross-border investment banks, being equipped with the tools to supervise investment banking in a far more consistent way across the EU than has been the case to date. The ECB is likely to be in a strong position to demand that incoming groups have more substantive operational and control presences in the Eurozone, and the signs point towards the ECB’s inclination to make those demands.

“A key challenge for the industry is how to preserve the business benefits of a global booking model in an increasingly fragmented regulatory environment. One more pressing aspect of this challenge is navigating what is likely to be a highly contested boundary between the two future European booking hubs: London and the Eurozone. Moreover, this decision-making process comes at the same time as supervisors are ramping up baseline expectations of what “good” booking model capabilities should look like. Recent supervisory scrutiny is driving banks to have comprehensive documentation, an integrated governance framework, and strong trading controls over their booking model. However, banks can benefit greatly from this focus on booking models to identify opportunities for optimization.

It would seem a good time, therefore, for banks to take the initiative and engage in a fundamental review of how their booking models work. The business benefits of a robust and clearly defined booking model remain high. These include more effective credit, market and operational risk management and capital and funding efficiencies. These benefits are explained further in section 3.1.4 below. Moreover, developments in the EU will likely force a reappraisal of European operating models, and supervisors elsewhere will continue to tackle the now familiar themes of supervisability, resolvability, complexity, transparency, controls and more. From this point of view, tactical approaches in the near-term only delay the inevitable, and banks would do well to grab the bull by the horns.

The ECB’s relative strength of position reflects the fact that many of the regulated banks restructuring activities into EU27 countries are new entities or are built on an existing entity starting from a very low base. As such, the ECB may be able to avoid grappling with some of the more difficult legacy issues which exist in UK and US entities. This should influence its views on certain practices, as it makes “cleaner” solutions available, and banks can expect to find themselves held to a rigorous standard from the start. On the other hand, given the deadlines associated with Brexit and the fact that supervisory decisions are having to be made in parallel with political negotiations about the future relationship between the UK and the EU, the ECB has shown some flexibility in its expectations for banks’ “Day 1” operating and business models.
2.1 Brexit and the EU27 perspective

The ECB has been developing its approach to booking models in a post-Brexit Europe, and its views are becoming increasingly clear: “empty shells” will not be acceptable, and banks will need to have effective governance, including local risk management, in place for Brexit Day 1. Brexit “Day 2” plans will need to involve the establishment of more substantive market risk functions “onshore” in the EU27, with a common working assumption being that banks might be allowed up to three years to build this up to full capacity. While the ECB’s approach continues to evolve, it shares the same drivers of concern as the UK and US authorities: are the businesses it will be supervising prudentially sound, viable and with the operational capability to determine their own destiny, particularly in the event of a crisis scenario?

Most banks looking at restructuring options plan to employ inter-affiliate trading arrangements between new EU27 entities and existing operations in the UK, US and Asia on Day 1. As such, little market risk would remain in the EU27 in the initial period after Brexit. Most banks envision trading capabilities in the EU27 on Day 1 sufficient for them to be able to discharge their potential obligations for recovery and resolution or business continuity purposes, enabling them to ensure that the market risk position remains flat on a day-to-day basis, in turn implying a need for relatively few traders.

It remains possible that some of the ECB’s more categorical statements on these subjects may become more nuanced over time and/or in bilateral discussions with individual banks. However, it is increasingly clear that no such assumption can be baked into baseline plans. This means that banks need to focus on producing concrete, medium-term projections for how these local risk management capabilities will be built up over time. Banks should undertake the analysis needed to create these plans, including identification and analysis of products and desks which may move “onshore”, the talent and headcount implications across all three lines of defense, the risk management infrastructure, the capital and liquidity needs of the EU27 entity, the need for advanced risk models, and more. Most banks have yet to start this analysis, but need to do so soon. One useful practice in the interim is to monitor the potential costs of externally re-hedging trades that are currently hedged with affiliates, to cover the potential loss of an intragroup counterparty.

“While the ECB’s approach continues to evolve, it shares the same drivers of concern as the UK and US authorities: are the businesses it will be supervising prudentially sound, viable and with the operational capability to determine their own destiny, particularly in the event of a crisis scenario?”
Development of the EU27 perspective

The ECB has been developing its approach to supervising booking models at an accelerated pace. Its views have been delivered through speeches, Q&A tools and industry workshops, and its expectations are gradually being brought into focus. However, there is a lot of detail yet to work through: although the ECB has articulated a number of outcomes it would like, it is yet to specify how it wants to see those outcomes achieved, and what sorts of practical arrangements it will deem acceptable in the delivery of those outcomes.

From the point of view of the EU27 countries, there are some clear concerns about the implications of Brexit for the supervisability and resolvability of investment banking. This seems to be encapsulated by the EBA's statement:

“It is possible that a UK-based institution will establish an entity in the EU27 solely in order to get access to the Single Market, with no intention to transfer or set up a local management unit. Under this structure, the subsidiary, instead of identifying and managing the risk stemming from selling financial instruments, derivatives or credit products to EU clients, could simply transfer all risks via back-to-back or intragroup transactions to the non-EU27 parent undertaking.”

This perspective is clearly shared by the ECB, which has consistently emphasized its zero tolerance for “empty shells”. For practical reasons there is a clear willingness on the ECB's part to entertain a build-up period from Brexit Day 1 to steady state, so that the immediate short-term disruption of restructuring work does not affect the provision of services to EU customers. This includes the ECB accepting a period in which inter-affiliate hedging arrangements are central to booking practices, but also a clear expectation that some of those arrangements will be phased out over time.

Relocating banks need to pursue structures which make sense for their businesses from a commercial and operational perspective. But banks also need to factor in the ECB's legitimate supervisory concerns around governance and the operational capacity and preparedness of entities it will supervise, many of which overlap considerably with expectations set out by supervisors in other countries. Some of the key issues include:

- control over on- and off-balance sheet exposures and an ability to manage the associated risks;
- substance and clarity of governance arrangements, particularly for risk management;
- the existence of local trading capability, both in terms of personnel and the operational capability to carry out transactions, such as having appropriate trading venue and FMI memberships and counterparty relationships;
- an ability to demonstrate that operational continuity will not be compromised by excessive reliance on operations in third countries; and
- the implications of booking practices for recovery and resolution scenarios, particularly in the event of the failure of an intragroup counterparty.

Consequently, it appears inevitable that there may be some fragmentation of the management of market risk, and therefore also the governance, infrastructure and financial resources which underpin it. This means that where banks have to date been concerned with a triangular world (with vertices in the US, UK and Asia Pacific region), the future looks increasingly square. Wholesale duplication of identical trading infrastructure, process and controls in the UK and EU27 would be sub-optimal, both in terms of operational costs and capital consumption, but the question then becomes: which products and services should go where? In order to minimize duplication, an optimization exercise will need to be undertaken based on whatever stable market equilibrium is reached in the years after Brexit – an equilibrium which may vary from product to product according to where there is sufficient liquidity. This will also depend on the location of trading venues and FMIs (influenced by MiFID II and ongoing revisions to EMIR). MiFID II needs to be a significant part of the equation, particularly in relation to best execution and the trading obligation, given that any post-Brexit utilization of non-EU execution venues will still require best execution.

Clearly there are some products for which it may not be straightforward to mandate a trading desk in the EU27 (such as non-EU equity instruments), but when it comes to products where there are the appropriate venues, FMIs (including CCPs) and liquidity within the EU (such as euro-denominated instruments), it may be more difficult for groups to justify retaining trading capabilities and risk management outside of the region. To the extent that market liquidity and clearing, especially of euro-denominated transactions, moves to EU27 countries post-Brexit, it is likely that the shift in the underlying economics of the business together with supervisory pressure would cause trading and risk management to move “onshore” from the UK to those EU27 countries. Under this scenario, the “square” may revert to a “triangle”, this time with vertices in the US, Asia Pacific and EU27, at least for some products.

2.2 US supervisory expectations

The US supervisory and regulatory environment continues to evolve. The Trump Administration has focused on recalibrating aspects of the post-crisis regulatory framework while maintaining many of its fundamental pillars. At the same time, Congress is working on legislation to amend the Dodd-Frank Act. In particular, both the House and Senate have developed regulatory relief legislation. The version most recently passed in the Senate by a wide margin, the “Economic Growth, Regulatory Relief, and Consumer Protection Act” would, if enacted, mark the most significant changes to the Dodd-Frank Act since its enactment in 2010. Within this wider environment of change, US regulators continue to refine their expectations for booking models. Where some banks have struggled with why they book a certain product in a particular way or how they control and supervise booking practices, authorities have taken action. However, for domestic US banks with significant cross-border activity, regulators increasingly expect greater transparency around legal entity structure below the holding company level, particularly around US subsidiaries conducting global business, and branches and subsidiaries in both the UK and Asia Pacific region. Areas of focus have included the adequacy of documentation, the control framework, the impact that booking models can have on resolvability and resolution plans, and the link to legal entity rationalization.

“Where banks have to date been concerned with a triangular world (with vertices in the US, UK and Asia Pacific region), the future looks increasingly square.”

For US banks with global operations, booking models affect discussions with authorities in both home and host countries. Emphasis in the US has been placed on bank-centric protections, including the affiliate transaction rules (e.g. Regulation W), as well as Regulation K, which creates boundaries for the non-US activities of the largest US banks.
For FBOs with US operations, authorities have focused on the role of booking models in resolution planning. FBOs will need to be able to demonstrate appropriate revenue and cost transfers when booking trades in the US.

Where previously US authorities’ expectations in respect of booking models have largely been implicit and addressed on a case-by-case basis, in future, we expect them to be increasingly explicit about their expectations.

2.3 Evolving supervisory expectations and the booking model mindset

The supervisory fragmentation of Brexit introduces a new dimension to the old problem of how to reconcile the competing views of different national supervisory authorities. The ECB’s views now need to be folded into plans alongside those of the PRA and FCA in the UK, the Federal Reserve, OCC, CFTC, and SEC in the US, FINMA in Switzerland, and Asia Pacific authorities such as the MAS. The EBA and national supervisors will also have a voice in this debate. In this context, banks need to prioritize constructive engagement with the multiple regulatory authorities with which they are dealing, with particular emphasis on the ECB given the emerging issues in relation to Brexit.

UK and US supervisors continue to be in the lead in terms of the depth of their expectations as a result of the work they have carried out over the last few years, whereas Brexit has clearly acted as a significant accelerator for the ECB to develop its own expectations. Two years ago the focus was on articulating a baseline in order to bring the industry up to a common minimum level, but there is now more of an expectation that the larger banks have internalized those messages. The current conversation is increasingly about whether documentation of booking practices drives transparency and influences decisions and debate, and whether the nature and efficacy of controls (including the use of any automated or preventative controls) are sufficient to mitigate the risks present in the booking model. This conversation comes at a time when supervisors are also concerned about conduct risk and controls to mitigate those risks, including accountability within the first line of defense. There has also been a notable uptick in the focus on documenting rationales for booking practices – that is, going beyond description and articulating the why.

“The current conversation is increasingly about whether documentation of booking practices drives transparency and influences decisions and debate, and whether the nature and efficacy of controls (including the use of any automated or preventative controls) are sufficient to mitigate the risks present in the booking model.”
3. Adopting a booking model mindset: practical implications

Banks need to adopt a booking model mindset across their businesses that coincides with their strategic approach to operations across various legal entities and jurisdictions. This is true irrespective of Brexit, but Brexit clearly accentuates the importance of the endeavor. In general, banks will be expected to demonstrate an end-to-end view of the relationship between new product approvals, origination, booking, risk management, governance (both divisional and legal entity), and the supporting operational infrastructure across legal entities and branches and between jurisdictions.

In light of strengthening supervisory expectations, some major banking groups have set up dedicated teams to enable key capabilities including:

- producing MI with an aggregate view of the booking model;
- managing related internal controls and ongoing or ad-hoc reporting requirements;
- integrating changes in booking practices;
- responding to global supervisory requests; and
- identifying business benefits and potential efficiencies.

While such teams are far from common practice, they can provide an advantage through their ability to maintain an up-to-date macro view of booking practices and ensure compliance with the booking model policies, principles, and practices.

Regardless of the approach banks elect to take to meet the minimum baseline or achieve leading practice, what has become clear is that the evolving regulatory landscape and a strengthening of supervisors’ expectations across the board will require banks to re-think their approach to booking models in 2018 and beyond.

Here we split the challenges into four broad categories:

1. Documentation and articulation of booking practices
2. Governance and oversight
3. Monitoring, controls and reporting
4. Efficiency and business drivers

3.1 Documentation and articulation of booking practices

Supervisors expect banks to document booking models comprehensively and ensure transparency of processes at a macro level. Documentation should take both an aggregated business-wide view and a legal-entity level view, and should be linked into incremental new business discussions. A booking model should be a documented strategic policy framework outlining what is permitted and the rationale; it should not simply aggregate descriptions of what happens in practice.

“A booking model should be a documented strategic policy framework outlining what is permitted and the rationale; it should not simply aggregate descriptions of what happens in practice.”

Documentation needs to reflect actual booking practices and be kept up-to-date. The triggers for updates will include: changes in the business model or risk appetite; developments in the mitigation of financial and non-financial risks; new infrastructure and technology; and other process changes. One or more documents may be needed, depending on the size of the bank and the complexity of its booking model, but at a minimum such documentation should articulate the approach and record:

- the over-arching principles which will determine where and with what limitations the bank will permit exposures or products to be booked to its business lines, jurisdictions or legal entities;
- the legal entity which faces the client for each booking practice;
- the legal entity which manages the risk for each booking practice;
- inter-affiliate risk positions and activities;
- the business rationales (such as client preferences, liquidity hubs, global centers of excellence, prudential and risk management efficiencies, or other operational reasons) for each booking practice, especially where remote booking and inter-affiliate transactions are concerned;
- regulatory or other legal rationales (for instance, those that place restrictions on how certain products can be transacted); and
- the risk management and control framework, including governance and oversight arrangements.
Changes to documentation should be subject to a robust change management governance process and key first line/business leads should attest to the document at least annually.

Supervisors increasingly expect some front-line staff to be able to articulate not only the products they trade, but also in which legal entities they book and where they manage risk. This goes well beyond having adequate documentation. Heads of Desk and those managing booking control functions should therefore be in a position to answer supervisory enquiries about booking practices.

Some banks have focused their booking model documentation efforts around decision trees, which attempt to set out the permutations of all booking patterns, while others have developed mandates for the front office that set out permitted products and activities.

3.2 Governance

A robust booking model framework requires cross-business and cross-functional engagement, but should ultimately be led from the top. Senior management should be familiar with and able to articulate the booking model, and should take responsibility for approving the booking model, with additional expectations for boards and senior management to understand how the booking model works (either from a consolidated perspective or a subsidiary or branch perspective within a particular jurisdiction). While many groups make most decisions about booking at the executive level, there are clearly aspects for which it is important to make sure the board is informed and involved, such as in relation to major changes to booking, the relationship with the resolution plan, and the implications of booking practices for business models, including their viability and sustainability.

“A robust booking model framework requires cross-business and cross-functional engagement, but should ultimately be led from the top.”

What’s more, with the US IHCs in place for non-US banks with more than $50 billion in non-branch assets, the UK’s SM&CR applying to UK branches of non-UK banks, and the EBA and ECB focused on the capacity and capabilities of EU27 entities post-Brexit, it is increasingly clear that senior management with oversight and authority over booking models needs to be local to the bank’s actual activities. Cross-border dual-hatting arrangements are not prohibited, but are increasingly seen as exceptional arrangements in need of justification rather than matters of course.

Independence of decision-making is clearly important from a supervisory perspective. For instance, with respect to remote booking, there is a clear expectation that legal entities can police their own boundaries, and if necessary reject trades where the board and management do not want to accept particular risks onto their balance sheet. These supervisory expectations for legal entity-level governance of booking models may create inefficiencies for a number of banks, particularly those which have historically organized booking model governance at the divisional or group level.

Overall capabilities should strive to make certain that booking principles (which should be embedded in policy) are supported by metrics, processes and accountabilities across the bank. This will help ensure that the principles are actually measured and embedded across the organization.

Banks should also think about the extent to which entities have control over their own destiny with respect to their business and operating models. For instance, when it comes to post-Brexit booking arrangements, some groups will want to make the case that the most efficient method of providing EU clients with certain products is to transfer the risk from an EU27 entity to the UK via inter-affiliate transactions, and in many cases there will be a sound argument for such arrangements. But from the ECB’s point of view, the question will be: who is making and deciding this case one way or the other? And if the facts indicate that the best operating model, from a client perspective, is to retain the risk in an EU27 entity, does that EU27 entity have the authority to decide this, and the financial and operational capacity to accept that risk?

For the largest banks, a centralized booking model function would be desirable in order to support the process and act as a stakeholder in all elements of the bank’s activity and decision-making which may have knock-on implications for booking arrangements. At the very minimum, banks need to have dedicated resources in place with the authority, experience and accountability for booking model governance. Roles and responsibilities should be clear, and should reconcile legal entity, business and/or regional lines of management as necessary according to the bank’s structure.

Having the resources for booking model governance and oversight and being able to demonstrate to supervisors that roles and responsibilities are clearly defined are equally important. For many banks, effective oversight has involved a combination of management committees and individual roles, responsibilities and accountabilities.
While supervisors may not have expectations for which specific senior management role has overall responsibility for the booking model, they do expect banks to be able to communicate and document with whom this responsibility lies. For example, the UK’s SM&CR does not have a “prescribed responsibility” for booking models, and the FCA and PRA recognize that responsibilities differ between banks and are likely to be split across SMFs. However, supervisors may still look for an explanation of any responsibilities regarding a bank’s booking model in SMFs’ Statements of Responsibilities, which require details of other “business areas, activities, or management functions of a firm” for which the relevant function has overall responsibility. Groups in the UK will need to find a balance between having too few SMFs responsible for the booking model (for instance, the CEO alone), and having too many (for instance, making all business heads responsible).

3.3 Monitoring, controls and reporting

Supervisors expect strong controls to be in place, particularly covering trading authorities and scope, inter-affiliate transfer pricing, legal entity financials and risk, and reporting across independent control functions, such as risk and finance. There continue to be issues with basic housekeeping, and supervisors are less tolerant of deficiencies, having made their expectations clearer and having carried out a variety of investigatory work in recent years. At the very least, booking practices need to be demonstrably related to trading permissions and restrictions, and there should be clear escalation procedures, with remote booking and inter-affiliate transactions in need of particularly close oversight.

“At the very least, booking practices need to be demonstrably related to trading permissions and restrictions, and there should be clear escalation procedures, with remote booking and inter-affiliate transactions in need of particularly close oversight.”

With respect to MI, there is a clear expectation that all incoming and outgoing remotely booked trades are captured at the legal entity level, with details of each product according to which business it is associated with, and the associated revenue arrangements. There should also be systems to track trades that have been mis-booked, which should feed into remediation processes. This information is important not only for senior management, but also for boards of individual legal entities and those responsible for group-wide oversight of legal entity structures. MI should provide comprehensive coverage of business activities globally, and should be shared with regulators in separate jurisdictions in a consistent manner.

From a supervisory and resolvability perspective, there are some commonsense things that banks can and should monitor and report in order to provide comfort to supervisors looking to understand their operating model, even in the absence of detailed requirements. In the context of Brexit restructuring, obvious supervisory concerns are the degree of intragroup counterparty risk to which EU27 and UK entities are exposed and the resolvability implications of those exposures.

Supervisors will want to understand the size and nature of those risks, including the substitutability of counterparties, and contingency arrangements.

Beyond the basics, the conversation is increasingly turning towards the nature of controls, and in particular preventative controls, where relevant. Banks should look to rationalize existing controls and make them more efficient. In time, supervisors will expect more preventative controls in order to strengthen the first line of defense, while potentially reducing the scope for risk management and compliance failures or production level issues in the second line of defense. This means embedding more of the control framework into the first line of defense, either through hard-wiring of controls, or construction of rules libraries which constrain traders’ options. Building such hard-wired or rules-based systems is not beyond the technical capabilities of most banks; indeed, any flexibility in booking practices ought to be codifiable if the business itself understands the reasons why booking happens in the way that it does.

However, more significant than the technical obstacles are the cultural obstacles to such an approach, given that many traders retain significant discretion in terms of where they book their trades, and automated or preventative controls imply a significant narrowing of such discretion.

Global banks are also increasingly looking to invest in automation and cognitive technologies across multiple areas of their businesses, including the embedding of controls into front office systems or aligning to rules engines that join up with front office systems. Supervisors are also interested in the ways such technologies may be deployed. Automation can significantly improve business processes by streamlining, enabling greater efficiency and allowing people to focus more of
their time and energy on more strategic areas, but it also changes the nature of the control environment. It is, for instance, possible to integrate automation tools such as business process management and business decision management to create a centralized rules engine or decision service to evaluate trades at the pre-execution stage of the trading lifecycle. These tools can be used to hardwire requirements that dictate where a trade can be booked, and block any non-compliant trades from being executed and booked. Tools such as RPA could then be used to manage the approval process for trades that require additional review.

“Beyond the basics, the conversation is increasingly turning towards the nature of controls, and in particular preventative controls.”

While technological solutions may streamline processes and enhance controls, supervisors are likely to have concerns about the potential impediments to resolvability these solutions can create. For example, some banks may utilize a “closed system” which requires trades to be hedged with a particular affiliate. However, such a framework could hinder resolvability and operational continuity if the affiliate were to fail. Supervisors will therefore expect any technological solutions to take adequate account of their concerns around resolvability, for example, through the use of “open systems” which allow hedging both with affiliates and also with third parties. The appropriate type and level of automation is beginning to emerge through appropriate use cases.

However, where new technology is deployed in the context of booking models, supervisors will need to be brought along for the journey, whether this is RPA for routine and repeatable tasks, or tools relating to more complex end-to-end processes.

3.1.4 Efficiency and business drivers

This paper has concentrated mostly on the regulatory and supervisory drivers for banks having an effective approach to booking models. It is essential however not to lose sight of the business drivers of banks’ approaches to booking models, which in most circumstances pre-dated the recent increase in supervisory scrutiny. These business drivers include:

- risk management: it will often be more effective to manage the risks of a particular set of products in a single hub as this will allow specialist risk management skills and expertise to be concentrated there;
- capital and funding efficiency: the hedging efficiencies resulting from managing risks at a portfolio level, and the netting benefits that arise from the use of hubs, can be significant. The more dispersed and fragmented booking becomes, the more these benefits reduce;
- operational efficiency: concentration of risk management activities in a single hub can yield efficiencies from economies of scale;
- FMI efficiency: with the regulatory drive to clear derivatives (and the associated capital benefits), it is becoming increasingly efficient for banks to rationalize membership of different CCPs and to concentrate booking, for certain sets of products, into those entities/CCPs. Similar considerations arise in relation to trading venues;
- client preferences: clients will often have a particular requirement or preference for contracting with a single or small set of legal entities, e.g. for tax purposes or to minimise the number of ISDA agreements they have in place; and
- additional factors: additional factors can influence legal entity choice and product bookings, including regulatory and legal permissions, depth of the local talent pool, IT systems and tax regimes.

The ultimate objective of firms is to optimize their booking strategy in light of these business considerations while fully meeting supervisory imperatives. If they fail to work towards this objective they risk inconveniencing and in some cases losing clients as well as deploying capital and liquidity sub-optimally.
4. Where does this leave us?

4.1 Demonstrating robust booking models
In the last 18 months, global banking groups have been dealing with the heightened supervisory expectations (particularly from the UK and US authorities), which have emerged from the continuing scrutiny of banks’ booking models and associated governance and controls. Up until now, supervisors have not challenged the fundamental premise on which banks’ booking models have been founded, namely that it is more effective and efficient to transfer certain types of risk to specific hubs where they can be managed centrally. There are, however, signs that the ECB is prepared to question some of the foundations of the current approach. It is not yet clear exactly what the ECB will conclude on the acceptability of inter-affiliate and remote booking practices. However, in our view, if banks are to demonstrate to any supervisor that their booking model is properly documented, governed and controlled, they need to be able to answer the following questions:

1. Are your booking practices documented to a sufficient level of detail, and is senior management closely involved, e.g. through approvals or attestations? Are your boards of directors properly informed? Are systems and processes in place to ensure that your booking model documentation is kept up-to-date?

2. Does what you do make sense, and are current practices backed up by appropriate rationales? Is there a set of principles that allows you to make sense of those practices and rationales and which anchors to strategic objectives – at both consolidated and also individual legal entity level?

3. Do those responsible for your booking model understand their responsibilities, and do you have the processes and resources in place for them to be able to fulfil these responsibilities? Are Heads of Desk and those managing booking control functions able to articulate booking practices in sufficient detail if required by supervisors?

4. Can you demonstrate governance and the control environment around the booking model, proportionate to the scale and complexity of the activities? Do you have sufficient reporting for inflows/outflows as appropriate between external and internal counterparties, and are you able to demonstrate the effectiveness of controls across the three lines of defense? Have you established clear booking model roles and responsibilities across business and control functions?

5. Do you have a consistent internal view of what key terms mean? Are you able to classify activities according to whether they are remotely booked or inter-affiliate trades, where they are originated and risk managed, or otherwise? Are you able to identify those transactions classified as such?

6. Do you have a thorough understanding of the supervisory expectations for booking practices in each jurisdiction in which you are located (including branches of your parent bank)? Do your individual legal entity boards and governance forums understand and engage with the impact of the booking model on specific legal entities? In particular, do you understand the significance of the new regulatory and supervisory divide resulting from Brexit?

7. Have you integrated considerations arising from the business as usual impact of your booking model into your recovery and resolution planning? For instance, are your booking policies and principles compatible with ensuring operational continuity and self-sufficiency of material entities during a recovery or resolution scenario?

8. Do you understand the significance of different legal entity types (e.g. credit institutions, investment firms, subsidiaries and branches) in your booking chains, and do you understand what the changing shape of supervision in the EU will mean for your utilization of these entities?

9. Do you have a firm understanding of the transition from short-term Brexit restructuring to a longer-term, more sustainable solution in light of possible market evolutions?

10. Do you understand the implications of a more fragmented booking environment for your business model, particularly in terms of capital and liquidity resources, clearing, netting sets, transfer pricing arrangements, tax and more?

11. Are you exploring technological solutions to embed or create a more integrated booking control framework, including the use of preventative controls?

12. Are you able to identify and manage the conduct of business implications of your booking model, such as conduct risk issues arising out of remote booking practices, or the delivery of regulatory obligations such as best execution?

13. Have you sought to reduce the overall complexity of your booking model, for example, through reducing the volume of split hedging?
Appendix 1: EU regulatory developments

Brexit
In the context of Brexit, there are a number of important developments, including statements on the approach to the supervision of relocating firms.

ESMA on outsourcing and best execution
ESMA’s July 2017 opinion in support of supervisory convergence for investment firms ranged across a number of issues, including “letter-box entities”, outsourcing, and best execution.

ESMA reiterated the importance of full and effective compliance with MiFID requirements around governance and internal controls, as well as oversight of outsourcing arrangements. The opinion made clear that where national supervisory authorities do not think a firm has established a “meaningful presence” or that a firm is not “genuinely operating” from an EU Member State, this is grounds for the refusal or removal of authorization. ESMA made particular mention of national competent authorities’ obligations to closely consider the appropriateness of investment firms using third-country parties to place or execute client orders, and also said national authorities should seek evidence of monitoring arrangements around outsourcing arrangements, such as documentation and record keeping.

ESMA also highlighted the importance of best execution, including in the context of intragroup hedging trades. Firms should be able to demonstrate sufficient oversight of such hedging arrangements, and supervisors will need to consider whether they are consistent with the delivery of best execution. In the context of MiFID II, this represents a higher hurdle than in previous years, given that MiFID firms must now take “all sufficient” steps, rather than only “all reasonable” steps, to ensure best execution.

Firms need to consider execution venue fees, clearing and settlement fees, and any other fees paid to third parties, and they also need to be able to demonstrate to clients on request that orders have been executed in line with best execution policies.

EBA on internal governance and outsourcing
In October 2017, the EBA published an opinion on issues arising from financial services firms’ relocation to EU27 countries in the context of Brexit, ranging across issues from authorizations, outsourcing, resolution, MREL, deposit guarantee schemes, and more.

The EBA noted that “empty shell” companies are a potential source of concern for supervisors. The EBA also raised concerns around the risk of a default of a firm to which market or credit risks have been transferred from an EU27 entity. To combat this risk, the EBA advised that EU27 entities must have enough Pillar 2 capital above their Pillar 1 minimum requirement, as well as in-house risk management and operational capabilities, to absorb any material unhedged or unsecured portfolio that would appear in the event of the default of the firm to which the risks have been transferred. The EBA said that firms should ensure that inter-affiliate and intragroup transactions are appropriately reflected in their market and credit risk strategies, as well as in their management of large exposures. Supervisors should assess likely concentration risk and the proposals for management and controls, paying special attention to large exposures or concentration risks that may result from proposals to utilize inter-affiliate transactions systematically.

Where the transfer of market risk is significant relative to the local market the opinion calls for enhanced cooperation between home and host supervisors.

In the absence of such cooperation, the EBA expects the national authorities to prevent or limit the transfer of significant market risk. The need for such cooperation extends to the supervisors of any non-EU third-country entities (e.g., in the US or Asia) to which the EU27 firm transfers significant market risk.

The EBA opinion also covers outsourcing policy, and makes clear that national authorities should ensure that outsourcing is not used with the intention of stripping a firm of its corporate substance, and that outsourcing should not impair management’s ability to manage and monitor an authorized entity’s business.

PRA on branches
In March 2018, the PRA finalized an update to its approach to the supervision of branches of international banks. The policy is of particular relevance to EU-incorporated firms with London branches in light of their changed status with respect to the UK after Brexit, and introduces specific new details in relation to wholesale branches which are relevant from a booking models perspective, with the supervisory statement making clear that the PRA’s expectations on booking models apply to branches as much as they do to subsidiaries. The supervisory statement also included a statement of the PRA’s general expectations of booking arrangements.

The supervisory statement confirms that the PRA does expect, in principle, to permit some EEA firms to operate in the UK as branches following Brexit. However, firms posing a greater threat to the PRA’s objectives may in certain circumstances have to establish subsidiaries, and the supervisory statement explains the factors likely to be considered in decisions.
The approach set out in the supervisory statement is based on the assumption of a strong regulatory cooperation with EEA supervisors, although the approach may be revisited if the assumption is not realized as Brexit negotiations proceed.

The approach document introduces three elements that the PRA will use to determine whether wholesale banking activity will require a UK subsidiary, while allowing significant room for supervisory judgment. These factors are:

- the importance of the branch to the financial stability of the UK – its “systemic importance”; and
- quality of supervisory cooperation with the home state supervisor. This requirement is especially relevant for “disintermediated branches” – where international banks branch into the UK via an intermediate subsidiary incorporated in a different jurisdiction from the ultimate parent.
- In the event the PRA is unable to gain sufficient assurance over the supervisability of systemic wholesale branches, the PRA will be able to impose specific regulatory requirements on a case-by-case basis.

In determining whether a branch that undertakes wholesale banking activities is systemically important, the PRA will consider, among other factors:

- whether it holds more than an average of £15 billion total gross assets including those traded or originated in the UK but booked remotely to another location;
- the Critical Functions it undertakes in the UK; and
- the overall complexity and interconnectedness of the business undertaken in the branch, for example whether it provides significant operational services or is otherwise interconnected to a systemically important UK bank.

The PRA will apply additional expectations in the authorization and supervision of systemic wholesale branches and will require greater supervisory cooperation with the home state supervisor for these branches, including requiring a degree of influence and visibility over the supervisory outcomes for the firm as a whole and the wider group.

The PRA will seek to achieve its supervisory objective for systemic wholesale branches through regular supervisory dialogue with the firm and the home state supervisor first, before it considers using its powers to apply additional requirements if the firm fails to meet the PRA’s expectations. The additional requirements may include governance, liquidity, reporting or even restrictions on the scope and volume of business. If the PRA is still unable to meet its objectives by imposing these additional requirements, it will likely require the firm to undertake its activity through a UK subsidiary.

Financial market infrastructures

In June 2017 the European Commission published legislative proposals to amend EMIR in relation to the recognition and supervision of third-country CCPs. The proposal represents a fundamental overhaul of the EU’s approach to the recognition and supervision of third-country CCPs.

It includes extensive and intrusive supervisory and enforcement powers for ESMA, a significant new role for the ECB and an ability to require the most systemically significant third-country CCPs to establish themselves in the EU as a condition for providing their clearing services to EU clearing members and their EU clients. Overall the framework provides ESMA, the Commission and the ECB with very wide-ranging discretion in relation to third-country CCPs.

ESMA will be able to differentiate between three categories of CCPs based on their systemic importance. “Tier 1” CCPs will include third-country CCPs that ESMA has determined to be non-systemically important or not likely to become systemically important for the EU. These Tier 1 CCPs will continue to be subject to the current arrangements for third-country equivalence decisions adopted by the Commission, while ESMA will be tasked with new responsibilities regarding their supervision.

Third-country CCPs which are deemed to be systemically important or likely to become systemically important in the near future for the financial and economic stability of the EU will be categorized as “Tier 2” CCPs. The Tier 2 CCP determination will be based on four criteria, for which there are not as yet any quantitative thresholds:

- the nature, size and complexity of the third-country CCP’s business;
- the effect that the failure of, or a disruption to, the third-country CCP would have on the financial stability of the EU;
- the third-country CCP’s clearing membership structure; and
- the third-country CCP’s relationship, interdependencies, or other interactions with other FMIs.
Tier 2 CCPs can only be recognized if they meet further conditions, such as ongoing compliance with EU prudential requirements for CCPs as set out in EMIR. The additional conditions and requirements imposed on Tier 2 CCPs mean that they will effectively be subject to joint supervision by ESMA (with input from the ECB and central banks of issue) and their home country supervisor. The procedures will require coordination between supervisors, and the proposal sets out that ESMA will establish such cooperation arrangements with the relevant third-country competent authorities.

Most importantly, however, ESMA, in agreement with the relevant EU central banks, has the power to determine that Tier 2 CCPs are of “specifically substantial systemic significance” for the EU financial system and recommend to the Commission that the CCP should not be recognized. In practice, this is the third category of CCPs. In this case, third-country CCPs would have to be authorized and established in one of the Member States to be able to provide clearing services to EU clearing members and EU clients.

The Commission’s proposal does not require the automatic re-location of third-country CCPs’ euro-clearing activities but has granted ESMA broad powers in determining which third-country CCPs should be recognized in the EU, such that ESMA can in effect deny them access to the EU unless they are established in a Member State, provided the criteria set out in the proposal are met.

In that scenario, EU clearing members and clients would incur significantly higher capital charges and would not be able to comply with the EMIR clearing obligation, if they continued to clear their trades through non-recognized CCPs. To be able to serve their EU clearing members, those third-country CCPs would have to move their clearing activities to the EU through the establishment of a legal entity in a Member State.

**Investment firm review**

In late 2017 the European Commission published a legislative proposal that will overhaul the regulatory framework for investment firms in the EU. The proposal distinguishes between systemic and non-systemic investment firms, with the former set to remain under the bank prudential framework, while the latter will get a bespoke regime.

This will operate via a change to the definition of a credit institution in the CRR, such that investment firms (and their consolidated groups) with total assets exceeding 30 billion euros which also provide underwriting services and deal on own account will be deemed to be credit institutions. These firms will be regarded as “class one” investment firms. Class one investment firms will thereafter be subject to the CRD/CRR, authorized as credit institutions, and supervised by the ECB in the context of the SSM for their operations in Member States participating in the Banking Union.

**SRB on resolvability**

The SRB is set to increase the intensity of its resolvability assessments as it moves towards full operating capacity by 2020. Utilization of inter-affiliate transactions, remote booking and intragroup guarantees with entities outside of the Eurozone are likely to become of increasing interest as the resolvability assessment framework evolves. The SRB has also signaled that it will carry out further work to develop its operational continuity framework, which may ultimately affect the extent of infrastructure supporting critical functions that is needed “onshore” in the EU after Brexit.

The EU’s resolvability framework broadly follows that of the FSB’s international standards, and has been implemented through the BRRD. The BRRD articulates 28 factors that resolution authorities should consider with respect to resolvability, including governance structures, liability structures, data capabilities, booking practices and intragroup transactions, and more. Cross-border intragroup transactions are significant factors in light of their contributions towards complexity and interconnectedness.

**The IPU**

In November 2016 the European Commission published its CRD V/CRR II package, which contained a proposal that would require third-country groups with multiple banking or investment firm entities in the EU to have EU IPUs at the apex of their EU legal entity structure. The European Commission stated that the policy is intended to facilitate resolution, and both the ECB and SRB have both supported the proposals. The IPU is similar in nature to the existing IHC framework in the US – see Appendix 2 for more details.
The Commission’s initial proposal would require a single IPU, authorized as a holding company or as a credit institution. The requirement would apply to the EU operations of third-country G-SIBs or to groups with aggregate EU assets of at least 30 billion euros, inclusive of branch assets, although branches would not be within the perimeter of the IPU.

Negotiations are ongoing for the entire CRD V/CRR II package. With respect to the IPU, issues under discussion include the threshold conditions (including exempting G-SIBs that don’t otherwise meet the thresholds), the possibility of allowing some firms to have multiple IPUs in the event that they are subject to home country banking separation rules, and the phase-in period for the rules (which may be as long as four years after entry into force). During negotiations, some (including the ECB) argued that branches of third-country entities should be required to become branches of EU entities within the IPU structure, or otherwise to subsidiarize. However, we understand that this is now unlikely.

The creation of IPU structures would enable the ECB and SRB to apply banking supervision and resolution powers to the consolidated EU operations of third-country groups, and will have knock-on implications for the way in which a variety of other regulatory requirements are applied, from prudential rules through to governance arrangements.
Appendix 2: From IHCs to IPUs

Learning from the US experience
With the EU’s proposed IPU requirement coming down the track, there are lessons to be learned from the experience of non-US firms’ implementation of the US IHC. Although the US IHC and the EU IPU are not identical requirements, implementation of an IPU can be fully expected to present comparable challenges. Some banks (most notably from the non-EU European and Asia Pacific regions) will have to implement an IPU having already gone through the experience of setting up a US IHC, whereas for others (particularly US groups) the IPU will be a novel undertaking.

Implementation and optimization challenges
After the FRB finalized its EPS rule in early 2014, non-US firms with more than $50 billion in US non-branch assets (such as broker-dealers, asset managers, and existing bank holding companies) had slightly over two years to lead transformations that involved establishing an IHC. Some institutions above this threshold restructured their operations to remain below $50 billion in US non-branch assets. While branches were explicitly excluded from the IHC requirement (as they are likely to be under the IPU), they are still subject to certain regulations under the EPS rule, such that governance, risk management and liquidity requirements are often applied to branches within combined US operations.

IHCs have now been in place and fully operational since mid-2016. The implementation of IHCs was a major undertaking for affected banking groups as they needed to apply financial and risk management processes to the newly formed legal entity while also applying capital, capital stress and liquidity requirements.

Its introduction also clearly incentivized the downsizing of some banks’ US operations where the commercial benefits and upsides of maintaining such a sizeable US presence were deemed to be outweighed by implementation costs. However, some banks were not deterred by the new requirements.

Implementation programs were major logistical undertakings, similar in size and scale to large corporate restructurings – rigorous project management was critical, and design decisions needed to incorporate deep levels of detail and be documented assiduously. There were real financial costs to imposing regional structural requirements through the IHC in terms of trapped capital and liquidity, and financial optimization exercises in terms of prudential regulation, tax and accounting were all significant component parts of implementation.

Governance, particularly decision-making processes, underwent a major shift, requiring a change in mindset at the country/legal entity level towards oversight by a local board of directors, rather than the global parent. Implementation crystallized a lack of clarity in matrix reporting lines and dual/multi-hatting arrangements, and a culture shift was needed to adapt to a more sub-group view of the US operations of non-US banks.

Optimization of business operations within the IHC – and optimization of business between IHC entities and non-IHC branches – were critical for establishing the financial viability of the new structure. However, insufficient detail around issues such as revenue sharing and cost allocation arrangements continue to be an obstacle to such optimization work.

Banks face ongoing pressure to demonstrate transparency, accountability and oversight of:

- any business that is originated, booked or risk managed through US operations;
- cross-border activity involving US operations; and
- cost allocations of support and infrastructure across the IHC boards, senior management governance forums, and individual subsidiaries.

Tax and accounting issues were critical – for instance, the treatment of deferred tax assets had major implications for the financial feasibility of certain design options, as did the treatment of goodwill. A detailed understanding of issues such as past losses was critical.

Data challenges were common, particularly with respect to having sufficient quality of data at the right location in line with the boundaries of the legal entity structure of the IHC – data was often fragmented, and central collation of data did not always imply that the necessary central perspective on that data was available, or that ownership of risk was clear. Balance sheet forecasting also proved very challenging in light of data and business model optimization challenges.

As the financials and performance of the US IHCs begin to normalize – and enough trend/performance data is available via the FR Y-9C (Consolidated Financial Statements for Holding Companies) and FR Y-15 (Banking Organization Systemic Risk Report) – shareholders, analysts, and parent banks will further challenge the profitability and business model of non-US banks subject to IHC requirements, with a focus on cost-to-income ratios, staffing expenses, and revenue sharing between the IHC and other legal entities within the organization.
IHCs and booking models

Following the implementation of IHCs, US regulators have turned their attention to the global booking models used by US IHCs. In particular, authorities have sought to:

- analyze IHC and US branch movements in assets;
- understand US “managed” views;
- ensure appropriate governance and controls in differentiating origination, booking, and risk management of cross-border positions;
- monitor compliance with cross-border laws, regulations and supervisory expectations;
- understand the risks and implications of revenue transfer and cost allocation agreements;
- understand implications of booking models within business-as-usual, stress and resolution contexts;
- understand implications of trading controls and monitoring, with an emphasis on the leveragability of supervisory controls such as trader/trading desk mandates, Volcker implementation, and supervisory expectations and authorizations;
- understand connectivity of origination, including booking and financial flows for IHCs and branches;
- clarify reporting lines to parent and legal entity/subsidiary boards;
- focus on branches and booking models that involve UK affiliates and other key hubs or risk management centralization; and
- understand the full end-to-end risks and nature of booking models, including remote and inter-affiliate booking involving US banks and foreign affiliates.
Contacts

Ireland- Regulatory Risk

Sean Smith
Partner
Seansmith1@deloitte.ie

John Kernan
Director
jkernan@deloitte.ie

Ciara O’Grady
Senior Manager
Cogrady@deloitte.ie

Aishling Cunningham
Assistant Manager
Aicunningham@deloitte.ie

UK structural reform leadership

Vishal Vedi
Partner
vvedi@deloitte.co.uk

Simon Zeital
Partner
szeital@deloitte.co.uk

Nina Gopal
Partner
ngopal@deloitte.co.uk

Jaspreet Jhaj
Director
jajhaj@deloitte.co.uk

Alex Szmigin
Director
aszmigin@deloitte.co.uk

Francesco Bellasi
Director
frbellasi@deloitte.co.uk

Mark Adams
Senior Manager
markaadams@deloitte.co.uk

EMEA Centre for Regulatory Strategy

David Strachan
Partner
dastrachan@deloitte.co.uk

John Andrews
Senior Manager
johandrews@deloitte.co.uk

Katelyn Geraghty
Senior Associate
kgeraghty@deloitte.co.uk
The Deloitte Centre for Regulatory Strategy is a powerful resource of information and insight, designed to assist financial institutions manage the complexity and convergence of rapidly increasing new regulation.

With regional hubs in the Americas, Asia Pacific and EMEA, the Centre combines the strength of Deloitte’s regional and international network of experienced risk, regulatory, and industry professionals – including a deep roster of former regulators, industry specialists, and business advisers – with a rich understanding of the impact of regulations on business models and strategy.

Download a digital copy of this report, and others like it, at Deloitte.co.uk/BookingModels

This publication has been written in general terms and we recommend that you obtain professional advice before acting or refraining from action on any of the contents of this publication. Deloitte LLP accepts no liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BE, United Kingdom.

Deloitte LLP is the United Kingdom affiliate of Deloitte NWE LLP, a member firm of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (“DTTL”). DTTL and each of its member firms are legally separate and independent entities. DTTL and Deloitte NWE LLP do not provide services to clients. Please see www.deloitte.com/about to learn more about our global network of member firms.

© 2018 Deloitte LLP. All rights reserved.

Designed and produced by The Creative Studio at Deloitte, London. J15435