Brexit for Japanese Banks in Germany

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Brexit Top Topics for Japanese Banks in Germany

Management Summary

- Japanese banks with operations in Germany need to consider the current European and German regulations in force and also the future regulation in order to ensure full compliance.
- The primary areas of focus currently include framing the day 2 plan, i.e. choosing from different booking models and complying with supervisory expectations on outsourcing.
- Assessing the impact of future regulatory requirements is also important. Some of the relevant future regulatory developments include the requirement to establish an intermediate parent undertaking (IPU) and the new investment firm categorisation system by the Investment Firm Regulation (IFR).
- Compliance with the above mentioned regulations requires a certain level of implementation effort on the side of the local operations in Germany. While doing that, effective communication with the head office and the rest of the group is of vital importance in order to take timely action and avoid non-compliance due to delayed managerial decisions. Therefore, it is critical to effectively communicate German specifics and supervisors' expectation to the group's headquarter.
- In addition to the above, opportunities to increase the product and client base by making use of the local benefits should be carefully assessed in order to optimize profits vis-à-vis implementation costs of the German entity.

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Implications arising from the current regulatory environment

Banks have made huge efforts to implement their day 1 operating model with regard to the original Brexit date. While the Brexit is still coming, banks are facing the immediate challenge that the German entity has to be up and running already today.

Day 2 Plan

BaFin expects banks to detail out their day 2 plan (formerly: glide path), i.e. to continuously reduce the backing out of Market Risk to global booking hubs. This will lead to a build-up of local risk management capacity and a reduced reliance on outsourcing.

Booking Models

This will have a direct impact on the discussion around booking models: Supervisory expectations here are the opposite of what would be efficient form the point of view of a global banking group. Since ECB already requires banks to detail out their day 2 plan, it is no longer an option to simply prepare for a local booking strategy. Instead banks have to chose between two approaches:

- One approach is to break the global booking model and manage the risk of the Germany entity locally.
- A more visionary approach is to shift an entire global portfolio to Europe/Germany. This makes sense if large parts of the portfolio are anyway managed from the local entity, e.g. Euro denominated transactions.

Outsourcing

BaFin expects banks to reduce the level of outsourcing, particularly to avoid outsourcing concentration on the parent company.

Basel

It will be implemented in some variation in the jurisdiction of the Group headquarter but will be implemented differently in the EU (e.g. CRR II, FRTB). Detailed comparison between the different sets of regulation required to call out differences in content and timelines.

Direct ECB Supervision

When the local banks grow and hit the threshold of Euro 30 bn they will come under direct ECB supervision and will have to fulfill yet another set of requirements. Strategic decisions have to be made now in order to align with the banking group’s long-term strategy for the European operations.

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Future regulatory developments to consider (I)

Investment Firm Review (IFR)

- On 16 April 2019, the European Parliament adopted a Regulation on the prudential requirements for investment firms (IFR) and a Directive on the prudential supervision of investment firms (IFD). IFD/IFR is expected to be finalized by EU by end of 2019. IFR/IFD introduces a new prudential regime for certain investment firms, tailored to their activities and asset size. IFR/IFD also revises the MiFID II/MiFIR third-country regime for investment services.
- A specific prudential regime is required for investment firms which are not systemic by virtue of their size and interconnectedness with other financial and economic actors. Systemic investment firms should, however, remain subject to the existing prudential framework under CRD/CRR. The largest and most interconnected investment firms have business models and risk profiles that are similar to those of significant credit institutions and should be treated as such.

While many investment firms will see a tailored regime as a positive step, the implications of the new regime will differ from firm to firm. Each firm will need to assess what the regime change means for it and take action accordingly.
The new categorisation of investment firm could potentially lead to less requirements particularly for smaller investment firms. But to find the optimal scale and size has again become more complex.

The four-tier categorisation system based on the scale and scope of activities undertaken by investment firms is adopted :

Class 1: Systemic investment firms

Class 1-: Large investment firms

Class 2: Larger investment firms

Class 3: Small and non-interconnected investment firms

* Class 1, 1-, 2 and 3 are not official IFR/IFD terminology, but used for ease to distinguish between the different categories

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Future regulatory developments to consider (II)

Intermediate Parent Undertaking (IPU)

- The requirement for third country groups to restructure their EU footprint under a single top-tier IPU would have been relevant with or without Brexit. For some banking groups at least one IPU will have to be set up. For Japanese banking groups, where a split of certain banking activities is required by their domestic regulation, this will lead to at least two IPUs having to be set up. The questions around a cost-efficient setup could lead to some knock-on restructuring of the current EU operations.
- The requirement to establish an IPU will apply after mid-2021.
- The threshold for creating an IPU is EUR 40bn total asset across a third country group's European operations, including subsidiary and branch assets. The figures can simply be aggregated and do not have to be consolidated according to any specific GAAP. The total assets of each credit institution and investment firm in the Union of the same third country-group and the total assets of each branch of the third-country group authorized in the Union in accordance with the CRD, MiFID and MiFIR.

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Profit optimisation with the newly established subsidiaries

- Banks have to increase profitability. Newly established subsidiaries need to quickly develop their own business, since they can't only rely on clients to switch over from their UK parent company.
- There is an opportunity here to increase the product and client base by making use of the local benefits, which are:
  - Germany's AAA country rating which potentially translates into a prime rating for the institution.
  - The natural hedge against the Euro
  - Access to additional sources of funding in Germany and direct access to ECB funding.
  - The subsidiary may also expand its portfolio with new German-specific products like "Schuldscheindarlehen (SSD)" to increase its footprint in the competitive German market.
  - Establishing a strong financial infrastructure for new German clients such as the German Mittelstand should also be taken into consideration.