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Regulatory News Alert

Brexit: Political agreement on a transition period – Key take away

13 April 2018

Overview

The EU Chief negotiator Michel Barnier announced an agreement in principle on the details of a **Brexit transition** period with the UK on 19 March 2018. The European Council subsequently adopted a set of new negotiating guidelines on 23 March 2018 so that discussions on the **framework for the EU's future relationship with the UK** can start.

This agreement is key for Luxembourg-based entities as it will shape their medium term future for rights and duties stemming from their direct and indirect relationships with UK-based entities or counterparts within or out of group.

Despite speculation to the contrary, it was notable that the guidelines on the future framework adopted by the Council **do not specifically address financial services** and therefore do not engage with the vision set out by the UK Chancellor, Philip Hammond, in his speech on 7 March for significant market access for financial services firms between the UK and the EU post-Brexit.

For Luxembourg or remaining EU member state institutions, this agreement and early February EU Commission Notices help to draw a map of areas of potential concern to test the sustainability of business models. It is increasingly clear that some form of Brexit consequences (delegation, clearing, or brokering) will affect all institutions, whatever the final agreement.

While the political agreement on a transition period and anticipated start of talks on the future relationship are **positive developments** in the Brexit negotiations, the fact that the agreement on transition is **not yet legally binding** means it will be of **limited use to regulated businesses** unless it is underpinned by further guidance from the relevant regulators or legislation.

For **inbound EEA firms**, the Bank of England (BoE) and the Financial Conduct Authority (FCA) have clarified that regulated firms can continue operating in the UK with their existing licenses until December 2020, irrespective of whether the transition period is agreed. **UK authorization will only be needed from January 2021 onward**. The UK government has agreed to underpin this position with legislation if required. This is significant and welcome news for inbound EEA firms, which can now factor these additional 21 months into their post-Brexit contingency plans.

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For **outbound firms** from the UK, the picture for the moment is less positive. The European Central Bank (ECB) guidance remains **that firms can only rely on a transition period once there is legal certainty**. This legal certainty will come once the draft Withdrawal Agreement has been negotiated, agreed upon, and ratified by both sides.

The EU's Chief Negotiator has said that he wants to have the Withdrawal Agreement finalized by **October 2018** so that the ratification process can start soon after. In Europe, the ratification will require the **consent of the European Parliament**[1] and final **sign off by the Council** acting by a qualified majority[2] .In the UK, the government has committed to hold a **vote in Parliament** as soon as possible after the negotiations have concluded. This vote will take the form of a resolution in both Houses of Parliament. If the UK Parliament supports the resolution to proceed with the Withdrawal Agreement, the UK Government will then bring forward a **Withdrawal Agreement & Implementation Bill** to give the Withdrawal Agreement domestic legal effect.

As the conclusion and the ratification of the Withdrawal Agreement remain subject to political risk, the current ECB guidance expects banks to continue to **prepare for all possible contingencies**, including a no-deal scenario leading to a hard Brexit with no transition. Therefore, we would **not expect** outbound firms from the UK to make **significant changes to their plans** unless and until they hear differently from the relevant European authorities.

[1] The European Parliament must give its consent, by a vote of simple majority, including Members of the European Parliament from the UK.

[2] A qualified majority representing 72% of the 27 Member States, i.e. 20 Member States representing 65% of the EU27 population.

Details of the transition period

The political agreement is for a transition period of **21 months**; expected to start at 11pm on **29 March 2019** (UK time) and end on **31 December 2020**. The agreement makes no provision for any extension of the transition period; the transitionary terms are included in the draft Withdrawal Agreement (much of which is still to be negotiated).

Assuming the Withdrawal Agreement is ratified by both sides, the UK would not participate in the decision-making processes of the EU, but would have to comply with EU rules (both existing and those introduced during the transition period).

The UK would retain all the benefits of the single market and the customs union, so free movement of people, goods, and capital will continue, along with the freedom to establish and provide services across the single market. **Critically for financial services firms, they would be able to continue to use the EU passporting framework** to operate on a cross-border basis during this period.

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Implications for firms

- Firms seeking to take advantage of the transition period should ensure their **boards agree on a risk appetite** for the level of risk they are prepared to take, in the event the Withdrawal Agreement fails to be ratified. This is particularly relevant if an **outbound firm** from the UK is actively resequencing activities in the expectation that the current political agreement will be made legally binding.
- If firms do wish to re-sequence activities, they should agree with their boards or program leadership what state of readiness they want to get to, by when, and **which milestones would trigger reviews**. If outbound firms from the UK do re-sequence or delay some activities, they should aim for a state that allows them to **reaccelerate programs in Q4 2018 if the transition is not ratified**. This means that delaying actions such as key employee moves or technology build are particularly high risk for outbound firms.
- Firms that are sticking to their current contingency plans for now (**which we expect will be the majority of outbound firms from the UK**) should consider that employees may be more reluctant to move with the prospect of a transition, and EU27 clients may not wish to repaper transactions to any (new) EU27 entity at this stage. Concerns that **clients and counterparties will not engage synchronically** are probably well founded, given experience with previous outreach exercises such as the **Variation Margin** in relation to derivative clearing. Firms will need to incorporate this risk into their planning, recognize the limits to their own control of counterparty responsiveness, and try to get "ahead of the game" **through timely client communications**.
- The deferral of the Brexit repapering task has the benefit of **smoothing documentation demand** over a longer period, but could also present the risk of **future concurrency issues** with LIBOR benchmark replacement[3] and the phased implementation of European margin rules on non-cleared OTC derivatives[4] that are on the same time horizon and could present a documentation challenge. There may well be a limit to the extent of concurrent repapering which can occur in the market, and so, regardless of the transition period, there may be a need for additional forward planning, and the **early embedding of technology to deal with scale and complexity**.
- The movement of employees is more within control of the firm. In particular, even once there is legal certainty, there may be **strategic benefits from moving EU27 sales coverage** to EU27 locations at an earlier stage where the firm has limited or no presence in the EU in order to give an initial period for the new front office operating model to develop.
- Regulatory applications for **outbound firms** from the UK should continue until EU authorities make public statements otherwise. It remains important to **meet any agreed timelines and milestones with regulators**, unless there is specific agreement to the contrary.

- Currently most firms are working toward meeting a "Day 1" standard on 29 March 2019 and a "Day 2" standard within three years of that date (March 2022). **Firms need to consider the standard they should meet at the end of the transition period (1 January 2021)**. Any current plans that assume a "jump" to the "Day 2" standard may no longer be acceptable. Glide path plans, or setting out the journey from "Day 1" to "Day 2," will also need to be reviewed in this context. Regulators will likely expect a **greater amount of progress** by the end of any transition period (particularly around **booking model** and **risk management**). Firms should conduct initial business and operating model analysis on what this new "Day 1.75" model would look like as soon as there is clarity on how EU regulatory expectations are evolving.

[3] LIBOR will be phased out as an interest rate index in financial contracts by the end of 2021.

[4] There is a phase-in with respect of Initial Margin (IM) requirements under European rules on non-cleared OTC derivatives. IM Phase 4 will start in September 2019 and IM Phase 5 in September 2020.

Key areas for focus

- Firms should continue to establish their platform for repapering clients, even if they are planning to re-sequence their plans as a result of the transition. **EU27 clients may want some contracts booked to the EU27 entity before the end of the transition period**. Firms should also ensure they have relevant access to the major EU trading venues and Financial Market Infrastructures (FMIs), given liquidity may move during the transition. This means prioritizing the most important CCPs, exchanges, MTFs, and CSDs as soon as possible.
- It is worth considering now how a "soft start" from 29 March 2019 (and continuing during the transition period) would work. That said we **would not suggest this becoming "Plan A" until there is certainty from the EU27 authorities that the transition period can be used by outbound firms from the UK**. Examples would be for some EU sales/coverage employees to move to the EU27 entity (or its branches) during the transition period and to conduct EU27 business on an agency basis, booking to the UK entity (which would be allowable during a transition period based on current rules). This would have the benefit of starting some business in the EU27 without duplicating regulatory capital between two entities during this period.
- If the risk appetite allows, the technology build could be re-sequenced to the six months prior to March 2019. This may enable the firm to prioritize more time for other regulatory initiatives with a significant technology build such as GDPR.

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- While it may be tempting to align the timeline for internal risk model approvals to business decisions regarding the timing of client transfers to the (new) EU27 entity, firms may benefit from **maintaining momentum on internal risk models work** and using the tolerance period to develop the required usage and data history for their formal application. Postponing this work due to transition considerations may result in a more onerous and lengthy application process.

Next Steps

For inbound EEA firms there is clearer scope to re-sequence activities, including **work on regulatory applications**. However, we would expect these firms to carry on with **any infrastructure change work already initiated** to become a third-country branch. Inbound EEA firms should also continue to monitor any future guidance from European regulators (ECB/ESMA/EBA) that may have the effect of requiring them to relocate activities and personnel from the UK to the EU27.

We expect the majority of the outbound firms from the UK to continue planning on the basis that "**nothing is agreed (on withdrawal and transition) until everything is agreed.**" Firms should continue to engage closely with regulators and regulatory applications, and outbound firms should continue along the current timetable until European regulators make public statements to the contrary.

How Deloitte Can Help

Deloitte can help you define the appropriate strategy to prepare for Brexit consequences, be it through designing a new strategy, reorganizing your institution, or simply by preparing for the challenges ahead through licensing or setting up new or expanded services.

Deloitte can also help you stay on top of the regulatory curve with its Kaleidoscope RegWatch service tailored to your institution needs, which identifies and analyzes regulatory trends.

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