Brexit should still top the agenda
Regulatory update
JULY 2020
With Brexit officially happening on 31 January 2020, the United Kingdom (UK) has now taken its final step out of the European Union (EU). Does this finally end the uncertainty for European companies?

Unfortunately not. The overall future of the relationship between the EU and the UK after the transition period is still unclear.

On 25 June, the government of the UK notified the Council of the European Union that it would not request an extension of the transition period that was foreseen in the Withdrawal Agreement. This means that the transition period will end on 31 December 2020.

However, while the EU is determined to have a partnership that is as close as possible with the UK, COVID-19 has clearly affected the ongoing negotiations and only limited progress has been achieved.

Consequently, now the EU’s main focus is to intensify the negotiation process and create the most conducive conditions to reach an agreement before the end of 2020.

One element of the negotiation will definitely be focused on the EU equivalence regime, which will determine how the regime will be applied to the UK and, subsequently, the future EU-UK financial services relationship.

In today’s uncertain environment, conventional approaches cannot provide a fully satisfactory answer. Therefore, Member States, EU institutions and all stakeholders must step up their preparedness and readiness at all levels and for all outcomes. Brexit will result in a substantial structural change to the EU’s financial architecture and legal framework over the coming years. So, everyone needs to be ready.

The aim of this Brexit alert is to provide:

- A summary of the latest observed factors and impacts of Brexit on Luxembourg financial services; and
- How Deloitte can help in organizations’ potential reallocation and/or reorganization.
Brexit: The way forward

Timeline of the main events

23 June 2016
Referendum

31 January 2020
Brexit Date-
Transition period

End June 2020
End of possibility
to extend transition

31 December 2020
End of transition period
and “real Brexit”

Where
we stand

Negotiations

Ratification

Round one

Round two

Round N

Negotiation on EU-UK treaty post 2020

Recent Brexit events 2020

UK is now out of the EU – it is no longer present at the European Commission or Parliament (it no longer has any decision powers). The exit at the end of January 2020 is only confirmed and “solved” in the past, not planned in the future. The EU-UK bilateral negotiations still continue, despite COVID-19 and the illnesses of key leaders on both sides. At this stage, no real progress has been made on the draft agreement milestones that should be reached from June up to December (on different topics).

31 December 2020 will mark the last day of the transition period before the post-Brexit era, and open the road to the new normal.

In theory, any prorogation of the transition period should be requested before the end of June, however:

• The prime minister of the UK has said, without ambiguity, that the UK will not ask for it.

• Politically speaking, as seen during the exit discussions, an agreement can still be reached at any time. However, it could be different now that the UK is formally out.

If nothing is agreed and no prorogation is requested before the end of the year, it may be that a hard Brexit is the main scenario by the end of 2020. The caveat is that we now know what the EU can do regarding mitigating measures (central counterparties [CCPs], grandfathering, etc.).
General Brexit impacts on the EU’s financial landscape

Brexit’s overall impact on the EU’s financial service players is still difficult to predict and assess at this stage and may still change over time. Various factors and elements must still be clarified and negotiated, especially in areas that are strongly reliant on the UK.

Structural change to the EU’s financial architecture—Euro area reliance on the UK for financial services

- The importance of the London financial hub to the euro area financial system varies across financial activities. For example, derivatives clearing and investment banking activities are highly reliant on the UK, while UK-domiciled banks have a generally limited role in direct lending to the euro area's real economy. Therefore, the effect of Brexit will vary depending on the different types of financial firms, activities and sectors over time.

Loss of passporting—Relocation plans

- Institutions can pursue three different EU relocation options:
  - i. Setting up a new subsidiary;
  - ii. Setting up new branches; or
  - iii. Expanding existing subsidiaries/branches.

- In light of the forthcoming intermediate parent undertaking (IPU) regime, several players are reorganizing their European Economic Area (EEA) branches in parallel by reattaching current branches of UK entities to their new EU hubs.

Loss of passporting—EU’s existing third-country regimes

- Although the parameters of the future EU-UK financial services regime are likely to evolve over time, some services may continue to be provided directly from the UK via third-country regimes after Brexit; the national legislation of some EU Member States allow for the direct provision of certain services on a cross-border basis by third-country firms. In particular, the EU can recognize that a third country’s regulatory or supervisory regime is equivalent to the corresponding EU regime. However, the degree in which the UK could benefit from market access under EU equivalence regimes will be decided unilaterally by the EU and will depend on the UK’s future regulatory choices.

The FCA has previously declared its interest in a “principles and outcomes” based regulatory approach, as opposed to a strict rules approach. While ESMA and the European Banking Authority (EBA) are not fundamentally against such an approach, it adds a layer of alignment and a hurdle to equivalence recognition.

Management rules of data

- Assuming that the UK and EU will keep identical regimes, no additional provisions will need to be taken even though the UK will be a third country. However, for how long? Supervisors’ attitudes will be key, especially regarding cloud technologies and digitalization of services with enhanced procedures that apply to non-EU-based providers.

In February 2019, the European Securities and Markets Authority (ESMA) concluded, on behalf of all national authorities it represents, a Memorandum of Understanding with the UK’s Financial Conduct Authority (FCA) ensuring the provisioning of financial services throughout the anticipated “hard” Brexit. While taking the updated Memorandum of Understanding into account, and ensuring its validity for 31 December 2020, the following fundamental and long-term post-Brexit relations are yet to be defined:
Selected points of attention per industry

**Investment management**
This list, which is not in order of importance, attempts to shed some light on the most critical changes that may occur after 31 December 2020.

- The product recognition may need to be redefined to allow undertakings for the collective investment in transferable securities (UCITS)/alternative investment funds (AIFs) sales in the UK. At this stage, UCITS may still be sold in the UK but must be renamed and relicensed.
- Similar to the previous point, fund management companies that are authorized in the UK and currently managing UCITS/AIFs will need to relocate to continue servicing these UCITS/AIFs or, alternatively, appoint a third-party management company (ManCo)/alternative investment fund manager (AIFM) to manage the funds post-Brexit.
- The question of the environmental, social and governance (ESG) product definition remains due to the divergence between EU and UK standards. Attention will need to be paid to the gaps and divergences between the two universes, and will most likely be driven by client demand and proximity.
- The complexity of delegation and outsourcing will increase as the UK will be considered a third country by the EU. Notably, the EU is considering creating new rules for cloud outsourcing that may create a new set of challenges.
- The new ESMA Markets in Financial Instruments Directive (MiFID) consultation on third-country access will also limit the provision of investment services from the UK to EU-based clients, whether institutional or others, by imposing much higher standards of accessibility.

**Private equity and real estate**
From a Brexit perspective, private equity real estate (PERE) funds will be primarily challenged on three fronts:

- For AIF PERE funds, the first question concerns the label—can a non-EU fund be an AIF? Contrary to UCITS, AIFs can exist outside of the EU but are subject to the national private place regime (NPPR), which can be time consuming and expensive. And, if funds are based in the UK, they may have to relicense for local distribution anyway.
- The second set of issues will arise from the EU’s attitude towards “third-country regimes” and passporting. The Alternative Investment Fund Managers Directive (AIFMD) allows AIFMs access to the European market through a marketing passport. This passporting is currently under review and the expectations are that it will not be open; therefore, in order to have access to EU continental investors, it may be wise to relocate where your client base is present as a priority.
- Thirdly, outsourcing is a factor for many structures. If an agreement is not reached on the future EU-UK relationship, it appears that rules for out-of-EU outsourcing will be more demanding, notably for cloud services, but also for outright outsourcing, introducing concepts like proportionality.

All in all, for PERE funds, whether AIFs and others, the question of who is the target is key. Are the investments and investors EU-based or are there major discrepancies in distribution locations? Then, a second question to ask is if the AIF label is deemed globally strong or just stronger than the UK one. In these circumstances, opting for an EU location could make sense. For PERE funds under other structures than AIF, the impact of Brexit will have to be analyzed on a case-by-case basis; however, what is certain is that the world will not become simpler.
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FMI/MTF access
- Identification of trading venues and minimum collateral requirements
- Direct NewCo access or access via another group entity
- Applying for memberships/timings

Booking structure and client coverage model
- Location of traders
- Local presence (i.e. branch versus rep office)
- Client preference and location

TOM design and business strategy
- Location and footprint of NewCo
- Transfer mechanism (SE/asset transfer)
- Business strategy, key markets and clients
- Products, services and pricing
- Business model and profitability
- Complex operational transfer of products, transactions and clients
- Design of new booking and risk aggregation structure

Regulatory
- Investment firm versus credit institution
- Authorization process and timings
- Regulatory dialogue
- Resolvability (including Operational Continuity)
- Regulators’ understanding of the business and approach to supervision
- Establishment of interactions with supervisors to allow a prompt communication process during the authorization process

Finance, capital and tax
- Model approvals and timeline
- Credit rating and Investor Relations
- Tax (e.g., use of DTAs, Transfer pricing mechanism, Tax Treaties and VAT)
- NewCo capital and funding requirements and timings

Corporate governance
- Substance: local management presence and oversight
- Board composition and reporting lines
- Outsourcing and intragroup dependencies

People and processes
- Transfer of existing staff (availability, timing, relocation packages, immigration)
- Access to local talent pool and employment structure and terms
- Reward structure, including regulatory environment
- Local processes and controls (e.g., need for local risk and compliance capabilities)
- Transfer mechanisms (e.g., branches)

These considerations all have transformation and change management implications
Insurance

- Brexit brings a number of regulatory changes for insurers and reinsurers. The post-Brexit regulatory compliance requirements are likely to be stronger than required by the Freedom of Services, the current arrangement, but not more than required by the Code of Liberalization of Current Invisible Operations (“Invisible Operations”) of the Organization for Economic Co-operation and Development (OECD).
- In this context, insurers could be required to set up cross-border branches or subsidiaries to continue writing cross-border business.
- However, UK-based insurers and intermediaries may not approach Luxembourg residents to sell insurance products.

Banking

- Brexit’s impact varies depending on the banking activity:
  - For lending and deposit-taking, the reliance on the UK is considered to be low.
  - The impact will be substantial for derivatives clearing, investment banking activities and securities and derivatives trading, as the reliance on UK financial firms is substantial and the provision of such services is directly linked to the EU passporting regime.
- Consequently, relocations of entities or tasks within groups may be the only viable solution in both the short and long term. But, this will require an increased level of supervisory convergence within the EU.

- Similarly, another element that cannot be neglected is the booking model.
  - Brexit challenges the back-to-back model that some credit institutions will implement for the trading activity by leveraging existing operations/execution desks in the UK.
  - EU will expect to see the necessary substance and solid risk management framework at the level of the European entity.
  - Similarly, the client booking and servicing model will be challenged due to the UK’s third-country status. EU/EEA clients will need to be serviced from the EU/EEA going forward—a principle which was reinforced by MiFID II recently. This challenges many of the servicing models of international banks and investment firms, requiring them to move clients between booking centers; a generally high-risk, high-resource activity that needs considerable planning and execution time.
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How can Deloitte help?

Deloitte has developed a systematic approach: a Brexit health check to assess the potential effects Brexit may have on your structure and organization. Then, based on both business development plans and legal realities, Deloitte can help you implement operational changes to support your robust post-Brexit environment strategy.

With Deloitte RegWatch, stay on top of regulatory news and prepare your organization to address future regulatory developments.