Get ready for an “EU27 Single Market”
Brexit has created significant business uncertainty and a potential change of the regulatory landscape for financial institutions. Although there is no single ”hard” or ”soft” Brexit, the effects and implications related to the Single Market will create a material impact on the services and operating model of banks.

Depending on the post-Brexit solution, legal entity setup and geographical footprint, there are a number of potential structural options that financial institutions shall envisage.

A pragmatic response to this situation might consist in creating a dual presence in the UK and the EU in order to access both markets: the setup of a light presence in continental Europe, and in particular in Luxembourg, would represent a contingency plan independently from the final scenario that will be negotiated between the UK and the EU.

The clock is ticking, and yet how can you prepare for a world post-Brexit while so much uncertainty is in the air? With the latest announcement of a snap general election in the UK, the shape of its future relationship with the rest of the EU is becoming harder to predict.

For the financial industry in particular, the countdown is vital as it means securing access to the 27 remaining member state markets before the Brexit takes place. Active planning and consideration of the opportunities offered within the EU are therefore key to navigating those changes.

Why financial institutions need a presence in continental Europe

With the UK leaving the EU, financial institutions in the UK will no longer benefit from ”passporting” rights under EU Directives such as MIFID, CRD IV, PSD, AIFMD or UCITS V. As a direct consequence, 508 million people and a GDP of US$18.5 trillion may become out of their reach overnight: indeed a fifth of bank revenue in the UK could be at risk if the passport is lost, which implies that around 20 percent of revenues are generated by passports.

Independent of the type of Brexit that will be chosen— ”hard” or ”soft”—, the effects and implications related to the Single Market will create a material impact on the services and operating models of financial institutions. Those will bring two consequences: (1) the restructuring of cross-border groups and (2) the need to obtain the required authorization from the competent authorities in continental Europe to access their respective markets.

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1 Source: Open Europe Report 10/2016
As of today, half of the world’s financial firms have indeed decided to locate their European headquarters in London, with almost 1 million people directly involved in the financial sector in the UK. The figure goes up to 2.2 million if employees working in related professional activities such as audit or accounting are being taken into account.

Depending on the post-Brexit scenario, the legal entity setup as well as the geographical footprint, there are a number of potential structural options that financial institutions shall envisage.

Considering the current uncertainty on the final scenario to be negotiated between the UK and the EU, the most pragmatic and more reasonable solution would consist in creating a dual presence in order to access both, the EU and UK markets. This contingency plan solution can be implemented by:

- Transferring the impacted business to the existing entity in continental Europe, subject to previous notifications to the relevant supervisors (i.e. the CSSF and the ECB) and fulfillment of standard requirements OR
- Establishing a new presence in Luxembourg, fulfilling the minimum substance requirements, to serve continental EU clients and, at the same time, keep the presence in the UK.

With less than two years before the EU-27 Single Market and no guarantee of achieving passporting rights yet, the focus should now be on designing your future cross-border strategy and the identification of the most appropriate EU hub for your activities. Indeed, the latest developments tell us that an action shall be taken fast as the waiting approach might turn out to be much more costly than setting up a new entity in a continental European country.

Regardless of the solution and geographical position selected, it is indeed essential to keep in mind the required authorization process and timeline necessary to secure your future gateway to the EU.

A similar approach shall be followed by financial institutions currently based in continental Europe and serving the UK market leveraging on the passport: to continue to serve this market in the post-Brexit scenario, these entities should as well consider establishing a presence in the UK.

Lesson learnt from the Swiss case: After several years of discussion on full access to the EU market, Swiss banks mitigated their lack of pan-European access by setting up subsidiaries in Luxembourg and Frankfurt. The waiting approach is much more costly than the extra costs related to setting up a new entity in a continental EU country.

Luxembourg subsidiary business logic: The “Luxembourg subsidiary” will offer services to EU-based clients through a Luxembourg-based subsidiary that operates a pan-European branch network and which benefits from the EU free provision of services within the EEA.
- Regulated by CSSF

UK subsidiary business logic:
- The “UK subsidiary” will offer services to UK-based clients through a UK-based subsidiary that operates a UK branch network.

Picture 2: relocation scenario

Source: Brexit: the United-Kingdom and EU financial services (European Parliament, Briefing, December 9, 2016)
Luxembourg represents the natural hub in the EU to perform certain activities

Amongst the various continental EU countries that financial institutions, in the majority investment firms, could consider to relocate their activities in order to continue to serve EU clients, the Luxembourg financial center might represent an optimal choice in consideration of the various competitive advantages and favourable conditions it offers.

The financial center of Luxembourg, recently confirmed as leading Eurozone financial center in the latest Global Financial Centres Index 21, demonstrates to offer competitive advantages and favourable conditions to create a suitable ecosystem for specific activities and businesses. According to the same study, it also figures among the 15 centers likely to become more significant in the future.

By essence, oriented toward international cross-border services, Luxembourg is indeed an important connection point for international investors in Europe and beyond. Luxembourg is already the largest investment fund center in Europe, second to the United States globally, and hosts more than 140 international banks. In particular, the working population is well exposed to the needs of cross-border business, with a long tradition of financial expertise, extensive knowledge of the needs of an international clientele, and being both multilingual and multicultural.

Focusing on single industries and activities, there are several opportunities offered by Luxembourg in relation to key financial services.

Looking at the Private Banking (PB) & Wealth Management (WM) services, thanks to its toolbox, Luxembourg is one of the global lending centers for PB and WM, which managed to re-establish growth after the crisis.

Home of the EU headquarters of key global private banks and investment firms, Luxembourg is recognized as the European hub for PB & WM business preferred for: its international and cross-border business configuration and experience, the opportunities offered by its wealth management toolbox and the benefits coming from tax optimization advantages. As a financial center, Luxembourg offers a complete range of services to both European and international private and institutional investors.

From a Brexit standpoint, and in order to offer financial market products to EU clients, banks and investment companies need a passport under the MiFID. If MiFID II provides third-country firms with access rights to the EU, this is however conditioned to the recognition of "equivalence determination" and limited to sole professional clients and eligible counterparties: retail clients are left out of the picture, and access to those clients remains dependent on the authorization of each of their individual member states. Realistically speaking, even for non-retail clients the outcome of "equivalence determination" negotiations is not guaranteed and might take time, preventing banks and investment firms located in the UK from directly serving EU-27 investors.

Concerning the asset management and fund industry, Luxembourg investment funds are the vehicle of choice for cross-border distribution.

While today, London remains the leading center for fund management activities with UK fund managers being "delegated" with the management of assets domiciled elsewhere in the EU, Luxembourg is the EU’s leading fund domiciliation center.

Luxembourg has long specialized in the structuring & manufacturing, marketing & distribution, transaction reporting as well as the administration, custody & risk management parts of the asset management lifecycle. For those reasons, it is already being used by 80 percent of the top 30 asset managers as their primary EU platform for distribution and is a leading fund center for real estate, private equity funds, onshore hedge funds and fund of hedge funds.

Unless another agreement is found, the possibility to delegate the management of EU-domiciled funds will be negatively impacted by the Brexit: the AIFM Directive provides for a third-country firm access under strict conditions, including recognition of equivalence by the Commission and formal authorization by ESMA, while no such cross-border rights are envisaged under the UCITS Directive. EU-based operations will therefore be required in order to maintain the management of EU-domiciled funds and serve EU-domiciled investors.

Additionally, considering corporate banking activities such as trade finance, Luxembourg demonstrates to be the "facilitator" of cross-border financing business between Europe and third countries.

\[32.7 \text{ percent of clients are coming from non-EU countries.}\]
Indeed, located at the center of the European Union, home to the European hub of major Chinese banks and naturally open to cross-border activities, Luxembourg is the ideal candidate for international financing activities from a business and regulatory standpoint.

Finally yet importantly, in the emerging activities such as digital banking & new payment solutions, Luxembourg offers a suitable ecosystem to develop digital solutions, which are becoming more and more compelling.

The EU regulatory banking framework allows banks to take deposits and provide lending solutions to all EU customers, either through a branch or directly on a cross-border basis, and the payment service directive (PSD) provides a similar passport in relation to the payment services. In a post-Brexit scenario, with the likely loss of such passports, financial companies will face the choice of either being compelled to comply with each of the EU-27 national laws or request to set up an authorized EU subsidiary in one of the member states to serve the Single Market from an EU-located hub. Given the upcoming introduction of PSD II in January 2018, new opportunities will arise in the payment value chain, potentially raising further interest in an EU presence.

As your future EU hub, Luxembourg would not only allow you to provide banking and payment services to continental Europe, but also offer favourable conditions enabling the development of digital banking and payment solutions. Those conditions include: being a leading cross-border financial centre, a major European e-commerce and e-payment hub, innovation-friendly and responsive financial regulator with dedicated FinTech division, world-class information technology infrastructure, and easy access to one of the faster and best technologies in the world.

Today, about 150 FinTech companies totalling about 10000 employees made the choice to base their EU development in Luxembourg, supported by a total of 10 accelerators and incubators managed by top financial players (such as ING or BIL). 20 of the top 100 global FinTech companies are installed in the Grand Duchy, such as Amazon Payments, Rakuten and PayPal.

Further competitive advantages can be derived from:

- **Securitization business**: thanks to the Securitization Law, that created an attractive legal, regulatory and tax framework, Luxembourg is seen as the primary center for securitization and special purpose vehicles (SPV)
- **Capital Markets in general and derivative business in particular**: Luxembourg offers the necessary means and experience to manage the post-trading activities of securities and derivatives, both, centrally cleared (ETD) and bilateral transactions (OTC), as part of the custodian business.

**Conclusion**

The UK decision to leave the European Union deeply challenges the cross-border distribution of financial and banking services from UK-based actors to continental Europe. Of course, there is no certainty as to how the access to the EU-27 Single Market will work as long as the negotiation of the post-Brexit regime for each relevant EU financial regulation is concluded; a process that could take several years. Concerned market participants should therefore start early to take steps to mitigate the regulatory and business impacts of Brexit, especially in the event of a “hard” Brexit that would prevent them from accessing the European market. With less than two years left, the focus should now be on the definition of their future European setup and the identification of the right EU hub for your activities. In that regard, Luxembourg offers key competitive advantages in general, and especially in relation to Capital Markets activities, Private Bank & Wealth Management services, asset management and the fund industry, as well as digital banking & payment solutions.

**Luxembourg offers key competitive advantages in general, and especially in relation to Capital Markets activities**
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