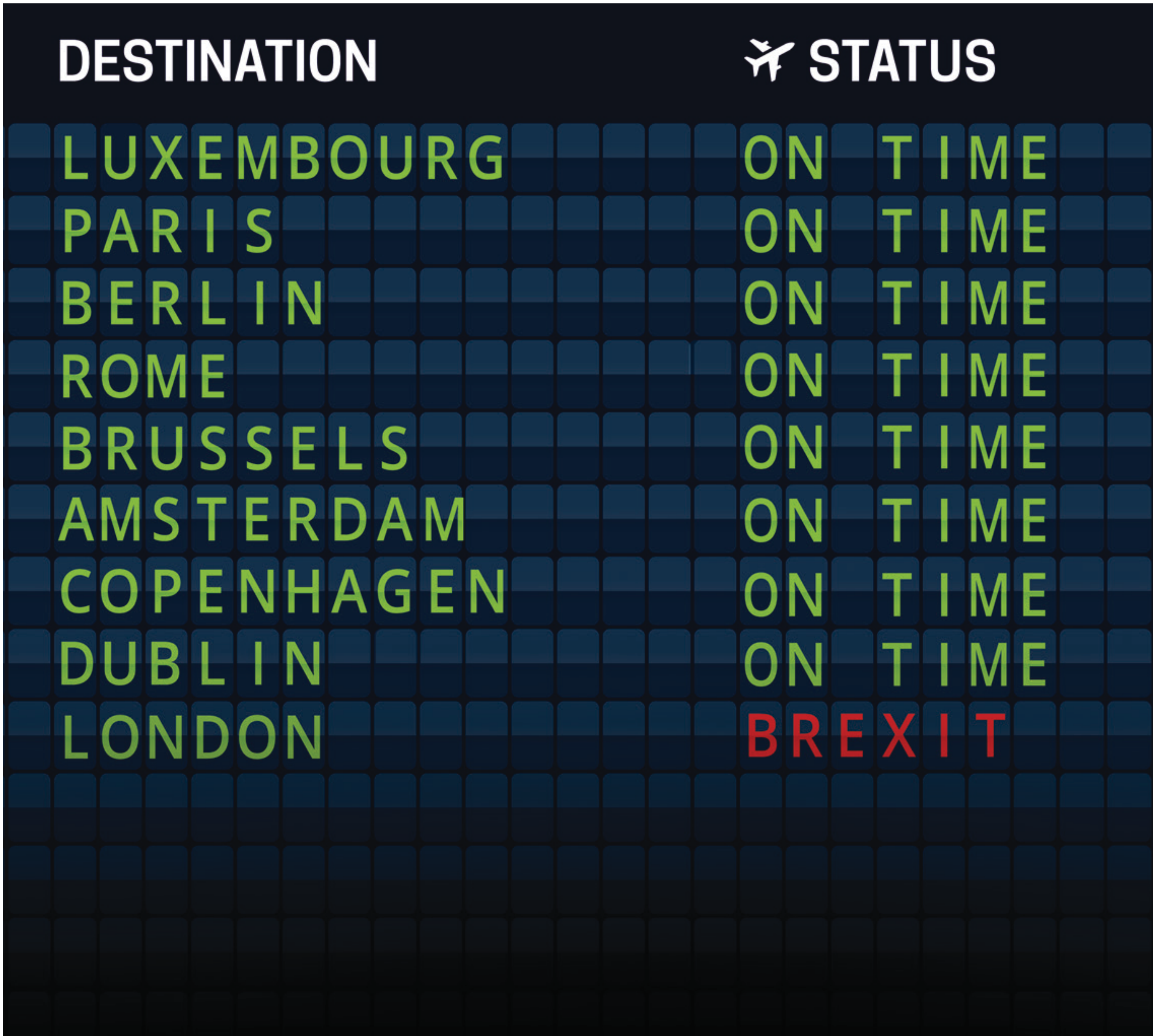

Get ready for the EU 27 single market

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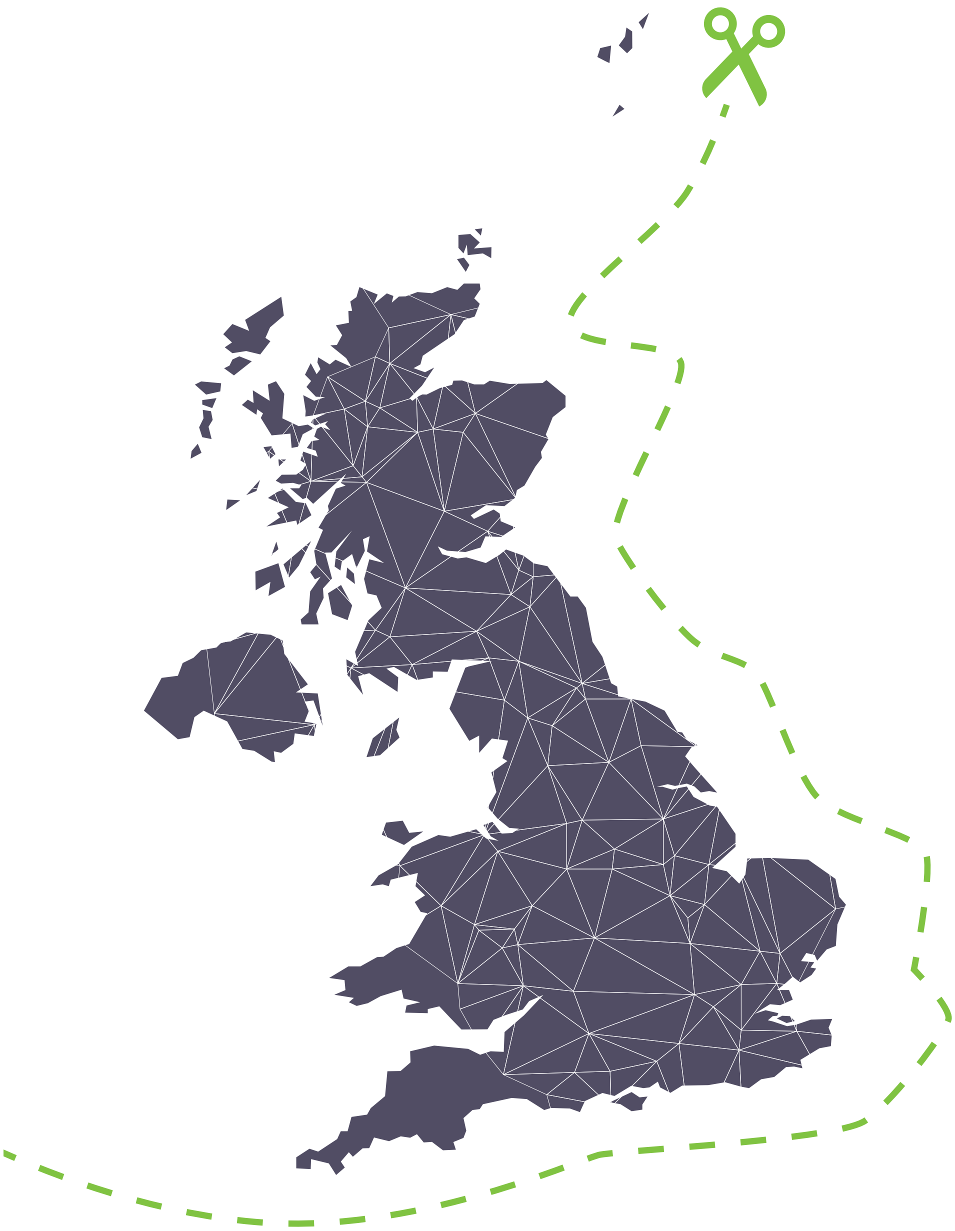
On 30 March 2019, in less than a year's time, the EU single market will shrink overnight from 28 to 27 member states when the United Kingdom leaves the union, initially to embark upon a transition period running until 31 December 2020. Now that an agreement on a limited transition period has been reached, the focus of negotiations can shift to the permanent future relationship between the UK and the EU. However, it is important to bear in mind that, as the saying goes, nothing is agreed until everything is agreed. With uncertainty still looming about the precise details of Brexit, financial institutions and businesses are facing unprecedented challenges as they seek to prepare themselves and their clients for the UK's departure from the European Union.



The impact of Brexit on your business
With the UK leaving the European Union, financial institutions in the UK will no longer benefit from "passporting" rights under EU Directives directives such as MiFID, CRD IV, PSD, AIFMD, and UCITS V. As a direct consequence, a market of 446 million people with GDP of €13 trillion is likely to move out of reach overnight. Whether you have a UK-based business targeting the EU, or an EU-based business dealing with UK clients and counterparties, it is vital that you have the clearest possible understanding of the impact Brexit will have on your company.

As matters stand currently, the loss of the EU passport would mean that UK investment firms are no longer authorized to offer their services in the EU. In contrast, EU-based subsidiaries could continue to operate in the single market if authorized, for example, under MiFID 2. In any case, the business model and structure of such subsidiaries will have to be reviewed by the relevant national authority to ensure sufficient substance and independence from the group. Brexit is also expected to affect established commercial activities, particularly with regard to instruments subject to the MiFID II trading obligation and the possibility of offering direct electronic access to clients. In the case of EU-based branches of UK firms, it is highly likely that they will be required to apply for a new license or an extension of their current license.

The fund industry will also face its share of challenges. The loss of their EU passports will mean that UK UCITS management companies and AIF managers will have to be treated as third-country AIF managers. They will no longer be allowed to manage and market funds in the EU. Unless targeted member states decide to allow such activities under a discretionary national private placement regime, local authorization will have to be obtained. And as the UCITS and AIFs authorized or registered in the UK will be non-EU AIFs, this also means that EU 27 management companies managing them will have to seek specific authorization to manage this type of fund.

Identification of your target structure: two sides of the same coin

9 months before the end of the negotiating period, what appears clear is that there will be consequences not only for firms in the UK and firms from the EU 27 delivering services or products in the UK, but also for EU 27 firms dealing with other EU 27 firms. From a legal perspective, it seems highly likely that access to services, products, and/or competencies will be curtailed, meaning that EU-regulated products or services may be stripped of their rights unless a company has a physical presence on both sides of the Channel.

Preparing for withdrawal should be on everyone's agenda, as the wait-and-see approach could turn out to be costlier than setting up a new entity in an EU country.

There are two sides to the coin when reorganizing the geographic and product footprint of a business:

01. EU financial companies engaged in cross-border activities with the UK or that have a UK-based entity will have to seek authorization from the prudential regulation authority. Additionally, they may need to review their connections with financial market infrastructure such as stock exchanges, lead arrangers, trading venues, etc.

02. In contrast, UK entities will only have to set up a (light) presence in the EU 27 or move to a dual presence in the UK and in the EU 27. By only requiring the fulfilment of the minimum substance requirements, this solution should be understood as a contingency plan independent of the final scenario yet to be negotiated between the UK and the EU, whereas the transfer of a significant share of your operations would constitute a pragmatic response to the current uncertainty that Britain's financial institutions face today

In designing the future operating model, there are two common causes for concern to consider.

Preparing for withdrawal should be on everyone's agenda, as the wait-and-see approach could turn out to be costlier than setting up a new entity in an EU country.

First is the rather stern stance adopted by the ESMA on the topic of outsourcing arrangements. The EU authority has issued opinions highlighting that:

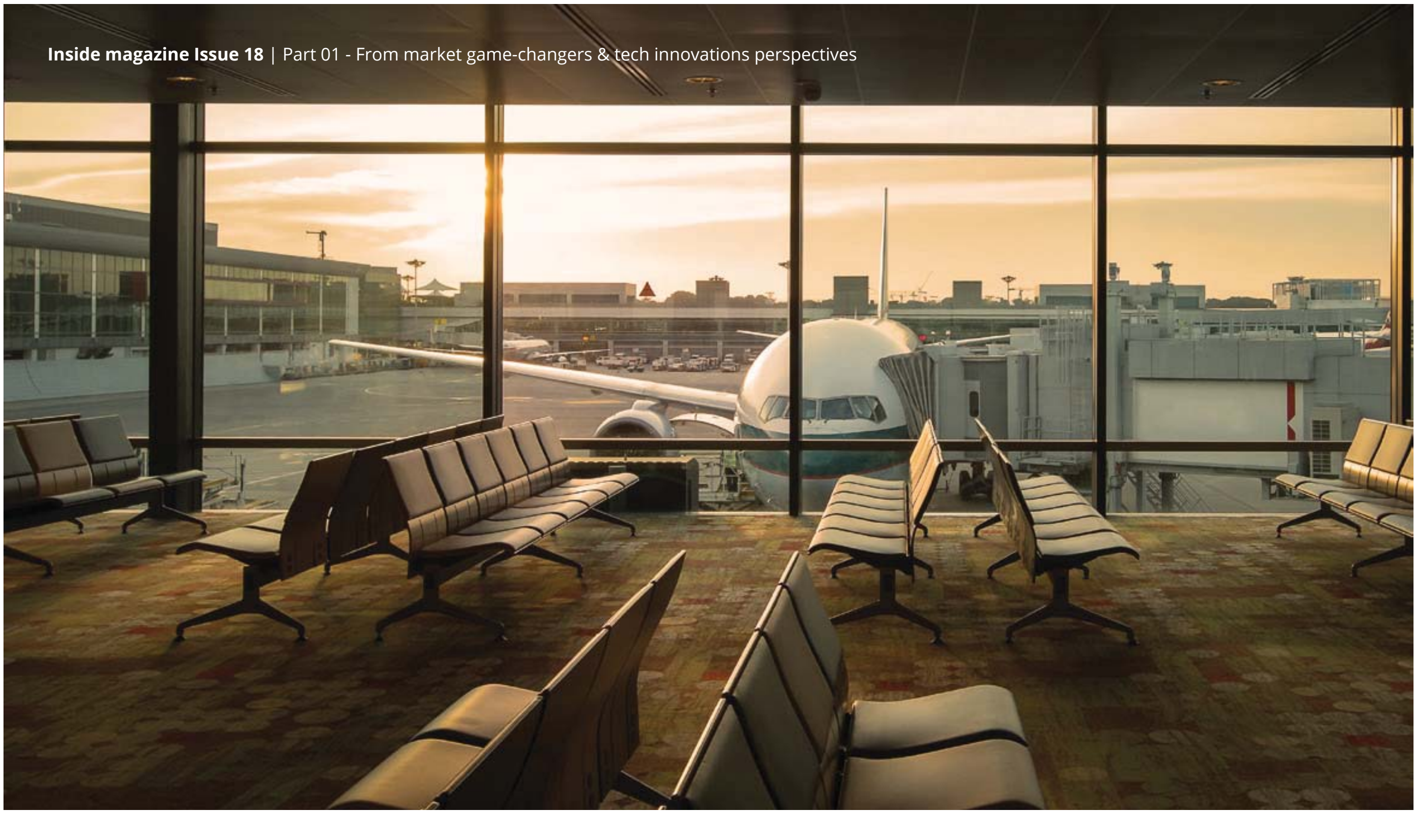
- A thorough due diligence procedure should be followed to ensure that service provider selection is based on an objective reasoning process aimed at identifying the most suitable counterparty to provide outsourced functions or services. In particular, the ESMA stresses that the selection of an entity within the same group should entail a higher level of scrutiny to ensure that the choice was based purely on objective reasoning and despite the potential conflicts of interest this outsourcing structure could have
- In any event, enough substance should be kept in the EU entity, and outsourcing of certain key functions and services will either be more strictly regulated or simply not allowed

The EBA highlighted this need for substance as well and expects an EU 27 entity to be able to carry out its business independently from its third-country group entities. All other EU authorities (EU Commission, ECB, etc.) plan to follow this strict line, believing it to be the best way to ensure a regulatory level playing field.

Second is the back-to-back booking model that new entities may implement to optimize hedging efficiency and market risk capital consumption. The authorities expect new local entities to have adequate resources to assess, govern, and manage part of all risk locally and not transfer all their market risks to a third-country entity via back-to-back transactions or comparable booking practices.

Luxembourg is the leading financial center in the Eurozone and is ranked second in the world behind the USA for asset and fund management. Last year alone, five banks decided to establish or expand their presence in Luxembourg and more than a dozen leading global asset managers as well as 10 insurance players made a similar decision. Further moves are expected in the coming months in the insurance, fund management, banking and FinTech sectors.

Luxembourg represents the natural asset administration hub in the EU to perform certain activities.



Opportunity #1

The asset management and fund industry: Luxembourg funds are the vehicle of choice for cross-border distribution.

If Luxembourg is the EU's leading fund domiciliation center, London currently remains its leading center for fund management activities, with UK fund managers being "delegated" the management of assets domiciled elsewhere in the EU.

Unless a political agreement is reached, the possibility to delegate the management of EU-domiciled funds will be negatively affected by Brexit. EU-based operations as well as operational transformation will therefore be required in order to protect the management of EU-domiciled funds and serve EU-domiciled investors.

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

Opportunity #2

Private banking and wealth management: Thanks to its toolbox, Luxembourg is one of the leading global centers for private banking and wealth management. After March 2019, this trend may be reinforced by the MiFID II requirement stating that firms must have an EU presence if they wish to access EU clients via passporting, or else firms may have to rely on "equivalence determination"—a process that is likely to take some time. Otherwise, access to clients may be dependent on receiving authorization in each individual member state. Hence, it is advisable for firms to consider expanding or establishing a presence for themselves now in an EU 27 member state. Time will be of the essence; the process could take up to 12 months with some regulators.

Home to the EU headquarters of key global private banks and investment firms, Luxembourg is widely recognized as the European hub for private banking and the wealth management business. This is as a result of its international cross-border business configuration and experience, the opportunities offered by its wealth management toolbox, and the benefits derived from its tax optimization practices. As a financial center, Luxembourg offers a comprehensive range of services to both European and international private and institutional investors.

Opportunity #3

Digital banking & payment solutions: Luxembourg offers a thriving ecosystem in which to develop increasingly compelling digital solutions, which are set to revolutionize the future of finance.

The EU regulatory banking framework (CRD IV) allows banks to accepts deposits from 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 payment services throughout the EU. With the loss of such passports post-Brexit, financial companies will face the choice of either being compelled to comply with each individual EU 27 country's national laws, or requesting to set up an authorized EU subsidiary in one of the member states in order to serve the single market from an EU-located hub. This question is even more crucial at present, given the recent introduction of PSD II in January, aimed at sparking new opportunities in the payment value chain.

Should you choose Luxembourg as your future EU hub, you would gain a base from which to provide banking and payment services to the entire EU 27 single market as well as access to favorable conditions for the development of digital banking and payment solutions. Luxembourg's strengths include being a leading cross-border financial center, and a major European e-commerce and e-payment hub, being innovation-friendly and having a responsive financial regulator with a dedicated FinTech division and excellent information technology infrastructure. The country also offers easy access to some of the fastest-growing and best technologies in the world.

Market dynamics

More than 310 FinTech companies have already made the choice to base their EU operations in Luxembourg, supported by a total of 10 accelerators and incubators managed by top financial players (such as ING and BIL).

According to public announcements, roughly 26 institutions are planning to relocate their operations to Luxembourg; some of them will establish a brand-new entity, while others will build upon their existing presence in the country. Big insurance groups such as AIG, Tokyo Marine, Hiscox, etc., as well as management companies (e.g., M&G Investments, Columbia Threadneedle, etc.) are relocating their activities to Luxembourg; similarly, investment banks such as JP Morgan are relocating part of their business by leveraging their existing presence here.

Should you choose Luxembourg as your future EU hub, you would gain a base from which to provide banking and payment services to the entire EU 27 single market as well as access to favorable conditions for the development of digital banking and payment solutions.

Conclusion

The UK's decision to leave the European Union fundamentally calls into question the cross-border distribution of financial and banking services from UK-based actors to the European Union, as well as the relationship of EU 27-based financial entities with UK financial counterparties and funds.

Although no withdrawal agreement has yet been reached, the effects and implications for the single market will nevertheless affect both the activities and the operating models of financial institutions, management companies and AIF managers. As a consequence, a thorough impact assessment of the consequences of Brexit for your business activities should be conducted, from which you can identify and define your post-Brexit model. Key changes such as the restructuring of cross-border groups and additional license applications will need to be considered in advance and should therefore be carefully planned in order to "stay ahead of the curve".

With less than a year left before Brexit, and in light of continuing uncertainties regarding the scope and length of the transition period, the focus should now be on the definition of your future European operations and the identification of the right EU hub for your activities. In that regard and as described in this article, Luxembourg offers key competitive advantages in the asset management and fund industry, private banking and wealth management services, as well as digital banking and payment solutions.