From planning to implementation

Article 50 trigger

The Prime Minister’s announcement of the Government’s decision to trigger Article 50 (Art 50) and commence the process of the UK’s formal withdrawal from the EU is momentous in many ways. However, for financial services firms – many of which have been working on their Brexit contingency planning for six months or more – the significance of today is that it means that they now have a maximum of two years in which to implement their plans. That said, there are many sequential activities that need to be implemented within this short period, especially if a contingency plan involves establishing a new entity in one of the EU27 Member States in order to provide continuity of service to EU clients. This in turn demands early decisions on essential issues such as location and legal entity design. In practice, for many, particularly banks, two years is an extremely short time to do everything that is needed.

In terms of preparedness, the universe of financial services firms affected by Brexit divides into three broad groups and their Art 50 trigger responses are likely to be as follows:

• firms which have done detailed analysis, concluded that the impact of Brexit on their ability to service their customers will be significant and have shortlisted two to three locations for a new subsidiary to enable them to access the Single Market once the UK leaves it. These firms will quickly move to identify a single, preferred location and a selection of design scenarios for deeper regulatory discussions and implementation;

• firms which have done a limited amount of business and product line analysis and have identified areas which need further investigation. The Art 50 trigger should prompt them to mobilise additional resources to accelerate their analysis and planning; and

• firms which have done very high level analysis but have not yet fully understood either the extent of their Brexit exposure or their specific implementation challenges. These are often firms which have existing entities in UK/EU27 that they could leverage. Firms in this group would be well advised to mobilise resources rapidly to determine the full complexity of the issues they face. Art 50 should be the trigger for boards to satisfy themselves about any residual doubts they have concerning the impact of Brexit on their firm’s business, including the impact of the “severe” scenario.
In this note, we will draw out some of the practical challenges that firms have been grappling with to submit their applications for regulatory approvals and (where relevant) set up a new legal entity (Newco) in good time.

**A design that transitions to a standalone entity**

A detailed structural and business impact analysis is critical to understanding the extent to which substantive legal entity change is necessary to continue to serve clients. Many firms in the first group (significant impact) have done this analysis and concluded that a new subsidiary in the EU27 is likely to be required.

Having made this decision, the focus turns to the “substance” that should be present in the entity. In the last few weeks, EU27 banking regulators have re-emphasised their message around the unacceptability of “letterbox” entities. Most firms have been planning on this basis from the outset but the detail has to be developed and finalised with both internal and relevant external stakeholders. Firms will need to develop one or more design options specifically around target operating model (TOM) and governance frameworks to mirror their structures, in order to support more detailed regulatory discussions around the “substance” required in the jurisdictions in the immediate and medium term. Regulatory expectations will be based on the scale and complexity of regulated activity that will be transferred and managed in the new entity over time.

Banking regulators have also been increasingly vocal about their expectations of relocating firms – Sabine Lautenschläger, Vice Chair of the Supervisory Board of the ECB, in a recent speech stated that: “Banks which seek to permanently book all exposures back-to-back with another entity in London should change their plans. And so should banks that plan to book all exposures with a euro area entity while having their risk management somewhere else…We are aware that it is a burden for UK banks to apply for a new licence in the EU. With a view to internal models, we would aim to be accommodating regarding the timing. There will be a transitional period in which new euro area entities might use internal models that have not yet been approved by the ECB.” Regulators are showing an appreciation of the immediate implementation challenges for firms and are increasingly open to discussing how the short-term operating model will transition to a longer-term standalone entity. This, in turn requires firms to develop both a short- and long-term implementation strategy.

Some of the areas that have proven to be most challenging in the analysis and design phase are the Newco TOM and its interaction with the existing UK entity, redesign of the shared service centre support, defining the extent of middle and back office outsourcing, developing a governance structure and developing capital and liquidity requirements. These are all intrinsically interdependent and need near-, medium- and longer-term design and transition considerations. These details will be essential to support discussions not only with regulators but also with senior internal stakeholders.

**Which regulatory licence to go for?**

Many capital market firms have a choice between being authorised as a credit institution (bank) or a full scope investment firm. Both are subject to essentially the same prudential framework. The fundamental driver of this decision is the entity’s business model and the regulated activities it is seeking to undertake. However, an additional factor, which is relevant to the timeline, is that when it comes to authorising new credit institutions in the eurozone, the application is initially considered by the national competent authority (NCA) in the Member State in which the entity is being established, with the final decision being taken by the ECB. For investment firms the whole process is dealt with by the NCA and may therefore be quicker.

It is also important for firms to look to the future, as the regulatory outlook is far from static or certain. Two developments are highly relevant. The first is the European Commission’s proposal (as set out in CRD V) that certain entities be required to establish a holding company (Intermediate Parent Undertaking) for their EU subsidiaries. The second concerns the prudential requirements for investment firms, on which a proposal is expected from the Commission later this year. Danièle Nouy, Chair to the Supervisory Board of the ECB has noted that in her view it is important that an investment firm (broker dealer) should be supervised by the SSM as a bank, when it is behaving like a bank.

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1 Caution should be the life of banking – Introductory statement by Sabine Lautenschläger, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, at the AFME Board Meeting in Frankfurt, 22 March 2017
Internal model approvals
Regulatory approval of internal capital models, which have a direct impact on the quantum of regulatory capital to be held in the Newco, can typically take over six months to obtain. The ability to leverage existing approvals (such as data and use testing) to fast track model authorisations is being explored by firms with EU27 banking regulators. In recognition of the time and complexity involved in setting up an authorised Newco, the ECB has indicated a willingness to consider transitional arrangements when an entity can use an internal model approved in the UK by the PRA. However, the ECB will reflect on any regulatory comments on the quality of the models and firms will still be required to apply for model approval in the Euro area. Even if existing model usage and processes are taken into account, national regulatory requirements and procedures will still have to be complied with, which will take time, especially in those EU27 countries which are likely to receive a higher number of applications for model approvals. Where only part of the portfolio covered by the internal model is being relocated, firms are looking to create virtual portfolios for the relocated portfolio to evidence the use case to support the regulatory approval. This will also have implications for the existing model approval of the residual UK portfolio.

Regulatory engagement
Regulators are seeing an increase in firms approaching them for informal conversations. In the next few months, these conversations will become increasingly focused on regulatory authorisations and internal model approvals. Regulators (both in the UK and EU27) will need to manage their resources and engagement cycle with firms. Regulators in some of the key EU27 financial centres may simply not have the availability to engage with all interested firms immediately “on demand”. Consequently, firms would be well advised to initiate or progress conversations to stay towards the front of the queue. In this context, firms may find it useful to prepare a regulatory engagement plan which sets out ongoing interaction with and communication to the relevant regulators and supervisors in the right manner and order.

When is two years less than two years?
An area that is gaining increasing focus in contingency planning is the set of activities that can only happen in a sequential manner after Newco has been authorised. This includes activities such as applying for membership of Financial Market Infrastructures (typically six months or so) for trade clearing and settlement and novation of clients to the new entity. While a certain level of preparation can be done in advance, there are limits on how much progress can be made before Newco has been authorised.

Given the very short timeframe, the current focus is very much on minimising execution risk by moving the least amount of activities to continue to be able to provide an uninterrupted service to clients and maintain access to relevant markets.

Early regulatory conversations and flexibility will minimise client impact
The uncertainty around the timing and terms of cross-border market access between the UK and EU27 presents a contingency planning challenge for all affected firms. Some fundamental decisions around TOM, governance structures, booking model and capital and liquidity requirements need to be made sooner rather than later. This will pave the way for more meaningful conversations around substance and transition plans with the regulators. Needless to say, implementation plans need to be flexible enough to adapt to the fluidity and uncertainty around the transition timings and terms of the future relationship between EU27 and UK. The Art 50 trigger is bound to focus minds at the most senior level as we move one step closer to Brexit. In the face of uncertainty a well thought out design underpinned by detailed analysis, with appropriate transition phases to allow for any opportunities that emerge as part of the negotiations, should ease the path for a successful business transition with minimal client impact.

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