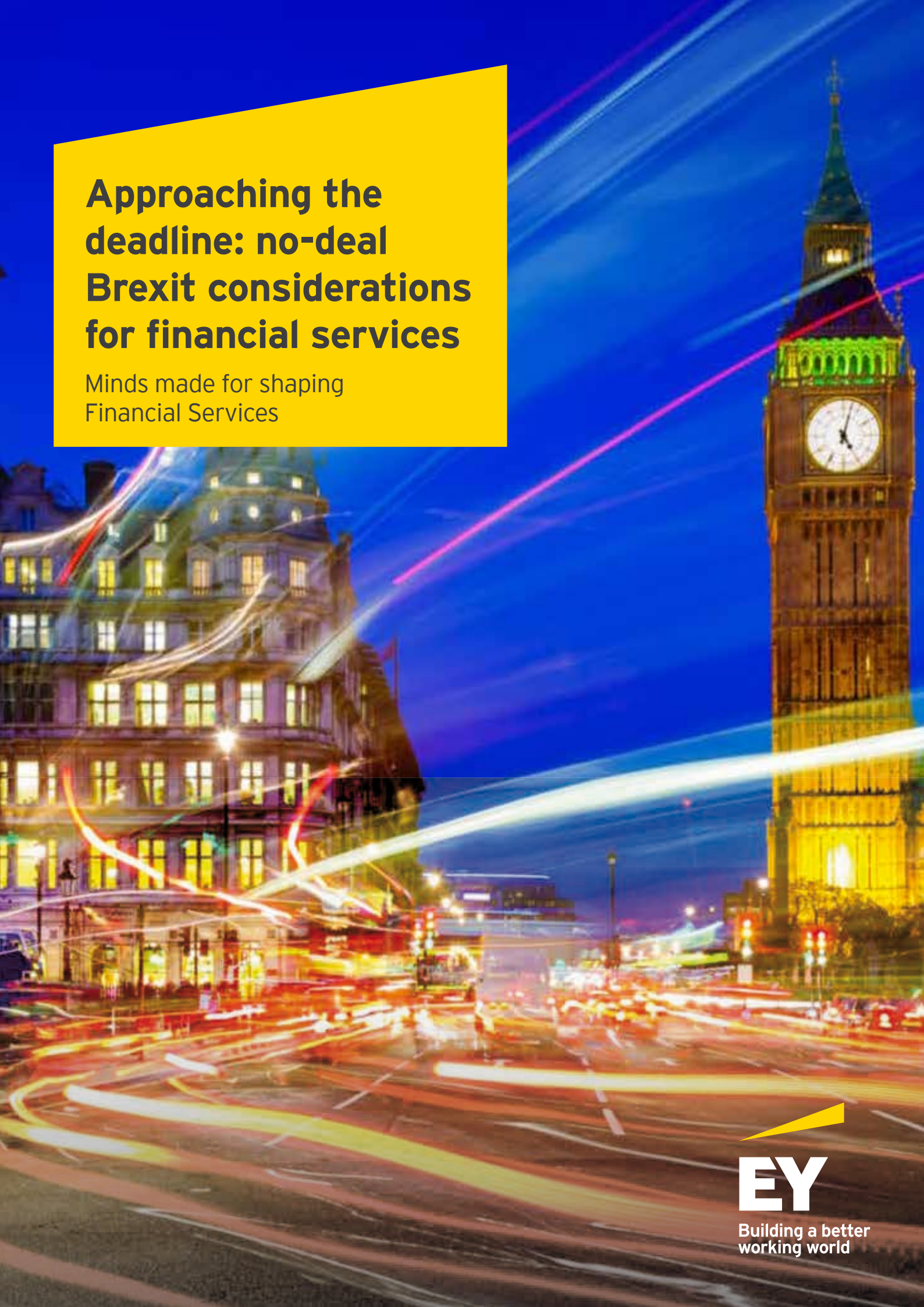
Approaching the deadline: no-deal Brexit considerations for financial services

Minds made for shaping Financial Services



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Summary

This is the eighth in a series of board papers from EY that assess the impacts of Brexit on the financial services sector. With less than four weeks to go until the UK's planned withdrawal from the EU, and with the Withdrawal Agreement not yet ratified, this paper looks at measures that firms can take to be better prepared for a no-deal Brexit. We have identified what we see as priority issues where firms can still make significant progress.

In addition to our own thinking, the ideas contained in this paper are based on a continuous programme of Chatham House Rule discussions with governments at both political and administrative levels, as well as with firms, regulators, professional observers and analysts across Europe.

We are grateful to all those who have taken the time to contribute to our thinking, and welcome the opportunity to debate and discuss the views presented in this document.

Liam McLaughlin
Partner
EY UK FS Brexit Lead

Prolonged uncertainty

Introduction

With Brexit at an impasse, the decisive moments of the four weeks remaining until 29 March remain impossible to predict. Absent a breakthrough, the current default position is that the UK will leave the EU on 29 March without a deal.

As we write, eyes are focused on the Prime Minister's attempt to secure further concessions from the EU on the 'Northern Ireland backstop'. Any revised deal would then need to gain enough votes in Parliament to overcome the unprecedented defeat the Government last suffered when it put the deal to a 'meaningful vote'. Given the challenges ahead, uncertainty is set to continue.

Expectations among certain officials, commentators and politicians is that the negotiations could well go down to the wire in late March, with the EU Council meeting of 21 March possibly the last chance to convene all EU leaders to seek a breakthrough. At this point, any deal would almost certainly require the UK and EU to agree to an extension of the Article 50 period to allow for formal ratification of the deal. In the absence of a deal, when the UK ceases to be an EU member at 11:00 p.m. GMT on 29 March, the UK and EU will be trading on a very different basis.

Preparing for a no-deal

Both the UK and the EU have been putting in place contingency plans in the event of a no-deal across different sectors of the economy. Whilst the UK approach has generally been to try and maintain the status quo, the EU has restricted its actions to areas where a no-deal scenario would 'create major disruption for citizens and businesses in the EU27'.

For financial services, the European Commission has adopted legislative measures, including:

- A temporary and conditional equivalence decision for a fixed, limited period of 12 months to ensure that there will be no immediate disruption in the central clearing of derivatives
- A temporary and conditional equivalence decision for a fixed, limited period of 24 months to ensure that there will be no disruption in central depositaries services for EU operators currently using UK operators
- Two Delegated Regulations facilitating novation, for a fixed period of 12 months, of certain over-the-counter derivatives contracts, where a contract is transferred from a UK to an EU27 counterparty

The Commission is also working with Member States to ensure that there are national mechanisms in place to enable existing cross-border contracts – particularly in derivatives and insurance – to be serviced for a limited time.

The UK Government and financial services regulators have also taken actions to allow EU firms to continue their existing passported financial services, whether through a UK branch or on a cross-border services basis, in or into the UK through the Temporary Permissions Regime (TPR).

Whilst the above measures are welcome, they still leave a huge amount for firms to do to ensure they are ready for a no-deal Brexit. Impacts on the broader economy, the ability for people to travel and work in different countries, the transfer of personal data cross-border, and tax are only some of the wider issues firms will face. Boards will need to ensure they are confident in their answers to the following:

- Can your business operate legally on 30 March 2019?
- Have you fully communicated with the UK and EU regulators regarding areas where execution may not be complete by 29 March, and sought tolerance or further guidance where required?
- Have you communicated your actions to clients?
- Is your new short-term model commercially viable, and how quickly do you need to revise it?
- Can you react decisively and rapidly to address market volatility and execution challenges?

This paper reviews ten critical areas related to each of these questions, and considers steps that firms should take over the next four weeks.

It should be noted at the outset that this paper does not attempt to identify the potential immediate or longer-term impacts on the economy or the financial sector. Instead, it is based on the premise that changes will occur and financial institutions need to be prepared for all no-deal eventualities.

How ready are you?

Key questions financial services firms should

Business structure and governance

- Do you have clear criteria for making a go or no-go decision on the remaining critical actions in your no-deal contingency plan?
- What governance has been put in place to understand and agree the risks being transferred as part of the business migration?

Business viability

- Have you assessed the potential impacts of economic uncertainty on business sectors, your clients, financial products and services, and, therefore, your business model and strategies?
- Given the political uncertainty, do you have appropriate liquidity plans in place, in all relevant currencies, and have you built appropriate stress scenarios into your Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP)?

Client outreach

- When will you execute contingency plans for clients that may not be migrated to your new EU27 location in time?
- Are all clients aware of the impacts of a no-deal Brexit, including the impacts it will have on trading via the firm?

People considerations

- Are the appropriate people in place to support your new operating model?
- Have you ensured key talent and skills can be hired, and are your plans resilient to any disruption in free movement of labour?

Financial market infrastructure

- Have you secured all the relevant financial market infrastructure (FMI) and central counterparty (CCP) memberships in the UK and EU27, considering the cross-jurisdiction market access issues?
- Have you tested your front-to-back connectivity to the relevant FMIs, CCPs?

Regulatory reporting

- Given changes to your booking and operating models, have you identified and differentiated your financial and regulatory reporting for tax and prudential purposes respectively?
- Have you clarified your data requirements and updated your internal processes to allow for accurate reporting to home and host supervisory bodies?

consider as the chance of a no-deal remains

Data adequacy

- Have you identified contracts that require model clauses, and lined up business pre-approval?
- Have you assessed the impact of revised data architecture and processing on EU data subjects?

Legal and contract continuity

- Do you have contingent options (legal and operational) should certain clients not wish to have their contracts transferred or leave it too late for them to be completed by 29 March?
- Have you mapped your product life cycles and contractual performance to assess how you will fulfill future obligations with all parties concerned?

Tax

- Do you have a plan in place to address the loss of availability of EU tax directives?
- Are you able to accelerate initiation of any pending litigation with EU and UK tax authorities that are dependent upon EU directives or Court of Justice of the European Union (CJEU) case law?

Conduct

- Have you ensured continuity of client services in the event of no-deal?
- How will you meet regulatory expectations for communicating with clients and acting in their interests during the migration of your current book of business to the new entity?

Technical considerations

Business structure and governance

Business deadlines are tighter than political timelines due to the need for people, capital and inventory to be in place ahead of 29 March. For instance, adequate time needs to be provided for connectivity testing between the EU27 entity and the FMI.

All entities involved in the migration will need to understand the risks that are involved and how these risks are adequately capitalised before, during and after migration. This means that firms need to have adequate capital in both entities, preparing for migration to be paused or stopped partway through the process. How can the UK firm become comfortable that all risk has moved?

If numerous financial institutions are undertaking migrations over one weekend, how will the regulators ensure that they have adequate oversight of all migration activities taking place and that the systemic risks are understood?

Firms should establish governance fora that will allow them to test the robustness of their go or no-go decision-making criteria, in order to ascertain whether they are sufficiently clear, made with appropriate seniority and broad enough to consider a range of scenarios.

Client outreach

Ongoing political uncertainty has meant many firms are facing challenges ahead of setting up their EU entity and enticing clients to move. Firms are taking differing approaches: some are pushing with as much speed as possible to repaper clients and be ready for business on 1 April, whilst others have been tentatively watching the political situation unfold and delayed their plans.

The timeline for repapering and novating clients into the new EU entities has always been challenging. This is further compressed by ongoing uncertainty delaying client acceptance of repapered contracts; therefore, some firms are considering alternative processes to enable them to continue to service their EU27 clients from the UK in the event of a no-deal Brexit.

Despite having invested heavily in planning, very few firms have completed their Brexit migration journey which we see as being comprised of four key steps; legal readiness, systems onboarding, operational readiness to trade and back book migration. Typically, firms have focused on the first three steps but these cannot be completed unilaterally and require engagement from firm's clients.

To expedite timelines firms can deploy additional resources to support the large-scale effort of completing onboarding requirements and novating positions. In particular:

- Conducting onboarding activities
- Following up with clients and sales teams to prompt a resolution of documentation
- Conducting novation outreach discussions, scheduling novations and executing novations

Contract continuity

With the EU passporting regime ceasing to apply to the UK, uncertainty in relation to the continuity of cross-border contracts; namely a firm's ability to perform contractual obligations that involve regulated activities, will be widespread. The implications for industry have already been extensive, including significant demands on management time and costs related to business-wide repapering projects.

Industry bodies have highlighted the potential issues and called for action. In late 2018, the UK Government published draft legislation, complementing the TPR – to ensure that EEA firms that do not enter the TPR or leave without authorisation, can wind down their existing contractual obligations in the UK for a limited period. There remains no blanket solution. The UK acting unilaterally will only partially manage the issue, and, so far, measures proposed by the EU and Member States have been inconsistent in their approach.

There are a range of risks that arise from the transfer or termination of financial services contracts, including commercial risks from counterparties seeking to renegotiate terms, and credit risk arising from new entities that contracts are transferred to. Counterparties need to consider their respective regulatory obligations (for example, due diligence and best execution) and this could cause unexpected issues in the coming weeks.

Firms have begun the exercise of repapering and reassessing their jurisdictions of interest. Large sell-side organisations are well advanced in their planning. However, some of their clients have been reluctant to engage, preferring to wait for further clarity on the possibility of a no-deal scenario. Highly compressed timelines could lead to an increased resource demand in the approach to a no-deal scenario.

Engaging with the relevant regulators and critically assessing your future book of clients and contracts is essential to minimise disruption and limit risk. Firms should also seek advice on their choice of transfer method and approach for redocumentation to ensure that they have the best tools ready to finalise their no-deal Brexit activity.

Data adequacy

The European Commission has confirmed that it would not provide an immediate data adequacy determination in the event of a no-deal. This means that personal data cannot be sent from the EU to the UK unless firms have resolved issues through either model clauses or adopting Binding Corporate Rules for intra-group transfers.

Relatively few firms have completed the implementation of model clauses, and whilst firms could adapt Binding Corporate Rules, to cover intra-group transfers, model clauses provide a far simpler mitigation method for firms. This also aligns with the approach advocated by the UK Information Commissioner's Office.

There are four key stages of actions firms should make in this regard:

- Risk acceptances at Board Committee level
- Identify impacted data flows
- Locate contracts and approve model clause amendments
- Execute according to well-defined go/no-go criteria

Separately, on the client side, firms need to be aware of their data transfer relationships with external suppliers where the UK processes data; for example, an EU firm with UK data processing centres.

Firms should also be conscious of the need to update privacy notices, as these state the need to obtain explicit consent if data is transferred outside of the European Economic Area. Firms should therefore seek to ensure that their staff have the requisite data training to avoid breaching data regulations.

People

Businesses are using any reasonable means to ensure they have the appropriate people in place by 29 March to run the business and ensure regulatory compliance.

Competition for key talent is high and, whilst there are steps employers can take to encourage staff to relocate, temporary measures should be considered as a contingency plan. Firms in the industry are considering a two-stage approach:

1. Adopting an interim solution using short-term assignments, commuting or dual-hatting, accepting some people may be in post temporarily
2. Gradually re-staff EU structures with permanent staff and develop longer-term talent pipelines

In order to ensure preparedness, firms should be:

- Reviewing and challenging existing mobility programmes or delivering specific assignment and tax services
- Identifying reliance on EU workforce based in the UK and categorising potential immigration impacts for business
- Examining the evolution of people strategies, policies and processes to reflect post-Brexit operating models
- Reviewing talent availability for immediate Brexit readiness, and wider skills and capability planning for UK and new EU27 entities
- Liaising with local regulators to understand their expectations before initiating staff relocations for specific roles

Regulatory reporting

Should firms encounter increased market turbulence, they may experience liquidity and capital difficulties. In such a scenario, banks may be required to report their liquidity and capital positions on a more regular cadence than they are used to.

The need to produce liquidity and capital regulatory reports with increased frequency raises issues of data quality and whether financial institutions have the requisite measures in place. This presents questions of whether boards feel they have adequately fulfilled their responsibilities and are aware of any deficiencies in data and overall quality of the report submitted.

All firms will also need to ensure that they can adhere to new regulations which they will find themselves subject to. For example, many firms will need to provide transaction reporting in their new EU27 entity for the first time.

To ensure that firms can cope with unforeseen market turbulence, they should engage with systems and data specialists to address data deficiencies. They should also test their data flows and inform the board of any insufficiencies in the quality of data. This may provide the board with reassurance if they need to respond to queries from the regulator.

Conduct

On the client side, firms need to ensure that they have provided clarity to clients on the services that they will receive in the event of a no-deal. Their respective end customers also need to establish whether they are comfortable with the local level of client asset protection if their assets are transferred to a new entity.

Firms will need to ensure that they meet all their regulatory requirements and establish whether boards understand and are comfortable with their new entities. In particular, business functions will need to ensure that they are adequately prepared to manage the hand-off of operations from in-flight Brexit programmes.

To mitigate some of these risks, firms should undertake a health-check or gap analysis. This will help to establish whether they are likely to meet regulatory expectations should they be subject to increased regulatory scrutiny or required to provide evidence to the regulator in a new country. Firms should also assess contracts for their relevant notice periods to understand any risks which may arise by terminating these contracts. Similarly, firms need to be cognisant of any spilt relationships with clients.

Financial Market Infrastructure

If the UK becomes a 'third country' without a Withdrawal Agreement, UK-based banks will need to acquire FMI and trading venue membership for their EU entities. FMIs and trading venues may also be forced to restructure, as they will not be able to rely on MiFID II passport rights enabling cross-border access between the UK and the EU. This will force UK-based FMIs and trading venues to create EU entities to provide members with continued access into the EU27 market. Similarly, it is expected that EU-based FMIs and trading venues will undergo a restructuring in order to maintain UK market access.

Whilst most banks have taken a proactive approach, they have been constrained by the fact that they need FMIs to act in conjunction with them. Most FMIs have adopted a patient approach, given the ongoing political and regulatory uncertainty, and banks now face difficult timelines to acquire FMI membership and go live in a new entity.

We continue to see on-going regulatory developments in this sphere, with the European Securities and Markets Authority recently confirming that three central counterparties (CCPs) established in the UK will be able to operate as third country CCPs, enabling them to continue to settle derivatives trades for investors and companies based in the remaining EU27 in the event of a no-deal Brexit.

To minimise disruption and mitigate unforeseen risks, FMIs and trading venues should seek migration assistance to manage the expectations of banks and dealers. To enable their respective preparedness, banks should assess what FMI dependencies they have and test their end-to-end connectivity and operational readiness in order to prepare for migration.

Tax

In a no-deal Brexit, EU tax directives will no longer apply to and in respect of the UK. The EU Merger Tax Directive prevents corporate income taxes being crystallised in several EU cross-border re-structuring situations. Where a Brexit-related re-structuring, for example the merger of a UK company into an Irish company, relies on the Directive to remove tax charges, particularly in any EU branch jurisdictions, it is imperative that such re-structurings are completed before Brexit to ensure that such taxes do not arise.

Firms will also need to consider UK exit tax risk on any move of assets or functions from the UK to EU27 jurisdictions – the subject of much discussion between industry and the UK tax authorities. Key questions to consider include:

- Have you assessed your potential UK exit tax exposure by reference to tax, transfer pricing and valuation principles?
- Have you got documentation in place to ameliorate risk?
- Have you socialised identified issues with tax authorities?

Furthermore, companies, irrespective of whether they are based in the UK, the EU27 or anywhere else, will post-Brexit no longer be able to rely on EU law when considering their tax position in the UK, or in future disputes with the UK tax authorities.

The ability of UK groups and companies to do so with respect to tax authorities in EU27 jurisdictions may also be constrained

compared to the current position. Accordingly, it's advisable to lodge claims or defences, ahead of 29 March, before competent courts where the prospects of success in a tax case depend on EU law arguments.

Finally, a similar point arises in relation to disputes involving the use of the EU Arbitration Convention. This Convention establishes a procedure to resolve disputes where double taxation occurs between enterprises of different Member States because of an upward adjustment of profits of an enterprise of one Member State.

Whilst the Convention is an international treaty rather than EU legislation, following Brexit, the UK would fall outside the territorial scope of the Convention. So, whilst disputes involving the UK arising pre-Brexit should fall to be dealt with under the Convention, disputes involving the UK arising post-Brexit would not. Consequently, it would be advisable (as the clock runs down to 29 March) to accelerate in-scope disputes wherever possible to fall within the terms of the Convention.

Business viability

As a result of Brexit, most firms have established new or significantly expanded EU entities with required resourcing and infrastructure, appropriate governance arrangements, additional layers of management, risk management frameworks, new booking models, outsourcing arrangements and infrastructure support.

Firms must now meet a new and significant additional regulatory burden outside the UK, including enhanced supervisory stress testing. This will all bring significant additional operating costs and additional capital (at least in the medium term), give rise to large intra-group exposures and treasury management considerations, and cause firms to evolve their recovery and resolution planning. This has already crystallised for most firms — certainly for any firm with sizeable EU business. A no-deal Brexit will not prevent them conducting business, but with additional resources, costs and capital commitment.

The additional impact of a no-deal Brexit, beyond those arising from restructuring to date, will primarily be felt through the macroeconomic impacts and second-order effects on bank customers and the flow-through to demand for financial markets products and services.

In a no-deal Brexit, financial institutions will remain open for business and able to service clients from an operational perspective. However, the future is more uncertain from a business model and viability perspective. Many firms will need to be extremely agile, prepared to follow client strategies, enter new markets and geographies, and deal with an even more diverse regulatory infrastructure.

Conclusion

A no-deal Brexit would bring a challenging set of circumstances to businesses across Europe. Overnight, companies will have to cope with different ways of trading, regulation, licencing, tax and moving their people around. Whilst extensive plans have been made and issues identified, it is unclear what level of disruption such a scenario might entail given the scale of change. Most will have never attempted such a wide-ranging overnight change to systems and controls, and they do not have complete control of the actions of all their suppliers and customers. Many businesses will be reliant on all of the organisations involved in their supply chain being ready, and their clients' consent for data or relationships being ported to a new EU entity.

Financial services firms, even those with the most Brexit-proof models will need to be prepared. The structures for dealing with any sort of unpredictability should be rehearsed: governance to ensure leaders can react quickly to clients and the market; communications protocols to share messaging rapidly internally and externally; and open lines of communications with supervisors. Firms should focus on identifying remaining gaps whilst also maintaining sight of their internal firm resilience to unforeseen market events.

The final few weeks ahead of 29 March still provide valuable time to finalise execution activities. Identifying any gaps that might still exist will be imperative in order to put in place contingency strategies ahead of time and allow for engagement with relevant regulators where necessary.

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Notes

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