Stand out for the right reasons
Financial Services Risk and Regulation

FSRR Hot Topic

European Banking Authority Brexit opinion: what does it mean for firms' Brexit plans?

Highlights

The EBA issued an ***Opinion on issues relating to the departure of the United Kingdom from the European Union*** *on 12 October. The opinion is wide ranging in focus and provides details on many of the most important issues firms are considering in the context of Brexit restructuring.*

Background and timeline of developments

The EBA plays an important role in driving regulatory harmonisation of prudential rules across the EU through developing the Single Rule Book for banking. These rules impact banks, investment firms, payment providers, e-money firms and credit intermediaries.

The EBA's Brexit opinion follows similar opinions issued by the EBA's sister authorities ESMA and EIOPA and provides a significant amount of detail on its expectations for supervisors and firms' plans for restructuring in the context of Brexit. All of the ESAs' opinions may be impacted by any provisions for financial services included in any trade agreement reached between the UK and EU. They are particularly important in providing clarity for firms seeking to understand how to plan for operations under any so-called 'hard' Brexit scenario.

As an opinion (rather than technical standard) the provisions in the document are not directly binding on EU supervisors (including the ECB) but they will provide an important framework for decisions made by EU authorities on firms' Brexit plans.

In this Hot Topic, we summarise the most important aspects of the proposals, and their implications for financial services firms.

Summary

The opinion is detailed and practical in its handling of the key issues for those firms planning on relocating activities to the EU-27 due to Brexit. On the whole the EBA has chosen to take a pragmatic approach. The opinion also reconfirms and reminds supervisors and firms of the requirements most relevant to Brexit restructuring in the Capital Requirements Regulation/Directive as well as in technical standards and guidance produced by the ESAs.

The key elements of the proposals are:

- **Authorisations:** The EBA has reinforced the point repeatedly made by the ECB and other ESAs that so-called 'empty-shell entities' established to gain passporting rights but with limited local presence will not be accepted. But where an institution is already known to EU-27 regulators or where the UK authorities have provided information to EU-27 authorities on the firm, requests for information can be streamlined.
- **Internal models for calculating capital requirements:** The EBA has sought to provide clarity on the use of internal models post-Brexit. Existing internal model approvals will still stand post-Brexit in many cases, where the exposures/portfolios remain the same as when the model was approved, but an assessment should be made of whether a banking group's circumstances have changed sufficiently to justify reassessing the use of the model. Banks wishing to undertake activities in the EU-27 should seek model approval from an EU-27 supervisor – but those supervisors can rely on assessments made by the PRA until a full assessment can be made by an EU-27 regulator.
- **Internal governance, outsourcing and risk transfer:** The EBA has reinforced the importance of robust local governance, the need to manage risks from outsourcing to the UK post-Brexit and the ability for local EU entities to be able to manage risk transfers such as back-to-back booking to the UK post-Brexit.
- **Resolution and deposit guarantee schemes:** The EBA notes that firms should take into account restructuring due to Brexit when considering resolution plans and strategies. And regulators should ensure that MREL issued by firms continue to comply with EU requirements. EU authorities should also consider the implications of Brexit on deposit guarantee schemes (DGS).
- In a number of areas the EBA also stresses the importance of cooperation between EU-27 regulators and UK authorities post-Brexit.This is a very positive message and the EBA is well placed to coordinate this cooperation.

How will these proposals impact firms' Brexit plans?

While much of the material in the opinion is consistent with pronouncements made by the ECB and national authorities (which should have been factored into firms' Brexit plans) there are a number of areas where the EBA has provided greater detail and where firms should take note.

Authorisation in the EU-27

The EBA's opinion provides further guidance on supervisors' approach to authorisation of new EU-27 firms or approval of new functions in existing entities. The EBA opinion reinforces the need for new entities to have a robust business plan, be located in the primary location of business and have fit and proper management and shareholders. Importantly the EBA states that regulators should take a pragmatic approach to authorisation where the entity being authorised is already known to them (for example where operations are currently being undertaken through a branch) and where information is provided to them by UK authorities. In these cases information requests can be waived or scaled back. The EBA has also included a list of questions that supervisors should consider when dealing with authorisation requests.

Those banks considering transferring business from an EU branch of a UK entity to another exisitng EU-27 branch should be aware that this will require supervisory approval and that doing so may be contingent on meeting conditions applied by supervisors.

As well as impacting banks the EBA's opinion will affect the Brexit plans of other financial institutions. Many firms wishing to continue conducting wholesale activity in the EU post-Brexit will seek to do so through an investment firm. These firms are currently not supervised by the ECB (although the ECB has indicated it would like to supervise them in future). The EBA has now also called for authorisation and supervision of systemically important investment firms to be done by the ECB, rather than national supervisors.

In addition, the EBA has called for the third country equivalence regime in MiFID II to be strengthened to require a stricter assessment of the prudential standards investment firms face in a third country prior to that country being assessed as equivalent by the European Commission (EC). If this amendment is made, it may impact the UK post-Brexit. But in all likelihood the FCA/PRA's prudential regime will remain at least as robust as that of the EU's, and so the change could have a more pronounced impact on other third countries with a less developed approach towards investment firms.

Treatment of internal models

Many firms seeking to relocate to the EU-27 in the context of Brexit will need to consider whether they have adequate approvals to continue using internal models for calculating capital requirements. The alternative to the use of internal models is the standardised approach which can result in considerably higher capital requirements. The EBA has provided some useful guidance on the scenarios in which firms must seek re-approval of internal models (summarised in annex A of this document).

Perhaps reflecting the extreme time pressures regulators are facing in processing authorisation and approval requests prior to Brexit, the EBA is advocating a pragmatic approach to model approvals, acknowledging that model approvals by the ECB or national EU-27 authorities may not be ready in time for Brexit. If this is the case, reliance can be placed on approvals by the PRA, assuming the model approved by the PRA matches the portfolios of the new or expanded EU-27 entity. A EU-27 regulator will also be required to approve the model at a future point.

Internal governance and outsourcing

Consistent with the position that 'shell entities' should not be accepted in the EU, the EBA's opinion reminds firms and supervisors that new entities established in the EU-27 or existing entities in the EU-27 must meet the governance requirements found in EU legislation and ESA guidance. In particular the EBA stresses that the management body and key function holders of EU institutions should perform their functions in the Member State of establishment and should be able to properly undertake their role with sufficient knowledge, skills and experience.

The EBA stresses that management and oversight of EU entities cannot be delegated to parent entities in the UK or elsewhere and that the EU entity should have oversight of and take responsibility for internal controls (risk management, compliance and internal audit) and risk strategy.

The EBA's opinion also notes that there are some differences in the way Member States have applied the remuneration requirements in CRD and that this may influence decisions on where to locate staff in the EU-27. In this context the EBA notes that the EC has already proposed harmonising the waivers available to supervisors in applying remuneration requirements.

Outsourcing to the UK post-Brexit is likely to be a key focus for many firms. Outsourcing of activities such as IT and data management is already a very common practice amongst cross-border groups but outsourcing arrangements to the UK post-Brexit are likely to be scrutinised closely by EU-27 regulators.

The EBA acknowledges that outsourcing is likely to continue to the UK post-Brexit. But it cautions that EU-27 regulators should ensure that outsourcing is not used to the extent that the entity in the EU is simply an empty-shell used to gain passporting rights. To prevent this the EBA emphasises the need for firms to have appropriate oversight of outsourcing arrangements, have controls in place to manage them and retain the ability to insource activities within an 'appropriate timeframe'. Firms should also undertake due diligence of outsourcing arrangements to assess the risks from these arrangements and to ensure these risks are managed adequately. The EBA emphasises the need for firms to have an appropriate number of staff in the EU-27 entity to manage these risks.

Back-to-back booking and intragroup transactions

The ability to use back-to-back booking between EU-27 entities and the UK post-Brexit is of particular importance to firms wishing to undertake cross-border wholesale activity. Back-to-back booking allows management of market risk to be fully transferred to another entity in a group through matching trades. This approach allows a greater degree of centralisation of risk management, often where most of the expertise resides, and reduces the costs of fully replicating functions in two entities.

The EBA acknowledges that back-to-back booking is not new, but sets out some potential concerns around its use. In particular, the EBA points to the counterparty credit risk from the EU-27 entity to the entity the risk has been transferred to, particularly should that entity fail. In the event of a failure the EBA points to the risks from direct losses to the EU entity, increased capital requirements due to suddenly unhedged positions, operational challenges from the need to manage the open book and finally deficiencies in the ability of the EU-27 entity to risk manage the positions.

In light of these concerns the EBA stresses that any EU-27 entity using back-to-back booking should have adequate capital (through Pillar 2) to absorb any potential losses from the risks from back-to-backs and the in-house risk management and operational capabilities to manage and unwind the positions in the event of the failure of the entity managing the risks. The EBA also stresses that firms should ensure that back-to-back transactions are considered in the context of managing large exposures and reflected in firms' risk strategies.

Resolution and deposit guarantee schemes

Brexit will lead to significant restructuring of groups in Europe, as they position themselves in the optimal way to continue to serve EEA clients. The EBA believes this may impact recovery and resolution considerations in three ways:

i. The impact of the proposed restructuring on resolvability should be considered and changes to group structure reflected in resolution plans.

ii. The possibility that EU-27 resolution authorities' powers will not be recognised by UK courts.

Additionally UK authorities' actions would not automatically be recognised in the EU-27.

iii. EU-27 authorities should ensure they are satisfied that they are able to write down or convert minimum requirements for eligible liabilities and own funds (MREL) issued under English law.

Restructuring in the context of Brexit has the potential to make group structures in Europe more complicated, something that can hamper resolution. This could be further exacerbated by the EC's proposals that third country globally-systemically important banks and banks with over €30bn in assets (including branch assets) and multiple subsidiaries should form an intermediate parent undertaking.

Firms should keep resolution considerations in mind when thinking about group structure post-Brexit and be prepared to update resolution plans accordingly. Issues i. and ii. above are likely to manifest themselves only in the event of a lack of cooperation between UK and EU-27 authorities. This eventuality seems unlikely, at this stage at least. But a lack of coordination and cooperation between UK, EU and national authorities has the potential to increase costs for firms in resolution planning and would ultimately increase systemic risk by hindering cross-border resolution.

In light of the reliance of EU banks on UK CCPs for clearing of derivatives, repo and other instruments the EBA also highlights the importance of EU-27 authorities engaging with the Bank of England with respect of resolution of CCPs.

Currently under the Deposit Guarantee Scheme Directive (DGSD), the deposits held by EEA branches of EU firms are covered by the home Member State's deposit guarantee scheme. In the UK, the Financial Services Compensation Scheme guarantees deposits held by EEA branches of UK firms in other Member States. After the UK leaves the EU this treatment is not guaranteed.

For third country branches, the DGSD requires Member States to undertake an equivalence assessment of the relevant third country, to determine whether its DGS offers equivalent protection to that under the DGSD. If not, third country branches from that country can be forced to join the local DGS. The EBA also notes that post Brexit, the DGSD won't apply in the UK (absent an agreement to that effect), so it will be important to achieve clarity on the DGS applicable of deposits held by UK branches of EEA entities.

The EBA believes that EU-27 authorities should clarify with the UK authorities which DGS will cover deposits held by EEA branches in the UK. Equally UK banks operating in the EU through branches (and their depositors) will welcome early clarity on which scheme will cover deposits held with them.

What does this mean for firms?

- The EBA opinion is not directly binding on EU-27 supervisors or firms, but it is likely to frame many decisions by regulators around Brexit restructuring. Firms should consider their plans for governance arrangements, booking models and use of outsourcing carefully with the opinion (as well as other pronouncements from ESAs, ECBs and national authorities) in mind.
- Time is tight for gaining authorisation in the EEA prior to Brexit in March 2019. Those firms that have not submitted authorisation requests should consider doing so as soon as possible. The EBA's position that where an institution is known to an EU-27 regulator or where information has been provided by UK authorities, information requests can be 'streamlined', should be useful. Firms should engage now with their primary EU-27 regulators to establish how this streamlined process will work for them.
- Gaining internal model approval from regulators can be a challenging process. This is particularly the case for complex models such as Internal Model Method models used to calculate counterparty credit risk. As such firms should establish as soon as possible whether new approvals will be necessary and engage with the relevant regulators.
- It is important that firms' restructuring plans result in structures which are efficient and cost effective, but equally firms will be required to address the concerns of EU-27 regulators (and the concerns expressed in the EBA opinion) about the need for local governance, risk management, outsourcing and risk transfer to the UK.
- Firms should now assess how their Brexit restructuring plans will affect resolvability. They should avoid, where possible, introducing undue complexity into group structures due to Brexit. Firms should reflect changes in structures in resolution plans.

Contacts

Conor MacManus

T: +44 (0)20 7213 8555

E: conor.macmanus@pwc.com

Annex A – Impact of Brexit restructuring on internal model approvals

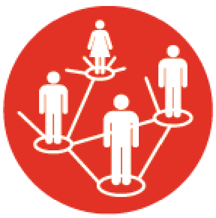
Scenario	Action needed
Existing EU-27 subsidiary of UK parent with approval given by joint decision pre-Brexit with no changes in exposures/portfolios.	No additional approvals required.
Existing EU-27 subsidiary of UK parent with approval given by joint decision pre-Brexit, but Brexit results in changes to activities/exposures/portfolios.	Submit an application to EU-27 regulator for model changes, extensions or initial approval on either a solo basis (if the change in circumstances is limited to the solo EU entity) or solo and consolidated basis (if the change impacts the solo EU entity and UK parent).
EU subsidiary with existing model approval is turned into an entity consolidating all EU-27 entities (i.e. an intermediate parent undertaking).	Submit an application to EU-27 regulator to use models at a consolidated basis.
New EU company established to act as IPU without model approval.	Submit an application for new model approval to use models on a consolidated basis.
EU-27 branch of UK parent 'converted' into EU subsidiary.	Submit an application for new model approval.
Branch of UK firm in EU becomes third country branch.	National law governs this scenario.
EU branch or subsidiary in the UK and Brexit related changes require changes in internal models.	EU-27 authority should monitor performance of model and assess the materiality of the changes in circumstances, and if necessary follow procedure for model changes or extensions.

171026-110122-JD-OS

Stand out for the right reasons

Alert

Protect



Adapt

Repair

Financial services risk and regulation is an opportunity

At PwC we work with you to embrace change in a way that delivers value to your customers, and long-term growth and profits for your business. With our help, you won't just avoid potential problems, you'll also get ahead.

We support you in four key areas.

- By alerting you to financial and regulatory risks we help you to understand the position you're in and how to comply with regulations. You can then turn risk and regulation to your advantage.
- We help you to prepare for issues such as technical difficulties, operational failure or cyber attacks. By working with you to develop the systems and processes that protect your business you can become more resilient, reliable and effective.
- Adapting your business to achieve cultural change is right for your customers and your people. By equipping you with the insights and tools you need, we will help transform your business and turn uncertainty into opportunity.
- Even the best processes or products sometimes fail. We help repair any damage swiftly to build even greater levels of trust and confidence.

Working with PwC brings a clearer understanding of where you are and where you want to be. Together, we can develop transparent and compelling business strategies for customers, regulators, employees and stakeholders. By adding our skills, experience and expertise to yours, your business can stand out for the right reasons.

For more information on how we can help you to stand out visit *www.pwc.co.uk*