

Stand out for the right reasons Financial Services Risk and Regulation

Hot topic

What a no-deal Brexit holds for financial services

Highlights

In recent weeks, governments and FS industry regulators have been announcing a range of preparations to get ready for a possible no-deal Brexit.

Individual Member States have also been announcing their preparations, focused on the areas of financial market responsibility where they have jurisdiction.

These measures focus on protecting EU consumers, firms and governments from “cliff edge” impacts if there is no deal.

With only limited exceptions, UK-based firms will find challenges which would quickly and steadily limit their ability to trade across Europe from a UK base.

With the 29 March 2019 Brexit deadline approaching, and a negotiated deal to provide an orderly exit (with an agreed transition period) still far from approval, questions are being asked about what a no-deal scenario would look like for financial services (FS).

The UK Government has made clear for some months that if there is no deal, it would still aim to provide as much continuity as possible for inbound FS business from the European Economic Area (EEA). An open, globally-integrated approach remains core to the success of UK-based financial services industry, regardless of Brexit.

The European Union (EU) has been clear that its priority is to maintain the integrity of its Single Market, so when the UK leaves the EU, by default it will become a so-called third country under the provisions of EU legislation. This means that access to EU markets for UK businesses will be limited to that specified for third countries in existing EU FS legislation, which depends in many instances on European Commission assessments of regulatory equivalence. If the UK leaves the EU without a deal, there will be no transition period to allow time for EU equivalence assessments to be made. This would mean immediate restrictions both on the rights of UK firms to legally provide services across the EU, and also on the rights of EU firms to trade in the UK, because for example EU-based firms are barred under EU rules from using third country (as the UK will be post-Brexit) exchanges unless there has been an equivalence determination.

Despite differences in priorities, both UK and EU officials recognised that a shared understanding of the financial stability risks of a no-deal outcome were important to underpin planning for both sides, and so a joint working group of the Bank of England (BoE) and European Central Bank (ECB) was set up in late 2017 and asked to analyse the risks. The mitigating actions announced in recent weeks flow from the analysis of the working group.

This Hot Topic paper identifies and seeks to put in context, the main preparations for a no deal Brexit announced by the UK Government, the European Commission, as well as the supporting actions and opinions of the sector-focused European Supervisory Authorities (ESAs). Member States in the EU also retain important authority for parts of the FS industry, and for the legal underpinnings by which contracts are enforced locally, and so we also look at the impacts of recent Member State announcements and the changes these suggest for firms, if they must handle a no-deal Brexit.

UK Government actions

Providing UK market access for EEA firms

In the UK, the Government's legislative approach has been focused on:

- *Legal basis:* Aim to ensure a "fully functioning financial services regulatory framework" exists at the point of exit, so the European Union (Withdrawal) Act 2018 transfers EU law relating to FS, to the UK statute book on exit day.

- *Treatment of EEA firms:* The UK is providing a Temporary Permissions Regime (TPR) that will allow EEA firms which have been passporting into the UK to continue their existing business operations for up to three years, as they apply for full authorisation under the UK's third country rules. Further temporary regimes will also be provided for EEA electronic money and payment institutions, registered account information service providers, and EEA funds that are marketed into the UK.

- *Continuity of contracts:* UK legislation will also ensure that contractual obligations (such as under insurance contracts) between EEA firms and UK-based customers can continue to be met.

- *Central clearing/operation of exchanges:* Draft secondary legislation establishes a temporary recognition regime (TRR) for central counterparties (CCPs), to allow non-UK CCPs to continue to provide clearing services to UK firms for up to three years while applications for recognition in the UK are made.

- *Other FS sectors:* The UK Government has committed to legislate, in order to deliver specific transitional arrangements for:

- central securities depositories (CSDs)
- credit rating agencies
- trade repositories
- data reporting service providers
- systems currently under the Settlement Finality Directive
- depositories for authorised funds.

The UK Government has embarked on a comprehensive legislative approach to deal with financial stability concerns. From an industry perspective, remaining concerns will mainly be with timing and certainty: whether the legislative programme can be passed by Parliament ahead of exit day.

European Commission actions

Concerning EU market access for UK firms, and protection of EU27 interests

In the EU, the Commission's approach to a no-deal scenario has focused on providing limited relief of the financial risks to EU27 governments, firms and citizens. It has encouraged firms, wherever possible, to implement private solutions

(e.g. novation of contracts to EU27 based entities), rather than public solutions, recognising that after Brexit, the UK will be a third country, so UK firms would immediately become subject to the EU's third country rules.

On 19 December 2018, the Commission announced the following will apply if there is a no-deal Brexit:

- *Central clearing of derivatives contracts:* The Commission will provide a temporary equivalence decision, for 12 months, to allow EU based counterparties to continue central clearing of OTC derivatives on UK-based exchanges, under the European Market Infrastructure Regulation (EMIR).

- *Central Securities Depositories:* The Commission will provide a temporary equivalence decision, for 24 months, to allow EU operators to continue using UK-based CSDs under EMIR.

- *Novation of derivatives contracts:* The Commission will adopt two Delegated Regulations to facilitate novation, for 12 months, of certain over-the-counter (OTC) derivatives contracts from a UK to an EU27 counterparty.

On 30 January 2019, the Commission announced additional preparations, to reflect agreements with UK authorities about how central banks will be treated. EU Central Banks and Treasuries (entities involved in the management of public debt), as well as their UK equivalents, will remain exempt from each other's regulatory requirements on a reciprocal basis. This will include the clearing, reporting and risk management requirements of EMIR, the Market Abuse Directive, the pre- and post-trade transparency requirements of the Markets in Financial Instruments Directive (MiFID II), the reporting obligations under the Securities Financing Transaction Regulation (SFTR), and well as the equivalent provisions of new UK domestic FS legislation which transfers existing EU rules in each of these areas.

The Commission's proposed temporary equivalence decisions for CCPs and CSDs were made conditional on the satisfactory conclusions of Memoranda of Understanding (MoUs) between ESMA and the BoE regarding the sharing of supervisory information. These were confirmed as completed on 4 February 2019.

Role and approach of ESAs

The ESAs play a role in coordinating policy of the EU's national competent authorities (NCAs), even where they do not have direct responsibility themselves. So in the context of Brexit, the ESAs have been issuing Opinions regarding issues of concern. Notably, there has been concern that UK-based FS firms would establish "letter-box entities" in the EU and then use outsourcing arrangements with their UK branches (non-EU branches after Brexit) to perform material functions or provide services back to the EU. The European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA) have all issued Opinions warning against such arrangements.

Recognising the importance of a prevailing business model for investment firms, ESMA announced on 1 February 2019, that it has also agreed MoUs with the FCA and national EEA securities regulators that will allow fund management outsourcing and delegation activities by EEA firms to the UK to continue.

Then on 6 February 2019, ESMA issued another Opinion, in the form of a Supervisory Briefing to NCAs about the supervision on third country branches of EU firms that provide investment services and activities. In this, ESMA calls on NCAs to closely monitor the activities being carried out in third country branches, and to insist on regular reports about:

- the geographical distribution of clients being served by the non-EU branch
- the activities and functions being provided by the branch to the EU-based head office
- the activities and functions being provided by the branch to other entities of the group
- the outcome of the regular assessment of the group's compliance function with respect to the activities of the branch.

This ESMA opinion also closely follows Opinions and supervisory practices from the other ESAs and the ECB. For EEA firms with UK branches, this is expected to significantly increase the reporting requirements of the branch activities.

Data protection

Transfers of data between the EEA and UK

On 12 February 2019, the European Data Protection Board (EDPB) issued its own **guidance note** on transfers of personal data between the EEA and UK after Brexit. If there is no deal, data transfers from the EEA to the UK will be treated as transfers to any other third country which does not have a GDPR data adequacy decision from the Commission.

The EDPB's note outlines the steps firms should take when making such data transfers, explaining the instruments that are available to them. The required processes could prove a major challenge for FS firms which operate across borders but have not already implemented alternative arrangements as set out in the guidance. For more details, please also see our PwC blog: **"No deal Brexit and the impact on cross-border data flows"**.

No deal preparations by Member States

Concerning EU access for UK insurance and asset and wealth management (AWM) firms, protection of national interests

In banking, supervision and authorisations for Eurozone countries is controlled by the ECB, but for insurers and all but the largest investment firms, access and supervision is a matter for national authorities in each Member State. ESAs

play a policy coordination role, but the Member States retain responsibility.

So in addition to the actions taken by the Commission and ESMA, there remain areas where Member States have decided to act, to address financial stability risks if there is a no-deal Brexit. Aligning with the Commission's approach, Member State actions are designed to focus on protecting the interests of their own citizens and firms. The common areas of coverage amongst a sample of key countries include:

- ensuring domestic firms will have access to UK-based interbank and settlement systems, by addressing "settlement finality" of payments made through these systems
- authorising UK firms setting up or expanding scope to operate under local legislation and supervision (insurers, investment firms, and some smaller banks)
- providing contractual certainty for performance of insurance contracts
- clarifying the scope of services and operational business models available for investment firms which operate across borders with the UK

There are also some areas where individual Member States have particular interests, and so have acted, such as the Irish interest in a CSD solution. The following table summarises the provisions which some of the key Member States for the FS industry have made.

Preparations for a no-deal Brexit for financial services - selected Member States

Germany	France	Italy	Netherlands	Ireland
<p>Approach: Draft legislation (November 2018)</p> <ul style="list-style-type: none"> - Amends German Banking Act - Allows BaFin to apply provisions for passported branches and cross-border services for a transitional period - U.K.-based firms may continue EU passporting rights through 2020 ... to service existing contracts - Permissions to be granted on a case-by-case basis - <i>New ...</i> where base salary is > €234k, firms no longer required to legally justify termination 	<p>Approach: French Brexit Law (20 Jan 2019)</p> <ul style="list-style-type: none"> - Government given power to adopt measures for a no-deal Brexit under Edict powers, without going through lengthy parliamentary process - No indication of intent to allow UK firms to continue service provision 	<p>Approach: Italy draft Brexit Law (press release – 24 Jan 2019)</p> <ul style="list-style-type: none"> - A Decree law, not requiring normal Parliamentary process, will be used to introduce a transitional period during which UK entities may continue to operate - similar to the transitional period planned in the draft Withdrawal Agreement - So far only an announcement of intent. Draft legislation not yet available 	<p>Approach: Dutch Omnibus Brexit legislation (November 2018)</p> <ul style="list-style-type: none"> - Government given temporary permission to bypass Parliament, to enable quick 'repairs' for any unforeseen adverse consequences of Brexit 	<p>Approach: General Scheme of Miscellaneous Provisions for UK Withdrawal from EU on 29 March 2019 (24 Jan 2019)</p> <ul style="list-style-type: none"> - Amendments to various bills to implement the EU equivalence decision for Central Securities Depositories (CSDs) - <i>Priority</i>- CSDs given that Euronext Dublin, (Irish Stock Exchange) uses UK based CSD (CREST) to settle trades in Irish equities and exchange traded instruments
<p>Banking, Cap Markets:</p> <ul style="list-style-type: none"> - Allows BaFin to grant permission on a case-by-case basis for UK firms to continue provision of services from passported branches, for a transitional period 	<p>Banking, Cap Mkts:</p> <ul style="list-style-type: none"> - Allows French firms to have access to third country interbank and settlement, by ensuring the finality of payments made through such systems - France to set out new ISDA master agreement terms to be used by an EU based entity 	<p>Banking, Cap Mkts:</p> <ul style="list-style-type: none"> - Intent to allow, on a reciprocal basis banking, investment and insurance firms to continue to operate according to existing laws and regulations - Protection of depositors and investors also to be guaranteed - Specific measure planned to guarantee settlement finality 	<p>Banking, Cap Mkts:</p> <ul style="list-style-type: none"> - Allows Dutch firms to access third country interbank and settlement systems by amending settlement finality provisions of Bankruptcy Act to allow clearing systems to rely on home country governing law regarding insolvency of a participant 	<p>Banking, Cap Mkts:</p> <ul style="list-style-type: none"> - Allows Irish firms to access third country interbank and settlement systems, by extending the protections contained in the Settlement Finality Directive to Irish participants in relevant third country domiciled settlement systems
<p>Insurance:</p> <ul style="list-style-type: none"> - Transitional arrangement for 21 months, to enable transfer or termination of existing contracts. 	<p>Insurance:</p> <ul style="list-style-type: none"> - Re: ongoing contracts, France will define a run-off regime to allow firms to perform contractual obligations which are in the best interest of clients 	<p>Insurance:</p> <ul style="list-style-type: none"> - As for banking, intent is to allow firms to continue operating for a transition period, as planned in Withdrawal Agreement 		<p>Insurance:</p> <ul style="list-style-type: none"> - Allowing UK firms to service existing contracts –eg paying out on claims - Temporary run-off regime for 3 years; UK firms may not write new business
<p>Investment Mgmt:</p> <ul style="list-style-type: none"> - Covered bonds ... proposal to grandfather claims secured by UK based real estate - UK real estate will remain eligible security for loans granted by German building societies 	<p>Investment Mgmt:</p> <ul style="list-style-type: none"> - Introduces specific rules for management of collective investments whose assets comply with investment ratio in European entities 	<p>Investment Mgmt:</p> <ul style="list-style-type: none"> - Pension funds may continue to hold UCITS and AIFs established under the laws of the UK during the transitional period 	<p>Investment Mgmt:</p> <ul style="list-style-type: none"> - Dutch Financial Supervision Act amended (8 Feb) to allow UK firms to continue provision of MiFID investment services (8 Feb) until 1 January 2021 	

Common elements:

Member States are addressing “cliff-edge” risks arising from a disorderly, no-deal Brexit by:

1. providing national treasuries and/or supervisors with more powers and greater discretion to act on emerging risks
 2. granting *temporary* permissions for UK firms to continue operations – for a limited time
 3. addressing issues to provide contractual certainty for derivatives transactions
- ... and in specific sectors
4. *Insurance* – allowing UK firms to run-off existing contracts, but maintaining pressure for firms to seek authorisation of an EU27-based legal entity
 5. *Investment management* – permitting delegation by EU funds to the UK, but limiting the scope of business which UK-based investment firms may conduct in the EU

What does this mean for UK-based FS firms?

The UK is on course to leave the EU with or without a deal on 29 March 2019. If there is no agreed deal between the UK and EU, there will be no transition period, so new trading arrangements will apply with immediate effect. Governments and industry regulators in the UK and EU have therefore been making announcements to clarify the rules that will govern financial services activities.

PwC has published a number of reports exploring the impacts of Brexit on both the UK and the EU27, notably in our 2017 report published with AFME: *Planning for Brexit: Operational impacts on wholesale banking and capital markets in Europe*, and then in our 2018 economic report: *Impact of loss of mutual market access in financial services across the EU27 and UK*, which identified and then estimated a €60bn combined impact to UK and EU-27 economies from the loss of mutual market access: potential losses are large.

But looking in detail at the no-deal proposals for FS from the EU and Member States suggests continuity would be only limited and/or temporary. The EU’s measures reflect a priority to enforce EU law regarding third country access to EU financial markets, from the date of Brexit. This will not allow UK-based firms to continue operating as they do today when selling services to customers across the EU. In each FS sector, no-deal measures are designed to continue exerting pressure to shift FS activities to an EU27-based legal entity, which can be directly supervised by EU or Member State authorities. Proposed interventions do not, so far, address other known no-deal risks: for example that EU firms will not be able to access UK equity markets without further equivalence determinations, nor to use the LIBOR benchmark rate even though its alternatives are still being phased in, or that higher prudential requirements for EU firms may result when UK exposures are counted as third country exposures. Member State approaches to ensuring contractual performance are also inconsistent, with gaps. Preparedness for Brexit amongst users of financial services is also reported to be low, which affects firms’ abilities to implement legal changes quickly.

In addition, because the European Commission does not intend to provide a temporary data adequacy decision for the UK under GDPR, firms which transfer personal data from the EEA to the UK as a part of their normal business processes will need to assess their compliance and implement any required new transfer instruments and procedures before 30 March 2019. Penalties for failing to do so can be severe.

In summary, a no-deal Brexit would require UK-based firms to adjust overnight to a post-Brexit operating environment where UK-based access to EU clients for many services is restricted, subject to cancellation at short notice (because dependent upon a temporary permission) or limited to running-off existing contracts (e.g. for insurance firms). Normal EU client handling procedures might also be affected by GDPR-related challenges governing data transfers from EEA countries to the UK.

Many FS firms recognised that most of these same challenges are likely to be faced either in the immediate event of a no deal Brexit, or at the end of a transition period. These firms have established new or expanded EU-27 based operations. For firms in this situation, the key challenges of a no-deal Brexit will be to ensure that business activities with EU customers are migrated in time, that operational issues associated with the expedited transition are properly managed, and that processes which required cross-border data transfers will be compliant. Firms that have not yet established EU27-based entities will need to urgently review the latest announcement identified here, to assess the impact on the clients and markets they serve.

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Alert

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