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Financial Services Risk and Regulation

Hot topic

What does the BoE's approach to a no-deal Brexit mean for banks?

Highlights

With less than five months to go until Brexit, HMT and the UK regulators are putting in place contingency measures to prepare for a no deal Brexit.

As part of this, the BoE published a set of consultation papers on 25 October 2018 setting out its proposed approach to on-shoring of EU regulation and changes to existing BoE rules as a result of Brexit.

Firms and financial market infrastructures (FMIs) should provide feedback on the proposals set out in this consultation package by 2 January 2019.

As a member of the EU, much of the UK's current regulatory regime is made up of directly applicable EU regulations. Once the UK leaves the EU, these will no longer apply in the UK and the UK regulators are putting in place a regulatory framework, which would apply from 29 March 2019 if the UK and EU-27 are unable to reach an agreement. HMT is responsible for creating the legislation to replicate the content of EU Regulations. The BoE is consulting on its approach to on-shoring Binding Technical Standards (BTS) and is proposing to make amendments to its rules to reflect the fact the UK will no longer be an EU member state and to bring EEA firms into scope of regulatory rules that do not currently apply to them.

The BoE's proposed changes focus on ensuring that there is a functioning legal framework for financial regulation on Exit day and will apply in the event that the UK leaves the EU without an implementation period ('no deal'). They are not intended to make substantive policy changes. A number of the proposed changes would however represent a significant change in regulatory approach. These will have implications for both UK authorised firms and inbound EEA firms.

Despite the agreement between the UK and EU-27 on a draft Withdrawal Agreement there is currently no certainty that the Withdrawal Agreement will be ratified so firms should take note of the proposals in the consultation papers. The aspects of the proposals most relevant to UK authorised firms will be the amendments to the PRA's rules as a result of Brexit (e.g. ending the preferential treatment of the EU). Those EEA firms passporting into the UK will be most interested in the PRA's proposed approach towards introducing new regulatory requirements and the timeframe for compliance with them. The BoE, PRA and FCA have also set out further guidance on the process for authorisation and recognition for EEA firms passporting into the UK (either through Freedom of Establishment, or Freedom to Provide Services), which incorporates the temporary permissions regime (TPR). The package of publications comprise:

- A consultation paper setting out the BoE's general approach to making changes to regulatory rules and BTS
- Dear CEO letters to PRA regulated firms, non-UK CCPs and non-UK CSDs
- A PRA consultation paper setting out the key changes to PRA rules and relevant BTS related to EU legislation
- A BoE consultation paper setting out the key changes to FMI-related BTS and rules
- A consultation paper setting out changes to BTS in relation to resolution and providing clarification of the BoE's Statements of Policy (SoP) on resolution

This Hot Topic reviews potential implications on UK authorised banks and UK branches of the EEA banks.

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Temporary transitional power to phase-in regulatory changes

HMT intends to provide the regulators with a temporary transitional power to phase-in regulatory changes resulting from on-shoring or amendments to the regulators' rules due to Brexit. This power will be used to allow both UK authorised firms time to prepare for these changes and EEA firms to transition to the new regulatory framework. The BoE has indicated that it will apply this transitional in most cases, but that some regulatory changes will not be phased-in and will apply from 29 March 2019. We highlight these changes in the sections below.

The BoE is also clear that any transitional relief granted under the power cannot last for longer than two years from Brexit. So firms should not interpret this as a potential waiver for their regulatory requirements on a permanent basis.

Impact on UK authorised firms

Preferential treatment of EU-27 assets

The BoE is proposing to end the preferential treatment of EU-27 exposures and assets for purposes of bank capital and liquidity requirements and align these with the treatment of third country firms and assets. This has implications for UK banks, given the preferential risk weighted assets (RWA) treatment of exposures to EU-27 assets and the treatment of EU sovereign debt under the Liquidity Coverage Ratio (LCR). These changes could lead to a material increase in capital requirements and assets currently eligible for the LCR may no longer qualify under the proposed approach.

In recognition of the significant impact of this proposed change, the BoE proposes a phase-in period of up to two years for this change. This means banks may have until March 2021 to comply with these amended requirements but should start to consider now what the prudential impact of these changes would be. For instance, increased RWAs may significantly impact the profitability of holding EU assets and banks should consider whether reallocation of asset holdings or redistribution of capital will be necessary if the proposed change is made.

Bilateral margining under over-the-counter (OTC) derivative contracts

The BoE is proposing a number of amendments to the RTS regarding risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty. These amendments may require firms to revise their bilateral agreements with counterparties and collateralisation of these derivative transactions.

The BoE is proposing that EEA government debt securities and other EU issued instruments would cease to be automatically eligible as collateral on the same basis as UK government equivalent instruments. EEA assets will be treated in the same way third country assets currently are. This means EEA assets will only qualify as collateral if they meet certain credit quality requirements.

The PRA's other proposed changes to the RTS relate to a broad range of topics including onshoring the covered bond exemption for covered bonds associated with OTC derivative contracts and references to Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Fund managers (AIFMs) in connection with calculations of initial margin thresholds.

The EU bilateral margin RTS contains a number of phase-in provisions but these do not form part of the onshored domestic legislation. The Bank advices firms to plan on the assumption that requirements arising from new EU legislation that comes into effect during an implementation period lasting until 31 December 2020 would apply to them.

So firms should consider if the proposed changes to the bilateral margin RTS will have any material adverse impacts on their margin requirements, bilateral agreements, operational or financial arrangements, or cross-border agreements. It will be important for the BoE to understand the costs associated with these changes and firms should undertake an assessment of these costs and respond to the consultation accordingly.

FSCS coverage for EEA branches of UK banks

The BoE is proposing to remove the deposits held by UK firms' branches in the EEA from the scope of the FSCS after Brexit. This means that the deposits held by UK banks' branches in the EEA will no longer be protected by the FSCS.

EEA states will consider whether to require that these branches join their deposit guarantee scheme under the EU Deposit Guarantee Schemes Directive (DGSD). If an EEA state requires branches to join, depositor protection would shift from the FSCS to that EEA deposit guarantee scheme.

Given DGSD and Bank Recovery and Resolution Directive (BRRD) will no longer be applicable to the UK, firms should also note that the ranking of deposits held by UK branches of EEA deposit-takers may be lower in the EEA Member States' creditor hierarchy than at present. This may mean greater losses for depositors.

Firms should note that the BoE also proposes to require UK firms that have branches in the EEA and whose depositors will no longer be protected by the FSCS following Brexit to notify affected depositors within one month beginning on the day following exit day.

Bail-in liabilities issued under European law and other resolution powers

The BoE is also proposing amendments to requirements around the Contractual Recognition of Bail-In. Any new issuance of bail-in liabilities by UK banks after Brexit under European law (with the exception of phase two liabilities) or existing liabilities subject to material amendments will have to include contractual bail-in clauses. The BoE is also proposing that banks should include contractual requirements for counterparts to accept limits on their early termination and security and enforcement rights in the event of a resolution (so called 'stay in resolution'). This means that the BoE will retain its power to temporarily suspend termination rights of any party to a contract with an institution in resolution. The BoE is not proposing to apply a phase-in for these changes. But instruments issued prior to Brexit will not have to meet the contractual bail in or stay in resolution requirement.

UK banks considering issuing bail-in instruments under EU law should consider the implications of these proposed changes on their plans for issuance.

The BoE is also proposing to make changes to the onshored BRRD BTS on a number of areas including the methodologies and principles for valuation of derivatives liabilities; setting a minimum requirement for own funds and eligible liabilities and methodology for assessing the value of assets and liabilities. Firms should take these changes into consideration.

Ring-fenced banks

In line with the Government's general approach of treating the EU as a third country, the BoE proposes to amend the Ring-fenced Bodies (RFB) Part of the PRA Rulebook and require that RFBs using EU central counterparties (CCPs) or central securities depositories (CSDs) ensure comparable outcomes in respect of account segregation to those specified for UK-based CCPs and CSDs.

But given the proximity to the ring-fencing regime coming into effect and the significant work firms have undertaken to be ready by the 1 January 2019 deadline, the BoE is proposing to permit ring-fenced banks to continue operating through a branch or a subsidiary in the EEA immediately after Exit day.

The BoE intends to reconsider this approach in light of the outcome of the independent statutory review of ring-fencing, which is due to commence in 2020-2021. So firms in scope of ring-fencing regime should monitor developments on this decision closely.

Reporting and disclosure requirements

Given the current volume of reporting and disclosure requirements, and the costs to firms and the BoE of changing reporting templates, the BoE is not proposing to make line-by-line changes to current reporting requirements. But to ensure these requirements remain effective after the UK's withdrawal from the EU, the BoE is providing greater clarity for firms on how they should comply with these requirements through draft supervisory statements (SSs) and statements of policies (SoPs)

While the SSs and SoPs provide firms with more clarity on how they should interpret cases where reporting and disclosure fields or definitions relate to the EU, they should review the PRA's proposals carefully and raise any areas which require further clarification.

Impact on the inbound EEA firms

The Temporary Permissions Regime

The BoE is proposing that EEA firms and FMIs that are currently able to provide services into the UK through passporting will need to seek authorisation or recognition to continue to be able to do so after Brexit. But, recognising the difficulty of authorising such a large volume of EEA firms prior to Brexit, HMT has committed to create the TPR. Under the TPR, EEA firms will be able to operate in the UK for up to three years prior to authorisation.

Those EEA firms in TPR with a branch in the UK will need to comply with the same regulatory rules that apply to other third country branches.

Cross-border service providers in TPR with no UK branch will be subject to a more limited set of rules, including rules that could apply to a PRA-authorised third country firm without a UK branch.

FSCS coverage for EEA branches of banks passporting into the UK

The BoE is proposing that EEA branches that accept deposits should become members of the FSCS prior to Brexit. Currently EEA branches are covered by home state deposit guarantee schemes. The BoE believes granting a transitional for this change would undermine its objectives and does not propose to provide one. This means that, in the event of these changes taking effect, the EEA firms will need to be covered by the FSCS by 29 March 2019. Those EEA firms impacted by this requirement should take steps urgently to ensure they will be ready to join the FSCS in this short timeframe.

Application of the Senior Managers and Certification regime (SM&CR) to EEA firms

The BoE is proposing to apply the SM&CR to EEA firms in the TPR, including cross-border service providers, although compliance will not be a precondition to enter the TPR.

This means that all firms and cross-border service providers in the TPR will be required to have in place individuals approved to perform the senior management functions (SMFs), including the Head of Overseas Branch (SMF19). Where relevant branches and cross-border service providers will also need to have persons in place to perform other SMFs such as Chief Risk function (SMF4).

Under the TPR the BoE can, subject to the FCA's consent, treat an individual that requires approval under the SMR as being 'deemed' to be approved, subject to that individual's SMF application being submitted. Where the firm has applied for authorisation prior to Brexit and applications for SMF approval have been included in the authorisation application, the BoE is able to treat these SMFs as approved from Brexit. Firms will have 12 weeks after Brexit to ensure their SMFs have 'deemed' or actual approval. This means firms, particularly those that are likely to have a significant number of SMFs, should start to prepare applications for SMF approval.

Supervisory responsibilities and cooperation with EU-27 regulators

Those roles and responsibilities which are currently being carried out by EU authorities will be reallocated post-Brexit to the most appropriate UK authority, to the extent that the roles remain relevant when the UK has left the EU. For example, post-Brexit the BoE will take on the responsibilities for recognising third country CCPs currently undertaken by ESMA.

Obligations that arise as part of EU membership for UK regulators to share information and co-operate with EU authorities will be removed. This includes the requirement for the UK authorities to participate in EU supervisory colleges and to take joint decisions with other EU regulators. For instance, the BoE will no longer have the obligation to take joint decisions with other EEA resolution authorities through BRRD resolution colleges. This means that the BoE will have sole responsibility for determining MREL for groups subject to consolidated supervision in the UK after the UK leaves the EU.

Applicability of EU guidelines and recommendations

After Brexit the obligation on the UK's regulators to make every effort to comply with EU Guidelines and Recommendations will no longer apply. Despite this, many EU guidelines will continue to be relevant to firms and FMIs. The BoE will continue to expect firms and FMIs to continue to make every effort to comply with any Guidelines and Recommendations that they are currently expected to comply with, where they remain relevant after the UK's withdrawal from the EU, except where the BoE and/or PRA has previously explained to the relevant EU authority an intention not to comply.

The BoE does not intend to reproduce and make amendments to the content of individual Guidelines and Recommendations issued by the EU ahead of the UK's withdrawal from the EU. Instead, they expect firms and FMIs to interpret the existing rules in the context of the new regulatory framework.

The BoE and PRA explicitly state that the proposals do not present an exhaustive list of Guidelines that will continue to be relevant to firms and FMIs, and that they may introduce further modifications to the proposals in this consultation package to reflect any changes to the rules and BTS during the period and any agreement that is reached between the UK and EU on their future relationship.

Next Steps

These proposals will only come into force if there is no Withdrawal Agreement between the UK and EU-27. Despite the recent agreement on a draft Withdrawal Agreement firms should start to prepare for the proposed changes, particularly those that are envisaged to come into force in March 2019.

If the Withdrawal Agreement is ratified, the proposed changes in the consultation papers are expected to apply from the end of the implementation period (December 31, 2020) and PRA authorisation will only be required at that point. Firms should note though that the proposed regulatory changes in the consultation papers may be modified in light of on any agreement the UK and EU may reach during negotiations on the future relationship.

UK and EU-27 firms should familiarise themselves with the proposed changes in the consultation papers. It will be important though for firms to continue to follow any new communications from the BoE on its post-Brexit regulatory approach. Firms should ensure that their plans for post-Brexit arrangements are consistent with the BoE's proposals but implementation plans should be dynamic enough to take into account developments in the negotiations and further announcements from the BoE.

The BoE's commitment to phase in the majority of the regulatory changes proposed will avoid a cliff-edge increase in capital and liquidity requirements in March 2019 in a no-deal scenario. But two years does not represent a long period of time to adapt to significant regulatory changes. So, action is required to prepare.

What do firms need to do?

- The BoE will continue to consider their approach to the potential use of the temporary transitional power, in light of responses received to this consultation. Areas which may be of particular interest to firms are the duration of the transitional relief for new regulatory requirements and whether further exceptions to the general approach outlined above are needed to take account of the BoE's and PRA's objectives. Firms should provide feedback on the proposals set out in this consultation by **2 January 2019.**

- Some of the proposed changes in consultation, notably removing the preferential treatment of the EU, may have a significant impact on capital, liquidity and margin requirements. Despite this change being subject to a phase-in, firms should consider the impact of these changes and assess their implications for prudential requirements and profitability.

- Some of the proposed changes in this consultation may take effect from 29 March 2019. Firms should urgently consider the implications of these proposed changes. The EEA firms not currently covered by the FSCS should take steps now to ensure they are in a position to be covered by 29 March 2019. Firms that are likely to have a significant amount of SMFs should start to prepare for the application process.

- Any firms that are preparing issuance of bail-in debt under European law after Brexit should re-consider their plans in light of the new requirements around contractual bail-in and stay in resolution clauses.

- EEA firms with cross border business into the UK that wish to continue after Brexit, should familiarise themselves with the requirements of TPR that will become effective on Exit day if no deal is negotiated. They will be well advised to comment on the consultation papers on the areas that may be challenging to comply with on Exit day. Early planning is advisable for branch authorisation and applications for senior managers' functions.

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Stand out for the right reasons

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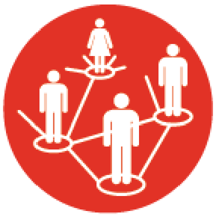

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