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Finance for Europe

AFME Members' Briefing

Ensuring operational readiness for a no-deal Brexit

22 January 2019

Simon Lewis, Chief Executive, AFME
Andrew Gray, Head of Brexit, PwC
Galina Dimitrova, Director, Investment and Capital Markets, The Investment Association

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Opening Remarks

Simon Lewis

Chief Executive

AFME

The Challenge of day-1 readiness: An industry update

Andrew Gray
Head of Brexit
PwC

Where do we stand today

1. State of play
2. Market access in different scenarios
3. Key Brexit risks
4. UK and EU regulators' response
5. Importance of UK CCPs
6. ECB expectations
7. Operational readiness

State of play

Most part banks are keen to minimise changes to their existing structure and operations and initially focusing on "no regrets" actions.

Planning and communication

- In most banks plans are well progressed and detailed
- There is some concern that banks' clients are less well prepared

Relocation of Staff

- Some banks have started to engage with staff regarding moving.
- If banks aren't able to relocate sufficient staff to the EU from the UK local recruitment may be challenging.

Regulatory Risk Appetite

- There is an ongoing discussion with EU-27 regulators on practices such as centralised booking models and aggregation of risks across groups.
- EU-27 regulators are balancing their own risk appetite with the need to reduce operational disruption

Market access in different scenarios

Equivalence Regimes in FS and implications on market access

Under both 'No-Deal' and current Withdrawal Agreement text, the future market access for the FS industry will be underpinned by equivalence regimes

Sector	Business Activity	Market Access through equivalence	Involvement of EU ESAs	Equivalence Decision adopted
Banking	Wholesale & Retail Banking (CRD IV / CRR)	No EU-wide access available (National Regimes only)	Y (EBA)	Y on prudential capital treatments (also relevant for intercompany trades)
	Investment Services (Mifid II / MIFIR)	EU-wide access to professional clients, venues and eligible counterparties	Y (ESMA)	Y - limited to derivative trading venues (US) and exchanges (US, Australia, HK, Switzerland)
Insurance	Direct Insurance (IDD)	No access available	N/A	N/A
	Insurance Intermediation (IDD)	No access available	N/A	N/A
	Re-insurance services (Solvency II)	EU-wide access available for re-insurance services only(Germany and Poland have a more-restrictive national regime)	Y (EIOPA)	Y, limited to Bermuda, Japan and Switzerland
Asset Management	UCITS funds (UCITS V Directive)	No EU-wide access available for third country funds - *Delegation permitted if supervisory cooperation is in place*	N/A	N/A
	Alternative Investment Funds (AIFMD)	EU-wide access available for third-country funds - *Delegation premitted if supervisory cooperation is in place*	Y (ESMA)	None to Date
Market Infrastructure	Clearing and trade repositories (EMIR)	EU-wide access for equivalent CCPs / CSDs	Y (ESMA)	Y - with the exeption of Trade Repositories
	Payment Services (PSD2)	No access available	N/A	N/A
Other	Benchmark Regulation (BMR)	Limited - benchmarks can be recongnized post decision	Y (ESMA)	None to Date

Should the UK leave the EU without a deal, it is unlikely that equivalence decisions will be adopted by the EU commission beyond what already granted to other third countries, in spite of current regulatory alignment between the EU27 and UK.

On the other hand, should the Withdrawal Agreement be ratified, the non legally binding text of the political declaration points at a timely deliberation (by Jun 2020) on equivalence in areas where equivalence regimes are available, opening up the possibility for the UK to get more access than other third countries have been permitted to under the regimes.

Market Access under Alternative Scenarios

With firms are preparing for operational readiness in a No-Deal scenario, different outcomes of the Brexit process will affect market access and allow firms to revisit business strategy

Scenario	Banking	Insurance and Asset Mgmt.	FMIs
Brexit Transition	• ***Pre-Transition end****: UK firms to retain use of EU passport* • ***Post-Transition end****: No access for Retail / Commercial Banking activities and Mifid II access for Professional Clients under equivalence regime*	• ***Pre-Transition end****: UK firms to retain use of EU passport* • ***Post-Transition end****: Limited direct access from UK for Re-insurers and Alternative AMs under equivalence regimes (Delegation available)*	• ***Pre-Transition end****: UK CCPs and CSDs* • ***Post-Transition end****: UK exchanges and CCPs and CSDs may be given access via equivalence. (Debated on EUR clearing might result in restrictions)*
'No-Deal' Brexit	• ***Short term (2019):*** *No access to be made available for UK firms* • ***Medium term (2020 and beyond):*** *Possible access for firms under Mifid II equivalence*	• ***Short term (2019):*** *No access made available for UK firms. (Delegation available)* • ***Medium term (2020 and beyond):*** *Access via equivalence for Reinsurers only, in line with other third countries. (Delegation could be revised)*	• ***Short term (2019):*** *CCPs to retain access under an emergency equivalence decision – no access for CSDs* • ***Medium term (2020 and beyond):*** *CCPs may retain access (EUR clearing debate could result in restrictions)*

Under an Art 50 Delay Scenario*, the current access is preserved as the UK is considered part of the EU.*

However, until further clarity available on future state, firms need to look at conditions on licenses for EU27 entities to preserve optionality against various outcomes.

Key Brexit risks

Brexit - Risk register

As Brexit approaches there are many Brexit risks firms need to monitor and manage

Risk	Description	Impact	Recent developments
Fragmentation of clearing markets	Should UK CCPs not be recognised as qualifying CCPs, they would not be able to provide clearing services to EU-27 institutions, and EU banks could no longer be clearing members.		• EC has announced that it would undertaken an emergency equivalence decision which would last one year
Access to UK venues	If UK venues are not recognised EEA firms may be unable to execute trades for those assets subject to the trading obligation under MiFID on a UK exchange		• N/A
Contract continuity	In many cases regulatory permissions are required to meet obligations under financial contracts between UK and EU-27 entities. Post-Brexit, these regulatory permissions may fall away.		• UK authorities have committed to make legislative changes to mitigate this risk • There will be no reciprocal action by the EU, although some other countries are taking actions.
Preparedness of clients	Many corporate clients of financial services firms are less well-prepared for Brexit than FS firms, and may find their treasury operations significantly impacted by Brexit, including due to: repapering of interrupted provision of cross border services that are predominantly found in London (underwriting, cash management services, clearing etc.).		• Both the UK Government and EC have issued a number of preparedness notices to stakeholder to help them prepare for a no deal scenario
Operational resilience	Experience shows that when firms are undertaking significant change programmes operational difficulties often arise, frequently to the detriment of their customers.		• N/A

Brexit - Risk register

Risk	Description	Impact	Recent developments
Prudential requirements for third country exposures	Under EU regulations such as CRR and EMIR, exposures in third country can be treated differently to those with EU institutions.		• The PRA has indicated it will remove preferential treatment of EU assets and exposures in its onshoring of prudential regulation, but the changes will be phased in.
Credit ratings	Under the CRA regulation, it will no longer be possible for EU-27 financial institutions to use credit ratings issued by UK CRAs for regulatory purposes, unless an endorsement or equivalence decision has been taken.		• N/A
Cross-border data transfers	Under GDPR, the sharing of personal data from the EU to third countries can be limited unless there is a "data adequacy" decision by the Commission, or other agreement. Cross-border flows of data between the UK and EU-27 are extensive, with many firms having data centres currently exchanging data seamlessly throughout the UK and EU-27.		• The EC has confirmed it will not undertake an temporary adequacy decision under GDPR

Brexit - Risk register

Risk	Description	Impact	Recent developments
Deposit protection	Deposits held in branches of EEA bank in the UK are insured by home country (Member State) deposit protection schemes. Deposits held in branches of UK banks in the EU-27 are covered by the FSCS.		• Post-Brexit, EEA branches in the UK will have to join the FSCS and UK banks' EEA branches will no longer be covered by the FSCS.
Access to payments systems	Post Brexit, the UK firms may lose direct access to European Clearing & Settlement Mechanisms (CSMs) such as TARGET2, EBA EURO1 and EBA STEP2. Non-EU financial institutions will not be able to use their UK branches to pay and collect funds.		• N/A
MREL/TLAC eligibility	MREL/TLAC instruments issued by EU banks in a third country must include a "contractual bail-in" clause, to qualify as MREL under the Bank Recovery & Resolution Directive (Art 55). T The BoE has also indicated that it will require MREL/TLAC issuance by UK banks under EU law post-Brexit to have bail-in contractual clauses.		• The SRB has published guidance for euro area banks. • The SRB expects new issuance of bail-in instruments to include contractual clauses • The impact on existing issuance will be considered on a case-by-case basis

UK and EU regulators' response

UK government and regulators' Brexit activity

Temporary Permissions Regime	• HMT has created a **temporary permissions regime** for passporting firms to allow them to continue operating in the UK post-Brexit. • The TPR will allow EEA firms to **operate in the UK for up to three years** prior to authorisation. During this period EEA firms will be subject to the same regulatory requirements as UK authorised firms, but these will be phased in. • The PRA has stated that PRA regulated firms should continue to plan on the basis they will have to be authorised by the end of 2020. FCA solo regulated firms may have longer. **The TPR is now open.**
Contract continuity	• HMT will also legislate to **ensure contractual obligations** in the UK can be met (e.g. insurance and derivatives contracts). The EU-27 has not made a reciprocal commitment.
Onshoring of EU regulation	• HMT has been publishing a number of draft statuatory instruments which will **bring EU regulation into UK law in the event of no deal.** • The intention is not to make substantive policy changes- but where EU authorities currently have a role in regulation this will be **replaced by a UK authority**. In some areas such as the **treatment of exposures to EU institutions** the impact could be signficant- albeit the PRA has indicated it may phase these changes in. • PRA and FCA will onshore Binding Technical Standards.

EU regulatory response

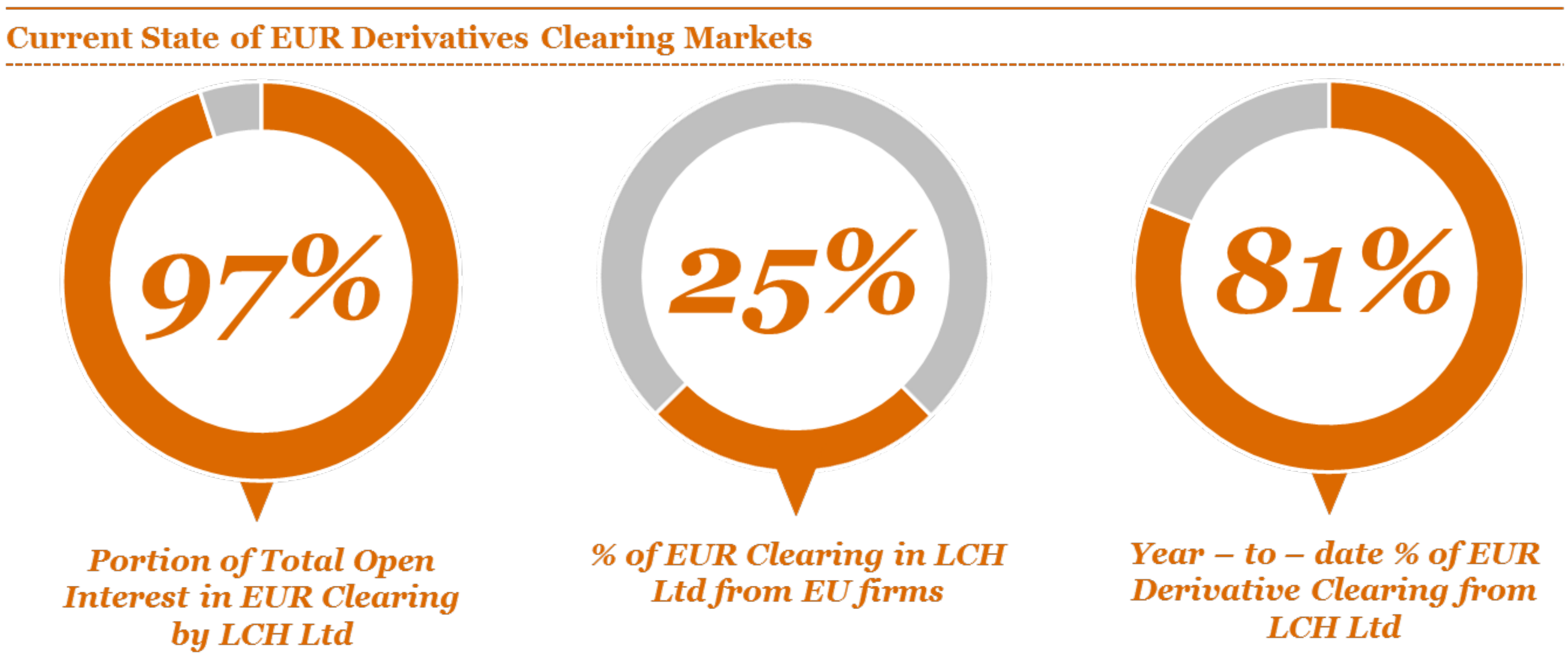
The EU has announced its regulatory response to Brexit will be limited to some measures on cleared and non-cleared derivatives

	Centrally-cleared derivative transactions	Uncleared derivative transactions
Issue	Under EMIR, EU banks can only be clearing derivative transactions at third country CCPs recognised by ESMA and located in a country deemed to be equivalent to the EU by the EC.	Due to Brexit firms have to novate their contracts to EU entities. New trades may be subject to new clearing obligations that were not applicable in original contracts.
Temporary solution	The EC has committed that in the event of a no deal Brexit, it would grant the UK **temporary equivalence under EMIR**. The temporary equivalence period would be limited to a period of one year.	ESMA has announced a limited exemption to allow certain non-centrally cleared derivative contracts between EU and UK counterparties to continue, **without requiring them to be either cleared centrally** if they are novated from a UK counterparty to one in the EU.
Challenge	While the announcement on a temporary equivalence decision is welcome, it does not represent a long-term solution: losing access to UK CCPs in March 2020 would still be hugely challenging for EU banks and market participants.	The scale of the challenge of novating such a huge volume of contacts to an EU-27 entity means the removal of the clearing obligation

Importance of UK CCPs

The importance of UK CCPs in the EU means clearing remains the biggest potential risk

EU issuers (including Corporates and Sovereign) are reliant on the availability of liquidity provided from international markets and CCPs when issuing new debt as IR risk is often pre-hedged via swaps



Not all OTC cleared products can be easily transferred out of UK CCPs

		Interest Rates					Credit Derivatives				Foreign Exchange		Other OTC	
CCP	Country	EUR	USD	CHF	GBP	JPY	US CDX	Asia iTraxx	EU iTraxx	EM CDX	Swaps	FX Option	Metals	Repo
LCH Ltd	UK	✓	✓	✓	✓	✓	✓	✗	✓	✗	✓	✓	✗	✓
ICE EU	UK	✗	✗	✗	✗	✗	✓	✓	✓	✓	✗	✗	✗	✗
LME	UK	✗	✗	✗	✗	✗	✗	✗	✗	✗	✗	✗	✓	✗
LCH SA	FR	✗	✗	✗	✗	✗	✗	✗	✗	✗	✗	✗	✗	✓
Eurex	DE	✓*	✓*	✓*	✓*	✓*	✗	✗	✗	✗	✗	✗	✗	✓
CME	US	✓*	✓*	✓*	✓*	✓*	✗	✗	✗	✗	✓*	✓*	✗	✗
ICE Clear US	US	✗	✗	✗	✗	✗	✓	✓	✓	✓	✗	✗	✗	✗

Notes:

✓ *- Full OTC product coverage (i.e. Tenors / Maturity / Underlying)*

✓* *- Partial OTC product coverage*

✗ *- No OTC product coverage*

Sources:

LCH, Eurex, ICE and CME websites and PwC analysis

- ***Similarly, certain listed derivatives contracts (ETDs) are only traded in UK CCPS such as ICE EU or LME, which will have to be traded OTC with EU clients and cleared via a third-party broker.***
- ***This will increase margin and capital requirements for EU firms, and ultimately hedging costs to corporate end-users.***

ECB expectations

ECB position on ‘substance requirements’ and booking models for incoming banks

Location	• The ECB is completely neutral regarding the location chosen by a bank • It seeks a “level playing field” of supervision throughout the euro area
Self Sufficiency	• Banks must be capable locally of controlling and managing all material risks affecting their entity, balance sheet and reporting requirements (governance and business execution capabilities)
Crisis	• Focus on resolvability in crisis, where banks can operate independently of parent / hub bank in a third country location with direct market access and lines of liquidity • This requires local infrastructure, staff and risk management functions

- ***The ECB’s stance will have a significant influence on the design of booking models and capabilities required to be developed in the EU entity, as well as access to FMIs and CCPs.***
- ***Whilst incoming banks will be evaluated in line with the stricter interpretation, institutions already operating in the EU are expected to be brought in line by ECB and local regulators over time.***

ECB expectations

Meeting supervisory expectations is adding to the operational challenge, but the ECB is making a distinction between 'day 1' capabilities and longer term self-sufficiency

Business Model

Operating Model

	ECB expectations
Business Origination and FMI access	Ability to originate continuously profitable business and access key FMIs on continuous basis.
Booking and Hedging strategy	No full reliance on intragroup back-to-back hedging strategies but diversified set of external counterparties
Intragroup Arrangements	Robust risk control mechanism: Monitor and manage independently intragroup exposures
Internal Governance, Staffing & Organisation	Adequate and skilled, locally based management body with decision making powers (control balance sheet and transactions).
IT Infrastructure & reporting	Produce regular, complete and accurate reports on activities and risks locally

Operational readiness

Hard Brexit assessment of priority areas

Phases	Key Considerations	Maturity Assessment		Priority Areas
		Client	Industry	
Programme Management	Managing and executing the Brexit programme		●	A prescriptive task based plan with strict deadlines which are frequently monitored and validated may be needed due to the tight timeframe.
	Clarifying base case Brexit assumptions		●	Further develop governance structures to ensure that base case Brexit assumptions are revised on an ongoing basis alongside emerging market information, and factored into planning activities across workstreams.
Legal Entity & Organisation Structure	Designing new organisational legal structures and entities		●	Build out day 2 plans which fully articulate how new branches and subsidiaries will operate as self-sufficient standalone organisations post-Brexit with fully developed governance, risk and compliance functions that do not rely on other operations and comply with local regulator requirements.
Regulation & Licensing	Obtaining required regulatory approvals and		●	Ensure there is open dialogue channels with all relevant regulators now to help head off potential challenges to licence approvals and discuss and agree difficult topics including day 2 expectations.
	Strategic tax planning (direct tax, events tax and transfer pricing)		●	Detailed tax work follows the legal and operating model decisions which means that tax implications of operating through different structures (corporate tax) and back-to-back booking models (transfer pricing) need to be progressed.
Operational Readiness	Defining the organisational operating & booking model		●	Scenario planning should include demonstrating that booking models (or appropriate contingency) can withstand market fragmentation in a Hard Brexit scenario. In addition, a comprehensive day 2 model needs to be completed including Governance, Booking Models, Model Approvals and Outsourcing. Dry runs and dress rehearsals need to be planned and performed to test operational readiness, these need to be in time so that lessons learned can be incorporated into actual operation.
	Updating internal processes		●	Internal processes will need to be updated including employee training for not just Day 1 but also Day 2.
	Maintaining access to market infrastructure and clearing		●	A Hard Brexit would introduce restrictions on the ability of EU-27 members being members of UK CCPs. Develop contingency plans to ensure continuity of service in the event of Hard Brexit.

*There is a wide range of readiness across financial service institutions. The above maturity assessment is an indication of where the average is expected to be for banking and capital markets.

Hard Brexit assessment of priority areas

Phases	Key Considerations	Maturity Assessment		Priority Areas
		Client	Industry	
Risk Planning	Second order effect assessment			Model the potential changes in counterparty risk, market liquidity and costs of doing business through to 2022 - regulators have asked for a 5 year planning horizon.
	Strategic opportunities			Perform investigation into new areas of business and strategic opportunities, including using Hard Brexit scenarios to identify opportunities.
Clients & Suppliers	Repapering and migrating client contracts			Client engagement plans, repapering exercises and migrations take time and need to be prioritised.
	Examining contract continuity			Contract due diligence exercises include assessing whether contract terms and conditions need to be changed to comply with any new law or regulatory requirements.
	Managing supplier relationships			Supply chain contracts need to be assessed to determined changed before potential Hard Brexit.
	Assessing pre & post Brexit client exposures			Detailed client and industry sector exposure based on post-Brexit assumptions and potential economic implications need to be performed. This should include updates to current and potentially new mandates and risk appetite.
Technology & Data	Adapting technology infrastructure			Technology infrastructure is a key dependency for multiple priority areas. Full tech stand-up should be achieved so that dress rehearsals can be performed.
	EU and UK data handling requirements			The UK will become a third country under GDPR on 29 March 2019, and the EU commission have stated that they will not determine equivalency until this date. The implementation of Model Contractual Clauses with suppliers and Binding Corporate Rules across the group to ensure compliant data processing day 1 post-Brexit should be assessed and implemented where necessary.
People & Staffing	Maintaining compliance with UK & EU employment laws			To support staff a strong programme of internal communication should be implemented, with a key person assessment and plan to maintain service continuity and compliance.
	Achieving staffing stand-up in new locations			The costs and impact of the workforce stand-up on Day 1 but also the Day 2 staffing requirements need to be assessed.

**There is a wide range of readiness across financial service institutions. The above maturity assessment is an indication of where the average is expected to be for banking and capital markets.*

www.pwc.co.uk/brexit

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Preparing for a no deal Brexit: The Investment Management Perspective

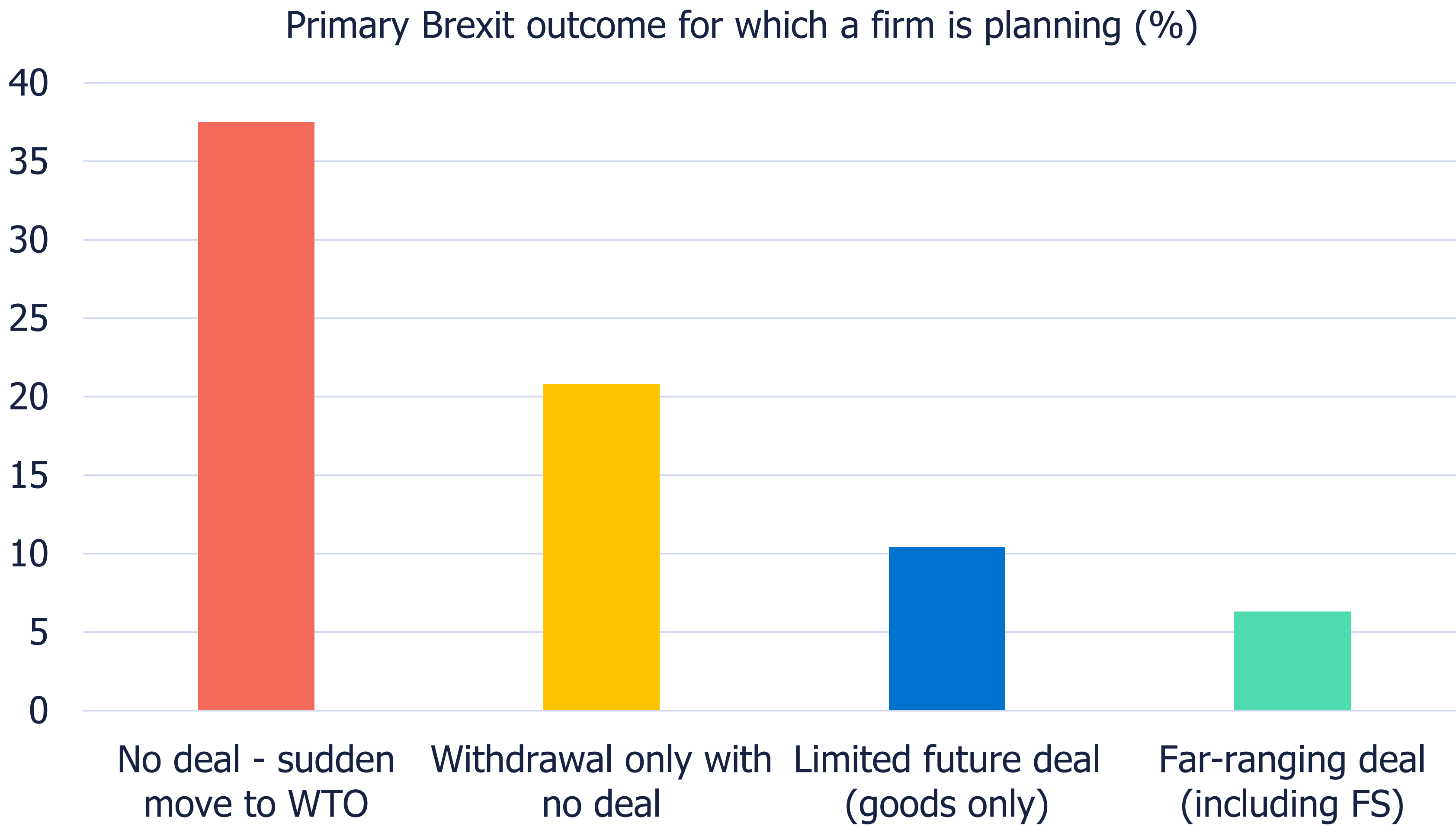
Galina Dimitrova
Director, Investment & Capital Markets
The Investment Association

THE IA'S BREXIT STRATEGY

Our Brexit negotiating priorities are based on three basic objectives, shared across FS, designed to reduce the operational impact on member firms:

- The UK **successfully negotiates at a technical level** with the EU and to ensure firms can offer products and services to clients across Europe.
- The UK remains an **attractive international centre for financial services**, for inward investment, and for asset management firms.
- The industry can continue to be able to **successfully serve savers and investors**, as well as companies and other projects in need of finance.

WHAT ARE ASSET MANAGERS EXPECTING?



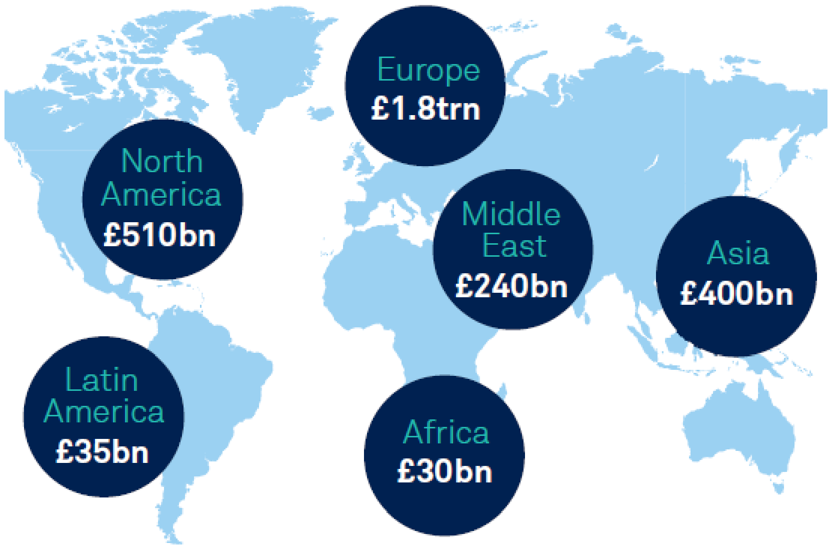
Source: October 2018 – PWC Asset Managers prepare for a no deal Brexit

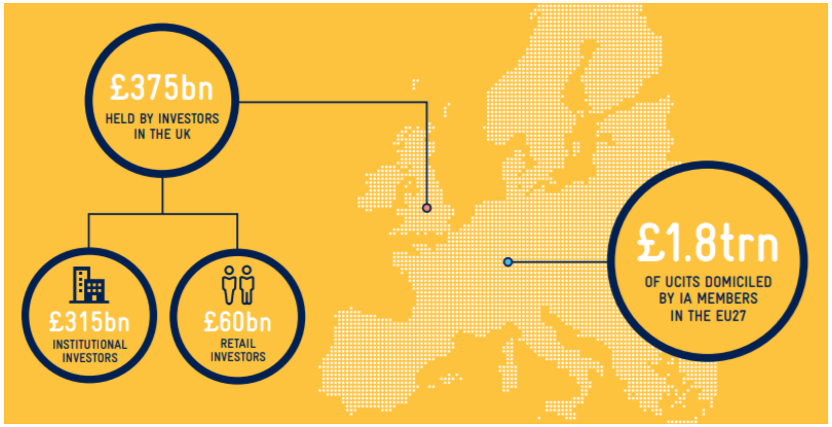
THE INVESTMENT ASSOCIATION

OUR 'NO DEAL' PRIORITIES

To mitigate the worst operational effects of a possible no deal Brexit, there are three things the UK Government must do in the coming weeks to help members continue to serve savers and investors across Europe:

- **Protect delegation** by concluding regulatory cooperation agreements in a timely manner ahead of 29 March 2019.
- **Preserve investor choice** by permitting access for EEA-domiciled funds beyond the end of the Temporary Permissions Regime.
- **Safeguard access to critical infrastructure** needed to operate efficiently across European capital markets, including UK trading venues.





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PUBLIC ASSURANCES ON COOPERATION AGREEMENTS

"UK authorities are ready to agree MOUs with their EU counterparts as soon as is possible… Unless the EU confirms it does not intend to put such arrangements in place, asset management firms can continue to plan on the basis that the delegation model will continue."

UK Government Technical Statement
23 August 2018

"The industry must be fully aware that there is a strong commitment from ESMA and all EU27 NCAs to have an MMOU with the UK FCA in place. It is upon this assumption that market players should work, when putting their contingency plans in place."

Robert Ophèle (AMF)
2 October 2018

"Taking the wider negotiations between the EU and UK into account, we plan to start negotiations with the UK FCA with the objective to have these MOUs in place sufficiently on time before the end of March 2019."

Steven Maijoor (ESMA)
3 October 2018

"The European Supervisory Authorities are encouraged to start preparing MOUs with UK supervisors to ensure that exchange of information related to financial institutions and actors is possible immediately after the withdrawal date in the case of a no deal scenario."

European Commission
13 November 2018

"ESMA and BaFin are determined to enter into an MoU. Asset managers may plan based on this assumption. Delegation of portfolio and risk management activities to companies based in the UK will continue to be permitted beyond Brexit date, 30 March 2019."

Jorg Kukies (BMF)
17 December 2018

"It is reasonable for firms to plan on the basis that MOUs will be in place by 29th March. Firms that delegate portfolio management to the UK can have sufficient confidence that this will continue to be allowed post 29th March"

Ed Sibley (CBI)
17 January 2019

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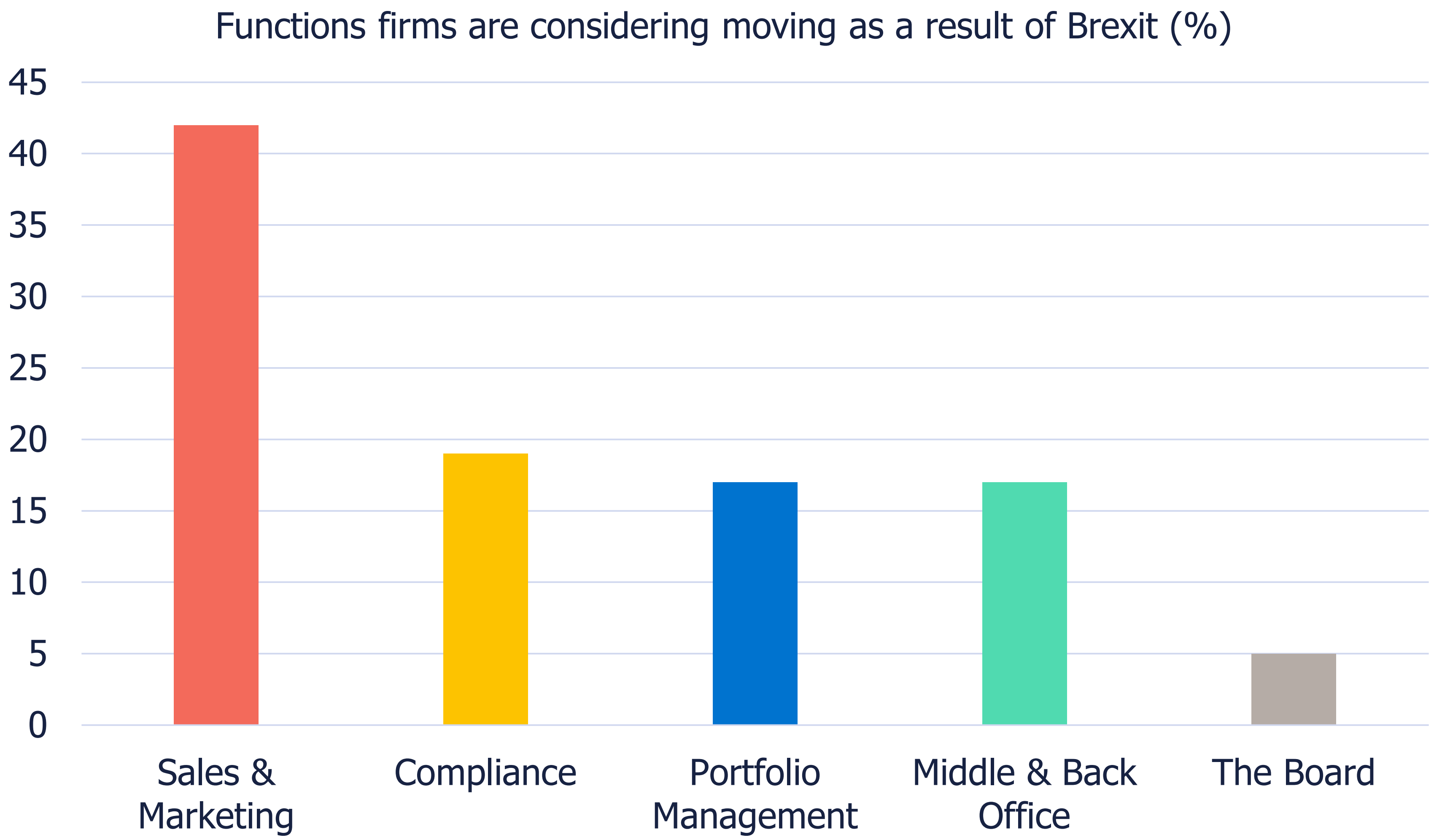
HOW ARE ASSET MANAGERS RESPONDING TO A NO DEAL?



Source: October 2018 – PWC Asset Managers prepare for a no deal Brexit

Q&A

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Offices

The Association for Financial Markets in Europe advocates stable, competitive and sustainable European financial markets that support economic growth and benefit society.

London Office
39th Floor
25 Canada Square
London, E14 5LQ
United Kingdom

+44 (0)20 3828 2700

Brussels Office
Rue de la Loi 82
1040 Brussels
Belgium

+32 (0)2 788 3971

Frankfurt Office
Skyper Villa
Taunusanlage 1
60329
Frankfurt am Main
Germany

+49 (0)69 5050 60 590

www.afme.eu