BREXIT BCCG EXPERTENGRUPPE
BANKING & FINANCIAL SERVICES

A TRANSITION PERIOD IS NOT AN ASK, IT IS RATHER A NECESSITY TO ENSURE UNDISRUPTED FUNCTIONING OF THE FINANCIAL MARKETS.

By the time of this publication, it will already be 9 months since the UK triggered Article 50 of the Lisbon Treaty and thereby officially started the process of leaving the European Union.

For the financial services industry, operating in an extreme low interest environment for years now and facing a continuously increase in regulations demanding stronger capital and liquidity buffers, Brexit, in whatever shape or form, comes at already very challenging times.

With the political negotiations progressing slowly at best, many uncertainties remain. This makes business planning and solid preparation post Brexit rather difficult and requires market participants to prepare for the worst: a "hard Brexit".

A hard Brexit turns the UK into a third country on March 29, 2019. At present, financial institutions often passport into the euro area via a physical presence of a UK entity. This passporting right would cease to exist on day one and all of them would lose their access to the single EU market.

To be prepared for this scenario, financial institutions must rethink their legal entity structure, decide on their future location strategy and apply for new licences to put day-one operational plans into practice.

The regulators, namely the European Central Bank, have expressed strongly that they will not accept empty shells or letterbox institutions. Instead they expect well-capitalised banks with sufficient liquidity, funding and sustainable profitability. They also expect entities with relevant risk-management and governance competencies to operate independently of their other group entities in third countries. Likewise, EIOPA has expressed similar concerns for the insurance industry, demanding that third-country branches must be equipped with the capital and the key functions necessary to operate independently.

In parallel there is general uncertainty around the transitional and future framework in which financial markets can operate, e.g.: Will existing services and contacts be grandfathered? Or will the EU clearing processes remain as is or will they be forced out of the UK?

With regulatory and legal uncertainties at hand, a rational implementation of future business and operating models under the assumptions of a hard Brexit by March 29th 2019 seems rather difficult, if not impossible, to achieve by the financial services industry as a whole.

Irrespective of any political agenda, the BCCG Banking and Financial Service Working Group therefore unanimously supports a general transitional arrangement of at least 2 years to allow for undisrupted functioning of the financial markets to continue to support the economy and its market participants.

More so, in the absence of a general arrangement, the Working Group sees a necessity for specific transitional arrangements for some of the challenges the financial services industry is facing.

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To demonstrate this need and in support of our recommendation we have chosen three separate topics to demonstrate the complexity of political and regulatory decision-making and its impact on their implementation.

BOOKING MODELS AND LOCAL GOVERNANCE

A bank's booking model determines, which products and which markets are served by which legal entity. This implies regulatory and operational requirements for the respective entity. The so-called EU passport has allowed for central processing and supervision of EU-domiciled customers. This has enabled the banks to capture operational and regulatory efficiencies by centralisation, usually in London. Hence there is a significant number of firms using simplified market access. According to information provided by the FCA in August 2016, a total of 13,484 companies use either a passport into the UK (8,008) or into the EU (5.476).

Driven by the Brexit decision and the exit from the single capital market, this simplified market access is at risk and may be eliminated altogether. Banks face the challenge of continuing to serve customers and markets in Europe and the UK while not significantly increasing associated costs and regulatory burden.

To this end, alternative booking models have to be defined that meet the new framework without relinquishing significant efficiencies.

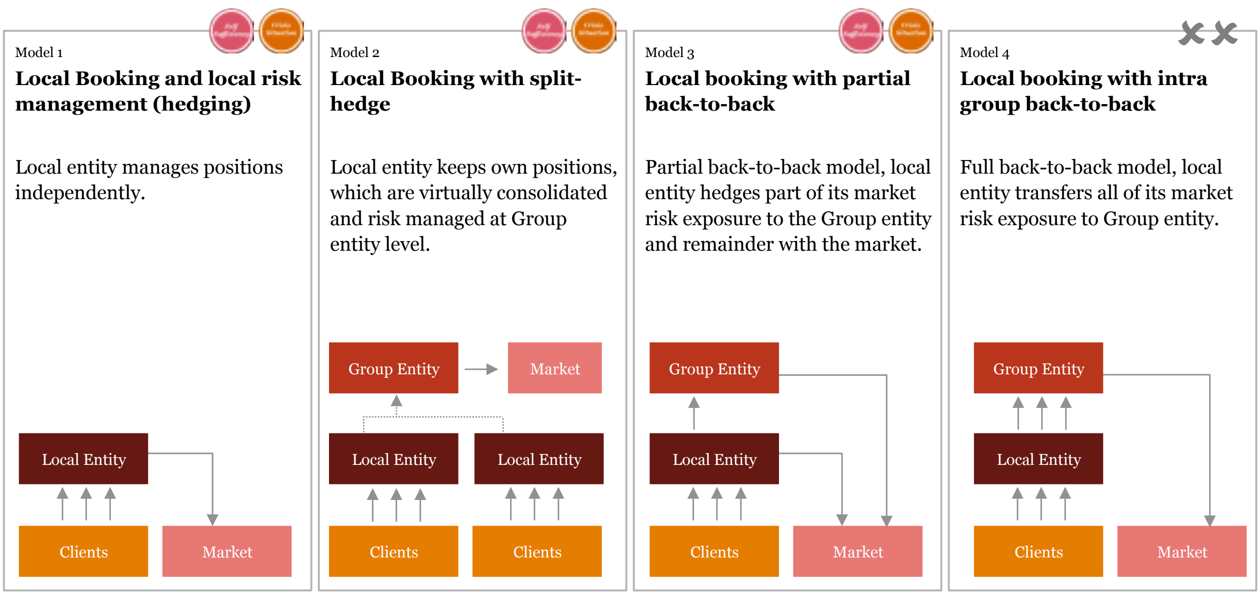
The essential element of such a model would be an entity domiciled and supervised in the EU (or in the UK respectively) from which customers can continue to be contracted in the event of the discontinuation of the EU-passport regime. Even if an existing entity in a new legal structure were to be used, a licensing procedure is usually required to obtain the necessary approvals for the augmented business scope.

The next step is to understand to what extend the existing centralised processes and functions could be re-used e.g. in an outsourcing model. Given different regulatory and operational requirements, this will need to be analysed at ech step of in the process chain.

- For sales and contracting the client, it will generally be necessary to work with the new entity's local staff.
- The execution of securities transactions in a market may be routed to brokerages following MiFID requirements. Direct market access may not be required, and other group entities can be used, if that fits the future operating model.

Booking models / Risk-management (hedging) practices

The ECB's stance concerning self sufficiency and crisis management capabilities in the local EU entity has a significant impact on the design of the booking model and associated business, operating and governance models



Conflict of interest: The more self-sufficiency and local management capabilities the regulator requires, the more complex and expensive day-1 readiness will be for the banks!

- However, risk management activities are more complex to manage. Operationally, it may be most efficient to hedge risk-bearing transactions with the company's main trading locations (model 3 or model 4). Depending on the size and complexity of the transactions, this may be in breach of regulatory requirements concerning the autonomy and self-governance of the local entity. Therefore, a detailed discussion on the granularity and scope of the hedging activities with the regulator is required. If local risk management (model 1) is selected, the bank-internal models for market and credit risk measurement may need regulatory approval.
- Efficiency is the main driver for designing back-office processes. The use of existing systems appears preferable, potentially complemented by locally required functionalities. Outsourcing settlement and clearing processes to existing locations is certainly an option. However, the requirements of the regulator must be respected concerning the resilience of the local entity. Specific uncertainties relate to the future of clearing processes, as outlined below. Outsourcing of risk management competencies depends on the volume and complexity of market activities, and many require regulatory approval.

This very simplified overview highlights some of the complexities but also a conflict of interest between banks and supervisors:

The more self-sufficiency and local management capabilities the regulator requires, the more complex and expensive day-1 readiness will be for the banks! In a recent speech, Linette Field, Deputy Director General of the ECB, re-emphasized that "the national supervisors would expect that a part of all risks is managed locally", that they would "expect banks to have sufficient capabilities in place to manage all material risks locally". The recently published EBA-Opinion EBA/Op/2017/12 provides more detailed guidance.

As briefly described, the outcome of this debate will significantly impact the design of operating models to be implemented following Brexit. Much of it depends on the outcome of the political Brexit negotiations.

Time is ticking, but given present uncertainty, obvious implementation risks and the necessity to ensure system stability, it seems rather necessary to allow for a transition period to implement the results of the Brexit negotiations.

GRANDFATHERING OF EXISTING SERVICES AND TRANSACTIONS

PM Theresa May's speech in Florence on 22 September 2017 and Michael Barnier's responseon that day to the speech made it very clear that the UK will leave the EU and cease to be a Member State on 29 March 2019. Accordingly the current position is that there will not be an extension of the two-year negotiation period under Article 50 (3) TEU and the UK will be from the EU's perspective a "Third Country" as of 30 March 2019.

Whether or not a comprehensive "transition period" as proposed by Theresa May inher speech in Florence will be agreed and implemented by 30 March 2019 remains to be seen.

Apart from the EU, and the UK potentially agreeing on a comprehensive transition period during which the current state of the rights of market participants in the UK and the EU could be extended on 29 March 2019 for a period of, for example, further two years, the EU Commission has issued since July 2017 a number of very specific grandfathering proposals relating to, inter alia, goods placed on the market, ongoing judicial and administrative proceedings and customs matters relating to goods in transit.

However, neither the UK, nor the EU, nor the relevant Brexit working groups of the relevant governments of the other 27 EU Member States nor the European Central Bank have yet issued proposals for grandfathering products and services from the financial services industry.

Such grandfathering for the financial services industry should be addressed by the relevant authorities, both at the EU level for EU-wide matters and at the domestic level for matters relating only to specific Member States, sooner rather than later, preferentially by publishing proposals for specific grandfathering rules, but at least by making statements as to whether and when grandfathering provisions will be discussed and dealt with. If such grandfathering rules are not issued, already the mere continuation of an existing contract will pose a problem. For instance, an insurer continuing to accept premiums following a hard Brexit would be engaging in "unauthorised insurance business".

There are a myriad of issues within the financial services industry where grandfathering is an issue, including for example,

1. ECB eligibility of repo material.
2. Issuances of bonds and other instruments made prior to 30 March 2019.
3. Continuation of existing lending transactions, derivatives transactions and other transactions that were entered into prior to 30 March 2019.
4. Continuation of existing collateral arrangements made prior to 30 March 2019. Especially in the case oflife insurance contracts will reach many years - if not decades - into the post-Brexit period.
5. Continuation of insurance and re-insurance contracts entered into prior to 30 March 2019.
6. Continuation of eligibility of cover fund assets for insurance purposes and mortgage bond purposes and other regulatory purposes.
7. In case of legal disputes, area of jurisdiction.

When deciding on whether the relevant existing status is continued during a grandfathering period, the relevant authorities should also regulate whether the relevant status of a product or transaction may be modified by the parties during the relevant grandfathering periods.

Not allowing for viable grandfathering solutions exposes the financial services industry to large reputational risks. In the interest of consumers, Brexit must not lead to a situation in which it will be impossible for the financial services industry to honor existing contracts.

EURO CLEARING

The case for the necessity of a transitional period becomes apparent when looking at one very specific topic: The clearing of Euro denominated securities as well as exchange traded and OTC derivatives. While for securities, there is no clearing obligation, the majority of equity transactions are cleared via CCPs. Exchange traded derivatives are often cleared directly with CCPs linked exclusively to derivatives exchanges. Finally, there is the clearing obligation under EMIR (European Market Infrastructure Regulation) to clear OTC derivatives such as interest rate swaps and credit default swaps which are used heavily by international as well as local banks to manage interest rate and credit risk on a macro level.
The EU seems to be considering the introduction of a requirement that euro-dominated securities and derivatives be cleared by an onshore CCP. This could be enforced by the EU Commission's proposal to allow the refusal of recognition of third country CCPs that are systemically important to the European Union's financial markets. Whether this will be applicable only to euro-area-domiciled banks or on a currency basis is another twist. The main challenge, however, is that cross-border flows within the current EU, including the UK, are huge.

Particularly with respect to interest rate swaps, credit default swaps and repo clearing, EU27 banks currently rely on the services of LCH Ltd. (UK). It represents the largest liquidity pool for those transactions in the current EU and consolidates flows from EU27 banks and UK banks, as well as many clearing members and internationally domiciled CCPs and CSDs, e.g. in the US and Japan, which also provide liquidity to EU27 banks. This is done on a multi-currency basis and euro-dominated transactions e.g. in swap clearing accounts for roughly 30% of overall transactions and are nationally cleared. Out of this 30%, roughly a quarter – which amounts to around 7% – are accounting for transactions concluded directly between EU27 banks. The residual part involves banks domiciled outside the EU27 including the UK or is cross-currency. One could conclude that this limited number and notional of transactions is significantly benefiting from the overall liquidity pool and cross-currency netting effects in LCH Ltd., thus reducing the costs of hedging for EU27 banks. Parts of those transactions of non-EU27 members are actually sourced in the EU27 economically and concluded with UK-domiciled banks and therefore are not attributed to EU27 banks in the official statistics. The extent to which this has an equalizing effect is not fully clear yet.

An immediate and strict implementation of a denial of recognition of 'location requirement' for the clearing of such transactions could result in the shortterm in:

1. Unwanted operational and legal uncertainty, as it is not clear yet whether transactions can be novated/transferred and whether non-EU27 clearing participants (especially the ones domiciled in the US or Japan) would be willing to follow this path, which is dependent on the attraction of flows of LCH's currently large liquidity pool (see above);
2. A short-term increase of hedging costs for EU27 banks as a separation – if it happens – of liquidity pools is often connected with an increase in spreads. In Japan, for example, where such a requirement was implemented, the spread differential between the Japanese on-shore market for Japanese banks is between 3 and 6 basis points compared to the subsequently established off-shore market in which non-Japanese banks are transacting – 1bp in the European market is estimated by LCH to account for up to EUR 25bn additional costs p.a. However, there is a counter-argument as spreads between LCH Ltd. and Eurex Clearing AG are close and further liquidity at Eurex Clearing would reduce local spreads there,
3. Potentially an increase of funds that need to be contributed to a default fund of as well as efforts to be spent to connect

to a CCP located in the EU27. It is expected that EU27 banks will need to connect to new CCPs rather than completely moving their relationships, at least in the initial years to come, until it becomes clear how liquidity pools will evolve.

All of this will in turn affect the risk pricing for EU27 clients and potentially drive up risk premiums to be paid when transacting with banks in the short term, while long-term effects are not fully clear yet.

The BCCG is advocating for a transitional agreement for OTC derivatives clearing which would allow for a smooth transitioning operationally, as well as to allow for the development of a solution that would minimise the mentioned impacts for banks, as well as their customers. And lastly, BCCG believes that the current choice of market participants should not be limited automatically by Brexit. The situation on repo and securities clearing is slightly more promising but still challenging, should there be no transition period or negotiated arrangement.

LCH Ltd. is by far the largest repo clearing CCP in the current EU. It has indicated its willingness to mirror its repo clearing functionality to its French subsidiary LCH SA (France), which is a fully licensed QCCP under EMIR. While the mirroring of functionality is not dependent on interoperability agreements between LCH SA and LCH Ltd., in agreement to allow for interoperability between the UK and the French entity post-Brexit, EU27 clearing members would be needed to allow smooth transfer of transactions to the French entity and the maintenance of the ability to tap the overall liquidity pool. Simultaneously, repo clearing at LCH SA would give ECB the possibility to monitor and – in crisis situation – influence and control Euro denominated repo flows. Eurex Clearing's repo clearing offering would be an alternative solution, however, switches will take time.

It is challenging to have those solutions ready by April 2019 as it would need significant re-papering and off- as well as re-onboarding of clearing members.

In securities / equities clearing, LCH plans to offer a solution similar to repo clearing. Additionally, the interoperability with EuroCCP NV and SIX x-clear should be maintained – if possible. However, the replication of services from LCH Ltd to LCH SA is technically and legally complex and time consuming. Particularly as the Continuous Net Settlement Cycle operated by LCH SA will have to be replaced by Trade Date Netting, as operated by the 3 current interoperable CCPs (LCH Ltd., EuroCCP NV and SIX x-clear). Cross netting between LCH SA and LCH Ltd. will therefore not be available technically post-Brexit. It is so far unclear if equity trades cleared by LCH SA can be exempt from the UK stamp duty as it is currently the case with LCH Ltd. based on bi-/multilateral MoUs in place between relevant bodies in EU27 and the UK. In case no exemption for stamp duty intermediary relief can be reached, there might be the risk, that trading UK stocks becomes more and more unattractive for European market participants and market makers. Those currently not connected to LCH SA will need to apply for membership and provide the technical connectivity. In case that there is no transition period, EU based members will be exposed to significant operational risk in case the project will not complete in April 2019.

Concluding, BCCG advocates for a transition period to be able to operationally make necessary changes happen, evaluate the situations to derive a solution which minimises operational costs and impacts on banks profitability and customers' cost of transaction with banks in the UK and EU27 and ultimately maintain choice for market participants.

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