# REG WATCH

## Mazars' regulatory newsletter for the banking industry

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## EDITORIAL

The banking industry and the wider financial services industry is being challenged by two major events that could eventually undermine its current financial stability.

The first of these events, Brexit, has been an unknown quantity since the 2016 vote, however no one had anticipated that there would be so many difficulties in negotiating a UK exit from the European Union. With the endless political negotiations, the possibility of a hard Brexit scenario is becoming increasingly likely. The whole industry is getting prepared – or as prepared as one can be. The HM Treasury has issued its approach to financial services legislation under the European Union (Withdrawal) Act 2018 while the FCA consulted on the Temporary Permissions Regime (TPR) and other amendments to its handbook to ensure a robust regulatory regime in the event of a hard Brexit. Banks are trying to keep up with these regulatory changes and are focussing on the assessment of the risks to their business posed by Brexit, under all possible scenarios, and many have begun taking mitigating action.

As if Brexit was not challenging enough, the financial services industry must begin preparing for the proclaimed death of the sacred London Interbank Offered Rate (LIBOR) and other benchmark rates which might not meet the requirements set by the new EU Benchmarks Regulation. A phase-in period started in January 2018 with the objective of a full application of all legal requirements by January 2020. Since then consultations have been issued and working groups set up in order to tackle the benchmarks replacement challenge. The UK supervisors keep warning the financial services industry to start preparing for the transition. Given the extent of the reform, the supervisors' concerns are more than justified.

Finally we also wanted to address the European journey toward a strengthened Anti-Money Laundering (AML) framework. The 5th AML Directive came into force in July this year and should now be transposed by Member States by January 2020.

In a nutshell, banks are dealing with pressures from multiple directions and this newsletter aims to provide you with some insights around some of the main challenges they face.

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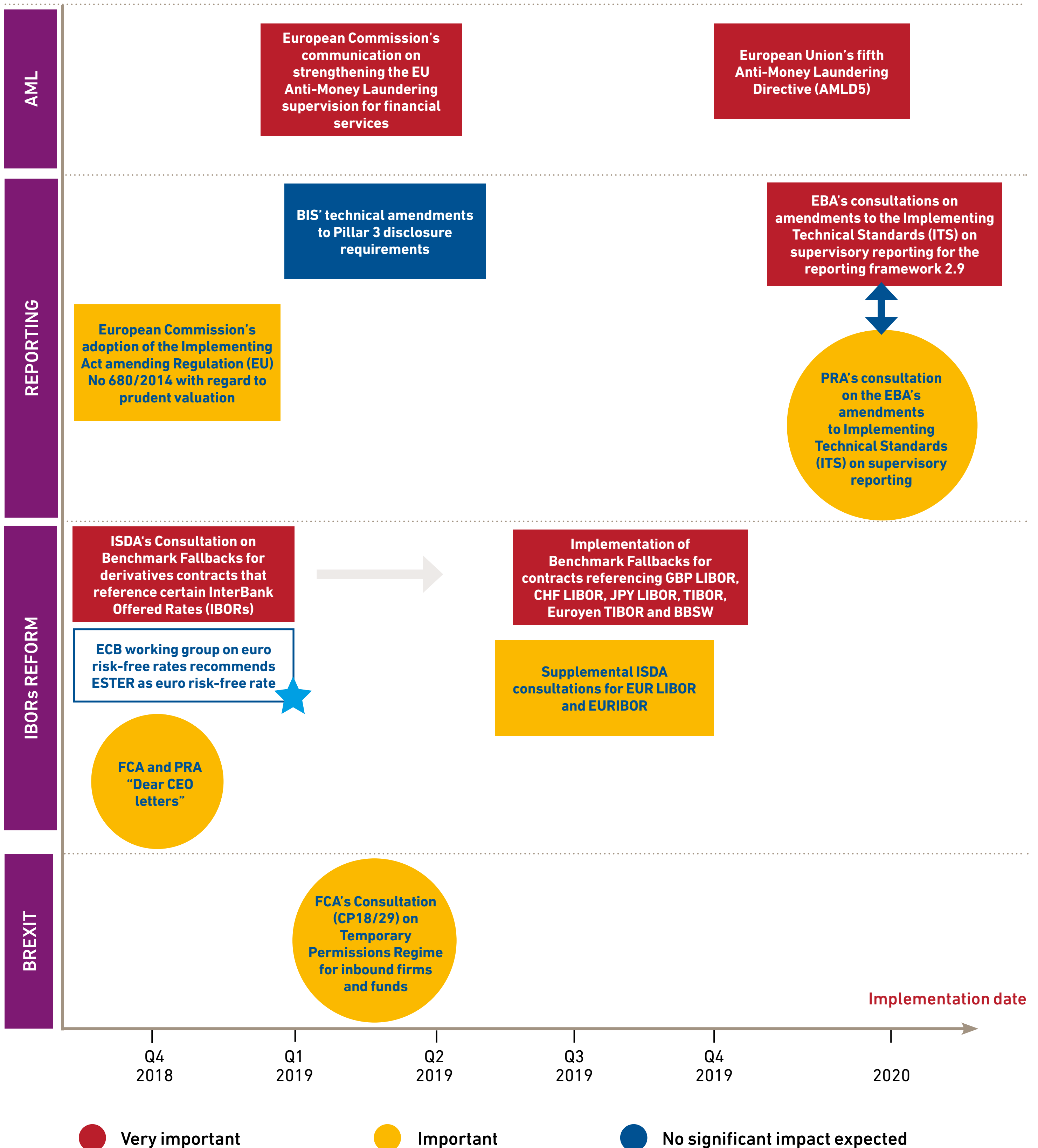
# 01 On the regulatory radar



## AML

### European Commission's communication on strengthening the EU Anti-Money Laundering supervision for financial services

- Details:
  - The text aims to propose a supervisory strategy in order to combat money laundering and terrorist financing threats and preserve financial stability.
  - One of the key suggestions is to strengthen the role of the European Banking Authority when it comes to international anti-money laundering issues.
- Target audience:
  - Financial institutions in the EU.
- Next steps:
  - The Commission calls on the European Parliament and European Council to endorse the actions set out in the Communication and to adopt the supporting legislative proposals by early 2019.

### European Union's Fifth Anti-Money Laundering Directive (AMLD5)

- Details:
  - This Directive is part of the European action plan towards a strengthened framework to counter the financing of terrorism.
  - Among other things, the directive focuses on:
    - Enhancing the transparency regarding company and trust ownership
    - Preventing risks associated with the use of virtual currencies
    - Facilitate access to information across Member States.
- Target audience:
  - Financial institutions in the EU.
- Next steps:
  - The Directive is effective from 9 July 2018 and Member States will have until 10 January 2020 to implement the directive into national law.

## Regulatory reporting

### Adoption by the European Commission of the Implementing Act amending Regulation (EU) No 680/2014 with regard to prudent valuation

- Details:
  - This text aims to incorporate within the COREP, the new standards introduced in March 2015 by the European Banking Authority's final regulatory Technical standard on prudent valuation.
  - As a result four additional templates related to prudent valuation have been introduced: one to be completed by all institutions subject to prudent valuation requirements and three others to be filled in only by institutions under the core approach.
- Target audience:
  - Institutions subject to prudent valuation requirements (eg. with fair-valued positions in their books).
- Next steps:
  - The new reporting standards will apply from December 2018.

### BIS releases technical amendments to Pillar 3 disclosure requirements

- Details:
  - This amendment aims to clearly disclose the potential transitional effects on the impact of expected Credit Loss (ECL) on regulatory capital and to provide additional information regarding the allocation of accounting provisions.
  - The three main amendments consist of:
    1. Disclosing the full impact of ECL transitional arrangements used in Total Loss-Absorbing Capacity (TLAC) resources and ratios
    2. Distinguish between general and specific provisions for standardised approach exposures
    3. Provide rationale for the above allocation.
- Target audience:
  - Applicable for banks using an ECL accounting model and banks using transitional arrangements for the regulatory treatment of accounting provisions.
- Next steps:
  - The additional amendments to the Pillar 3 standard will come into effect from 1 January 2019.

## Regulatory reporting

### EBA's consultations on amendments to the Implementing Technical Standards (ITS) on supervisory reporting for the reporting framework 2.9

- Details:
  - These three public consultations aim to ensure reporting requirements are aligned with changes in the regulatory framework.
  - The main areas covered by the three consultation papers are:
    - COREP: revision of securitisation templates - simple, transparent and standardised (STS) regulation
    - FINREP: amendment of non-performing and forborne exposures reporting, P&L and IFRS16
    - COREP-LCR: review based on the upcoming LCR delegated act.
- Target audience:
  - Applicable to all institutions which are subject to ITS on supervisory reporting.
- Next steps:
  - These consultations issued in August 2018 will run until the 27 October 2018 for the COREP-LCR one and until 27 November for the other two consultations.
  - Application dates:
    - COREP-Securitisation and FINREP amendments: 31 March 2020 – approximately one year is expected to implement the amendments;
    - COREP-LCR: application expected at the end of month following the date of application of the final LCR amending Act.

### PRA's consultation on the EBA's amendments to Implementing Technical Standards (ITS) on supervisory reporting

- Details:
  - This consultation proposes amendment to the PRA reporting requirements in order to take into account the EBA's proposed changes to Implementing Technical Standards (ITS) on supervisory reporting (eg. above)
- Target audience:
  - Financial services industry and supervisors.
- Next steps:
  - The deadline for responses to the CP19/18 changes is 12 December 2018, changes set to take place in March 2020.

## Brexit

### FCA Consultation paper (CP18/29) on temporary permissions regime (TPR) for inbound firms and funds

- Details:
  - The consultation paper set up a regime allowing European Economic Area's (EEA) firms to continue their activities in the UK in a hard Brexit scenario.
  - It describes how the TPR will operate and how the current FCS's rules will apply to TPR-authorised firms.
- Target audience:
  - EEA firms, electronic money and payment institutions and registered account information service providers. Managers of EEA-domiciled UCITS and AIFs that market those funds in the UK.
- Next steps :
  - The consultation will end on 7 December 2018.
  - The TPR will be applied from the UK exit day onwards.

## IBORs reform

### FCA's and PRA's "Dear CEOs Letters"

- Details:
  - On 19 September 2018, the FCA and the PRA sent a letter to the Chief Executive Officers (CEOs) of the largest banks and insurance companies under their supervision.
  - The letters aims at accelerating the preparation towards the new alternative risk-free rate.
- Target audience:
  - Largest banks and insurers under the FCA's supervision.
- Next steps:
  - The regulators expect the following to be provided by the scoped institutions by the 14 December 2018:
    1. A summary of the firm's key risks assessment and associated mitigation actions approved by the institution's Board;
    2. The name of the senior manager(s) that will handle this request as well as the implementation of the transition plan.

## IBORs reform

### ECB working group on euro risk-free rates recommends ESTER as euro risk-free rate

- Details:
  - On 13 September 2018, the private sector working group recommended the euro short-term rate (ESTER) as an alternative euro risk-free rate and replacement for EONIA.
  - ECB announced publication in 2019 of an overnight euro rate called ESTER which is similar to SONIA based upon wholesale unsecured overnight borrowing data. ESTER is one of the three candidates that could be chosen to be the preferred rate alternative to EURIBOR and EONIA rates.
  - The other candidates include (i) GC Pooling Deferred, a one day secured general collateral repo rate and (ii) The RepoFunds Rate, a one day secured general and specific collateral repo rate.
- Target audience:
  - Financial services industry and supervisors.
- Next steps:
  - The group is now examining options to ensure a smooth transition to this alternative rate. A round table is arranged on 9 November 2018.

### ECB Working Group to request to delay to the introduction of Euribor/ Eonia benchmark replacement

- Details:
  - The working group on euro risk-free rates (RFR) benchmark reforms, made up of industry led bodies and the ECB has called for the delay for the replacement benchmark for EONIA (Euro OverNight Index Average) and EUIBOR (Euro Interbank Offered Rate) rates.
  - The working group claims the likely benchmark replacement called ESTER (Euro Short Term rate) will not be available before the set deadline imposed by the EU lawmakers, potentially causing disruption in valuation and financial stability.
  - The working group has proposed a delay of up to two years to allow time to build the derivatives market that will help build market liquidity.
  - The EC (European Commission) indicated that they would consider a delay if there was high stakeholder support who could provide the necessary evidence for the reasons for the delay.
- Target audience:
  - All institutions using EURIBOR and EONIA rates.

## IBORs reform

- Next steps:
  - The current deadline set by EU lawmakers is 1 January 2020. The working group is proposing an additional two year extension and is subject to approval from EC and other EU regulated bodies.

### ISDA publishes Consultation on Benchmark Fallbacks for derivatives contracts that reference certain InterBank Offered Rates (IBORs)

- Details:
  - The International Swaps and Derivatives Association (ISDA) has launched market-wide consultation seeking feedback on the proposed amendments to 2006 ISDA definitions to address fallbacks to applicable risk-free rates (RFRs) for derivatives in circumstances where an associated IBOR is not available.
- Target audience:
  - To all market participants using the ISDA agreements, which covers GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW.
- Next steps:
  - Consultation ended on 22 October 2018. ISDA will launch supplemental consultations covering USD LIBOR, EUR LIBOR and EURIBOR.

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## Strengthening of the Anti-Money Laundering (AML) and Counter-Terrorist Financing (CTF) framework in Europe

In recent years, the European Commission (EC) has made a number of major changes to the AML/CTF legislative framework in a bid to combat and prevent the ever increasing risk of money-laundering and terrorist financing. Not only is the EC concerned with improving the legislative requirements, but also the supervision and enforcement of requirements in EU Member States. The new requirements have been influenced by the Financial Action Task Force's (FATF) 2012 recommendations. The roadmap below highlights key events in recent years:

1

### Assessment of improvements needed

- 15 February 2012 - Recommendations from the Financial Action Task Force to promote higher standards for money laundering regulation
- FATF call for improved consistency across global and European AML policies
- Need for a greater number of firms and sectors to comply with regulation

2

### Announcement of the 4th Anti Money Laundering Directive (4AMLD)

- New requirements and updates to obligations under the 3rd AML Directive
- Greater emphasis on risk-based approach and stricter due diligence
- 5 July 2015 - Published in the Official Journal of the European Union

3

### Implementation of 4th and 5th AML Directives

- 6 June 2015 - 4AMLD came into force – transposed by 26 June 2017
- 2 February 2016 - European Commission release the **Action Plan to Strengthen the Fight Against Terrorist Financing** in light of recent terrorist attacks in Europe
- July 2016 - Amendments to 4AMLD proposed in order to strengthen regulation in line with the Action Plan
- 19 June 2018 - Amendments published as the 5th AML Directive (5AMLD)
- 9 July 2018 – 5AMLD came into force - to be transposed by 20 January 2020

4

### Strengthening of supervision

- 12 September 2018 - EC release a communication proposing to strengthen supervision and enforcement of AML regulation
- EC plans to concentrate powers at the(EBA
- Plans to strengthen EBA's role to ensure cooperation, efficiency and information sharing

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## Strengthening of the Anti-Money Laundering (AML) and Counter-Terrorist Financing (CTF) framework in Europe

4AMLD was intended to be a fundamental change to regulation in order to improve standards and ensure consistency of approaches across the EU. One of the most important aspects of the new rules was the introduction of a more risk-based approach, forcing firms to adopt more risk-based policies and procedures. The directive also introduced stricter customer due diligence requirements and a clearer definition of Politically Exposed Persons (PEPs).

The need for improved regulation was further reinforced in the EC's 2016 Action Plan to Strengthen the Fight against Terrorist Financing, highlighting how regulation needed to incorporate a strong and coordinated response to combatting terrorism in Europe.

Further to this, on 9 July 2018, the Fifth Anti-Money Laundering Directive (5AMLD) came into force and should be transposed by Member States by January 2020. It details a set of amendments to 4AMLD aimed at further safeguarding against terrorism in Europe, in line with the EC's 2016 action plan. 5AMLD has a strong focus on improving transparency and, for the first time, addresses the potential money laundering risks that are posed by virtual currencies, extending the scope of regulation to virtual currency platforms and wallet providers. This introduction highlights an important shift towards addressing the growth in business-related cryptocurrency use that has been seen in recent years. 5AMLD also introduces stricter rules on the due diligence measures institutions must have in place for financial flows from high-risk countries.

Whilst there is clearly an extensive mandate of requirements in place under 4AMLD and 5AMLD it has been argued that recent high profile cases in the EU have highlighted that they are not always enforced effectively. In his State of the Union Address on Wednesday 12 September, 2018, Vice-President of the Commission, Valdis Dombrovskis, reinforced this, announcing:

> "Europe's Banking Union must be built on the highest standards of integrity. Anti-money laundering supervision has failed all too often in the EU. Today we are enabling the European Banking Authority to make sure that different supervisors cooperate and exchange information and that anti-money laundering rules are enforced effectively across EU countries."

One recent case that highlights this lack of supervision and enforcement is the Pilatus Bank money laundering scandal in Malta. In March 2018, following an investigation by the U.S Authorities, Pilatus was accused of being set up with criminal proceeds and evading sanctions through money laundering. Concerns were raised because Malta's Anti-Money Laundering Agency had already launched their own investigation in 2016, and reported that Pilatus showed "glaring, possibly deliberate disregard" towards AML, yet no further action was taken. This led the European Banking Authority to voice their concerns over the supervisory competence of the Maltese FSA.

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## Strengthening of the Anti-Money Laundering (AML) and Counter-Terrorist Financing (CTF) framework in Europe

Following this, and several other high-profile money laundering cases, in September 2018 the EC announced their plans to strengthen their supervisory framework to improve enforcement of the 4AMLD and 5AMLD and ensure consistency across Europe. The main change being the centralisation of all AML supervision at the EBA - moving away from the current tripartite management[1]. The EBA will have a more comprehensive oversight of AML regulation in order to prevent and combat financial crime more efficiently. The greater centralisation of resources should ensure that risks to the financial system are effectively and consistently incorporated into the strategies of all the relevant national supervisory authorities within Member States.

The EC has laid out several action points[2] they plan to enforce in order to centralise tasks at the EBA and enhance the EBA's controls. The key tools and adjustments are highlighted below:

1 The EBA, the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA)

2 12 September 2018, "COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS: Strengthening the Union framework for prudential and anti-money laundering supervision for financial institutions."

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## Strengthening of the Anti-Money Laundering (AML) and Counter-Terrorist Financing (CTF) framework in Europe

One of the most important changes is the creation of the new committee within the EBA to bring together the three European Supervisory Authorities. This change aims to enhance cooperation, information sharing and efficiency, whilst also giving the EBA a greater governing role. In order to further improve information sharing, the EC has also proposed the creation of a data hub to ensure national authorities across countries have access to important information and trends.

Overall, these improvements will extend the reach of the EBA in order to create a **more resilient system** to prevent and combat money-laundering and terrorist financing. 4AMLD and 5AMLD have been important steps in strengthening legislation, yet the EC still feels that "asymmetries in the distribution of tasks and competencies" need addressing. The EC has called for the European Parliament and Council to consider their improvement plans and take relevant legislative action **by early 2019**. Firms will not only need to consider the upcoming changes they will have to implement under 5AMLD, which is to be transposed by 2020, but also the enhanced scrutiny and greater level of international data-sharing and transparency they will be subject to.

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## LIBOR reform: the clock is ticking…

Would the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) start to worry about the ability of their supervised banks and insurers to transition from to sacred London InterBank Offered Rate (LIBOR) to the Sterling Overnight Index Average (SONIA)?

On 19 September 2018, the FCA and the PRA sent a letter to the Chief Executive Officers (CEOs) of the largest banks and insurance companies under their supervision. Through these "Dear CEO" letters the UK supervisors want to make sure that the firms' senior management and board are fully aware of the key risks associated with the LIBOR reform and that the necessary actions will be taken in a timely manner. As a result, by mid-December 2018, these firms are expected to provide the regulators with a board-approved summary of the firm's key risks assessment and actions planned to mitigate the identified risks as well as with the formal appointment of the senior manager(s) responsible for the implementation of the transition plan.

Some may think that these "Dear CEO" letters sound excessively alarmist as there is still a couple of years before the LIBOR discontinuation but that would be without understanding the widespread use of those IBORs across financial instruments such as derivatives, bonds, loans, deposit, securisations. Put it simply, those contracts linked to InterBank Offered Rates (IBORs) represent hundreds and hundreds of trillions of dollars of outstanding volume overall (around $350 trillion of financial instruments tied to LIBOR).

One can easily understand why the UK supervisors want to ensure that its largest financial services players will be ready to move from the existing IBORs towards the new benchmarks – the so-called "alternative risk-free rates" (RFRs) – when the time will come. However the problem might not come from a lack of awareness or involvement from the industry but more from the magnitude of the reform.

As previously mentioned, the magnitude comes from the range and volume of financial instruments but also, and as a consequence, from the diversity of economic players using them. The latter is as important as the former as it raises the question of the awareness among all the players. Surely, when it comes to issues related to IBORs or financial instruments, one can expect those issues to affect banks in first place. And indeed, these contracts constitute a large part, if not most, of their balance sheets. However, one should not forget that if banks use those financial instruments they also sell them to plenty of counterparts, banking or not.

Insurers are among those counterparts that use, quite importantly, IBORs-referenced instruments for investment purposes, hedging strategy (eg. interest rate and inflation swaps to cover pension's schemes) or even as part of their valuation requirements. Indeed, the current regulatory discount rate imposed the European Insurance and Occupational Pensions Authority (EIOPA) to insurer's liabilities is a risk-free rate based on LIBOR. Any change in the LIBOR will then result in a change in the value of the liabilities which will then lead to a necessary recalibration of the associated hedges.

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## LIBOR reform: the clock is ticking...

Identical concerns can be raised for corporate companies who buy investment products pegged to IBORs (floating-rate notes tied to IBORs) or enter into derivatives contracts as part of their hedge strategy.

In order to illustrate the variety of impacts of the IBORs reform, let's consider an example: the bonds referencing LIBOR and, in particular, those which mature beyond the end of 2021[3]. In July 2018, the Working Group on Sterling Risk-Free Reference Rates issued a new paper regarding Sterling bonds referencing LIBOR and the associated risk that may arise from the index phasing-out . The first risk identified was the potential switch from a floating-rate bond to a fixed-rate one. This risk could be triggered if reference banks were to stop providing quotes after 2021 and if it becomes impossible to determine the interest rates from any fallback. In such a situation, the ultimate fallback would result in using the last determined rate for the rest of the bond's life-time which will have consequences on the investors as on the issuers. For the former, fixed-rate bonds might lose their initial appeal as they would become illiquid and might be less attractive in terms of coupon. For the latter, the switch might raise new risks in terms of Assets and Liabilities or Treasury Management and new needs in terms of hedging strategy. Indeed, floating-rate bonds issuance as investments can be associated with specific hedging strategies through derivative contracts. With the LIBOR disappearing, derivative contracts (hedging instruments) and bonds (hedged items) will be subject to specific and probably different fallbacks which might also be triggered at different times. This can cause a cash-flows mismatch which may then result in additional funding costs for the issuers, unexpected profits and losses or even in the disruption of the hedge effectiveness. Obviously, investors could face the same risk with their own hedging strategies.

Triggering any fallback or even switching from floating to fixed-rate bonds implies a strong prerequisite: the prior bondholder's consent (individual or quorum) to any amendments to the current terms and conditions of the bond notes. This can prove to be a quite difficult task: depending on the revised conditions and bondholders may or may not be willing to accept the new terms. A correlated risk to this is the litigation risk. Indeed, a switch from floating to fixed rate, or even a switch from LIBOR to an alternative fallback, might end up in a loss for the investors and with it an increased risk of litigation for mis-selling.

Through the floating-rate bond example, one can observe many types of risks and strategic questions that might arise. Now, let's keep in mind the volume at stake, out of the $350 million (or more) notional value of LIBOR-linked contract: 80% are Over-The-Counter (OTC) and Exchange-Traded derivatives[4] while bonds belong to the remaining 20%[5].

Through derivatives, the modelling and risk management challenges brought by the reform are yet more apparent than in the aforementioned example.

3 Year beyond which regulators will cease to require banks to continue submitting rates to calculate LIBOR

4 http://www.fsb.org/wp-content/uploads/r_140722b.pdf

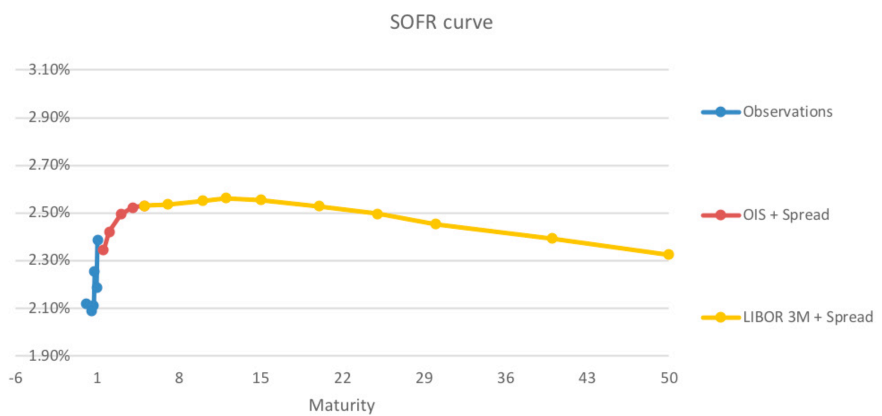
5 Together with Loans, Florating-Rated Notes, Short-Term instruments, securitised products, late payments, overdrafts, discount rates.

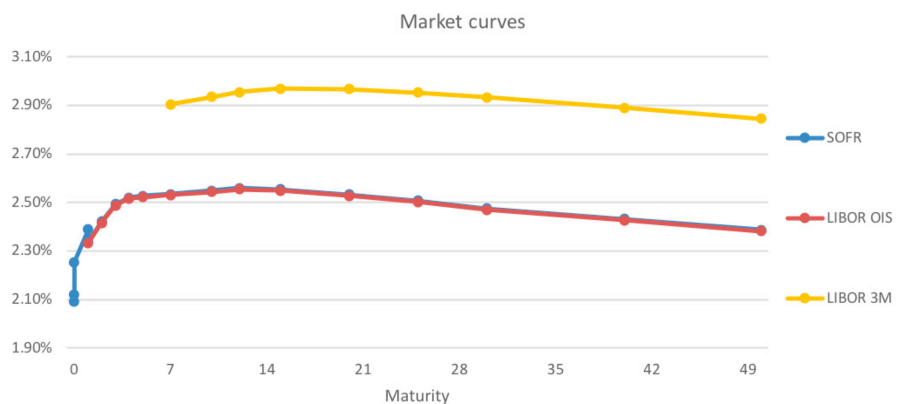
## LIBOR reform: the clock is ticking...

Indeed, using RFRs means new curves and hence new term structures to be built for each of these new rates. During the transition period in particular, basis spreads with the existing IBOR curves will need to be assessed and monitored for each currency and each tenor. Specific controls will have to be implemented and potential IT adaptations might be required in order to enable this multi-curve management and monitoring. Modelling issues have a direct impact on the valuation of the IBOR-references instrument and, in fine, a financial impact.

While the first SOFR OTC swap happened in July 2018, there is no convention set up for SOFR curve structure yet. At the moment, the SOFR market curve is not something anyone can rely on as it is based (FED fund rate) and add-on.

The below SOFR curve has been built based on market observations (0-18 months), OIS curves (18 months-7 years) and LIBOR 3M (7 years and beyond) to which spreads have been applied.




In this example, a 40% gap would be observed between the fair-value of a swap LIBOR 3M/Fixed rate and the fair-value of a swap SOFR / Fixed rate – assuming a 2% fixed rate.

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## LIBOR reform: the clock is ticking...

Beyond the valuation impact, a very important point in the above example is the current absence of observability of the SOFR market curve (in particular beyond 18 months) which may result in significant regulatory implications, in particular in light of the revised minimum capital requirements for markets risks and the punitive regime that will be applied to non-modellable risk factors.

The extent of the IBORs reform will certainly shake the financial and economic sphere. Risks to be taken into account are widespread across all economic players and the clock is ticking. Perhaps is it ticking faster than anticipated as the possibility of a hard Brexit scenario could jeopardise the LIBOR status within the European Union under the new Europe's Benchmark Regulation (that will enter into force in 2020[6]). Overall it might not be an understatement to say that this reform puts financial stability at risk and preparing for the transition is not an option, it is an emergency.

6 Risk.net "LIBOR to become third-country benchmark under no-deal Brexit"

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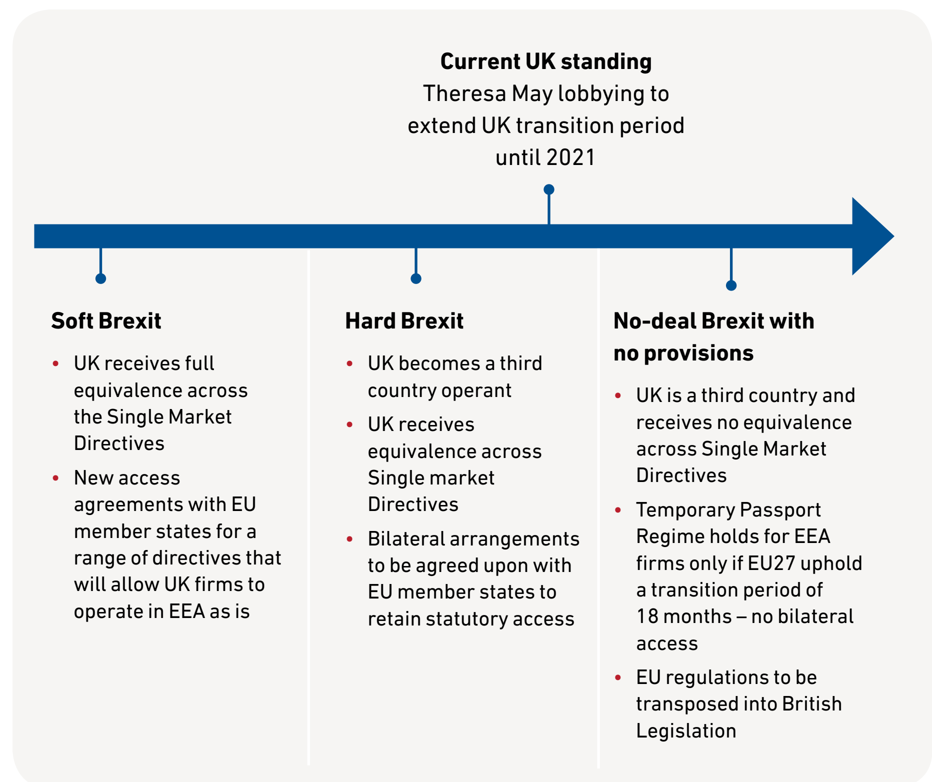
## Brexit – the no-deal way forward?

The past two years have been clouded with anticipation and speculation by banks around the cross border regulatory ecosystem once the 2019 Brexit deadline looms in. Moody's has recently issued a warning stating the risk of a no-deal Brexit has "risen materially" in recent weeks. With a hard-Brexit scenario becoming more and more plausible, regulators have been warning banks more directly about the urgency of preparing for a "no-deal"/"no-transition – that frightens the City of London's access to EU – and are imploring them to set aside more than adequate capital to fund their "to be considered overseas offshoots".




Brexit preparation has been the largest undertaking for the finance industry since the financial crisis. The worst-case scenario for the industry's extra capital needs is estimated at $30-$50 billion while new operating expenses could hit $1 billion.

So far during Brexit negotiations, the UK has committed to a two year implementation period for changes in financial rules, but the European Commission has not done so. On 9 October 2018 BoEs Financial Policy Committee issued a statement[1] which concluded that the UK financial services system was reinforced to withstand the disruption risk arising from a hard-Brexit. Advocating a transition period post D-day FPC stated "An implementation period would reduce the risks of disruption to the supply of financial services to UK and EU households and businesses as the UK exits the EU. The need for authorities to complete mitigating actions is now pressing." At this point nothing suggests that the EU authorities will enable UK counterparties to continue servicing contracts

1 https://www.bankofengland.co.uk/-/media/boe/files/statement/fpc/2018/financial-policy-committee-statement-october-2018.pdf

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## Brexit – the no-deal way forward?

with counterparties in the EEA. With this in mind, the regulatory landscape for UK firms is now speculated become a large patchwork of individual adaptations of third country regimes by EU member states

Until now, the Bank of England and the EU can't seem to agree on the implementation of a uniform cross border regulation for financial services. In the absence of a Withdrawal Agreement ratified on time by both parties, banks should be prepared for all contingencies, including the possibility of there being no transition period but rather an abrupt end to the UK's access to the EU single market.

HM Treasury (HMT) and FCA issued consultation papers in September 2018 and October 2018 respectively – setting out information that gives financial services firms and their customers an understanding of how they can prepare for a 'no deal' scenario, which is part of the government's approach to ensuring that the UK has a functioning financial services regulatory framework in any scenario to support financial stability.

FCA recently issued a consultation paper[2] outlining guidelines around Temporary Permission Regime for inbound firms and funds. The regulator provided a blueprint outlining plans to incorporate most, if not all, EU financial services regulation into UK law as well as in the FCA's rulebook. The FCA document also highlighted the details of the three-year temporary authorisations regime for EU firms which would continue to apply in the event of UK leaving the bloc without a decisive regulatory agenda. Key points from the technical papers are:

- HMT, FCA and PRA have undertaken a review identify legislative deficiencies that will arise when the UK leaves the EU. HMT is drafting statutory instruments to fix these deficiencies.
- HMT intends to introduce sub-sector specific transitional regimes for entities operating cross-border and outside of the passporting framework.
- UK financial services regulators will be given authority to phase in post-Brexit requirements, allowing flexibility for firms to transition to the fully domestic UK regulatory framework (Information about how HMT proposes to allocate responsibilities between the UK financial services regulators can be found in the draft Financial Regulators' Powers (Technical Standards) (Amendment etc) (EU Exit) Regulations 2018.)
- HMT set out its approach to onshoring financial services legislation under the European Union (Withdrawal) Act (EUWA) in June. This is intended to ensure that there is a complete and robust legal framework for financial regulation in the UK, whatever the outcome of negotiations between the EU and the UK, when the UK withdraws from the EU. HMT plans to lay a number of Statutory Instruments (SIs) to make the legal changes required to achieve this aim.

2 CP18/29*** "Temporary permissions regime for inbound firms and funds"

EU

## Brexit – the no-deal way forward?

The two potential regulatory scenarios that can emerge, given the status of negotiations, are:

1. UK firms operate as third country regimes with regulatory equivalence granted across EU
2. A cliff-edge no equivalence third country regime.

The table summarises the potential regulatory implications under the two scenarios; highlighting the discrepancies that HMT, the FCA and the PRA will need to address to ensure a smooth transition period.

| Regulation / Legal Basis | Equivalence Regime | No Equivalence Third Country Regime |
|---|---|---|
| CRD IV / CRR | No equivalence for wholesale banking services. | Third–country equivalence only applicable for certain aspects such as risk weighting but does not allow EU passport based market access. |
| MIFID II/ MiFIR | Equivalence for UK based investment services for sophisticated clients/ corporate client businesses. This is not applicable for private client businesses. Additionally, passport rights will no longer apply to MiFID II EEA market operators seeking to facilitate the participation of the exchange in UK markets | Individual EU member states transpose aspects of the directive as they see fit. UK will alter adaptations to this directive as they see fit. UK firms could be cut off from accessing global pools of liquidity at third country trading venues. |
| EMIR | Trading venues and CCP's will have discretionary access to each other. | Trading venues and CCP's will have discretionary access to each other. Terms of engagement between EU and UK are currently being decided to minimise disruption (estimated loss of £38 billion for UK in case no conclusive terms are devised before deadline. |
| CSDR | Equivalence already exists. | Equivalence will continue. |

EU

## Brexit – the no-deal way forward?

EU commission has proposed that MIFID subsidiaries of UK firms might only continue to provide their services provided they have a formal MIFID authorisation in the member state where they are present. Reliance on the parent company for to provide support will prove to be operationally arduous in light of Third Country provisions with no equivalence regime for UK firms.

In September 2018, the FCA published a direction pursuant to the Financial Services and Markets Act 2000 (FSMA) regarding how an overseas market operator can apply to be a recognised overseas investment exchange (ROIE). EEA market operators who currently make use of passport rights are advised to make a formal application to be recognised as a ROIE post-Brexit.

Furthermore, access to trading platforms, and provision of clearing services with UK based entities faces severe disruption particularly for securities and derivatives. BoE recently issued a stark warning that £41 trillion of cross border derivative contracts are at risk under the current uncertain regulatory parameters – backed by the fact that about 68% of all trading between EU clients is currently booked in the UK. EMIR forces the clearing of OTC-traded derivatives on an 'EU CCP' and consequentially after Brexit UK-based CCPS will no longer be eligible. UK and EEA firms have been advised by BoE that EU serviced derivatives would no longer hold validity under UK clearing houses; BoE has advised banks on both sides of the border to move their business or risk defaulting under EU law.

The movement of a large volume of contracts in a short time frame would be costly to, and disrupt the derivatives positions of, EU businesses and could strain capacity in the derivatives market. In addition, fragmentation of central clearing would raise costs for EU businesses. Industry estimates suggest that every single basis point increase in the cost of clearing interest rate swaps alone could cost EU businesses around €22 billion per year.

Financial institutions are navigating tough waters through the Brexit preparatory period without knowing what they need to evolve towards. The biggest challenge arises from conclusively understanding the full extent of effects and structural reforms arising from the various scenarios. Timing in this aspect is critical as UK's true comparative advantage over other locations will only emerge once negotiations end with conclusive decisions. A holistic re-evaluation of four key aspects should be considered as banks enter the final stage of executions – i) Policies and procedures ii) Third Party service providers especially clearing houses iii) Existing and pipeline client migrations and on- boarding iv) strategic evaluation of existing and potential service lines to feed into contingency planning. Contingency plans inception should begin with defining trigger points. Defining trigger points ensures that fail-safe strategies can be identified and executed to optimise operational performance and viability under any given Brexit scenario. In particular, financial institutions should identify potential risk channels and assess the associated impacts on their business model, solvency and liquidity. In doing so, they shall consider whether they have to or are willing to maintain a continued market access to the UK or the EU27.

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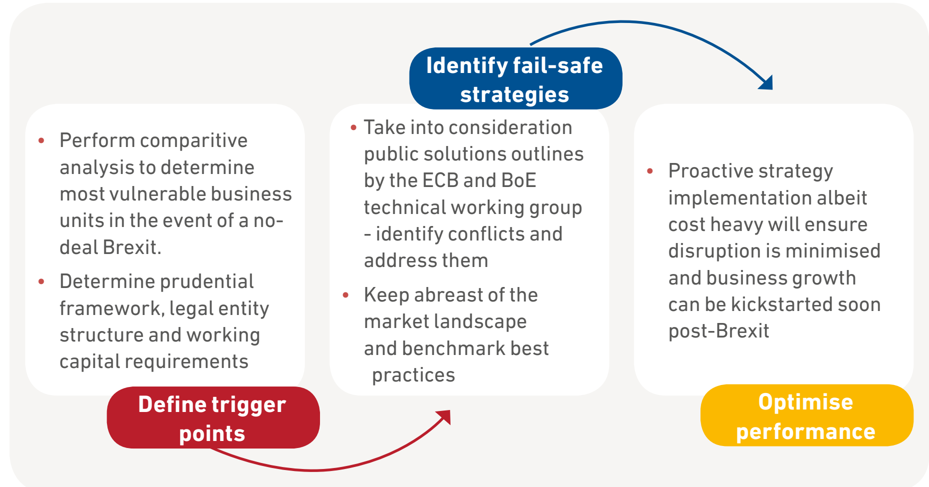


There is little certainty over what will happen next and the gulf between what the industry wanted at the start of the process and what it looks as though it will now achieve, is wide. The November 2018 Brexit summit has been cancelled because as there were no sign of significant progress in the negotiations.

Over the last few days, tiny steps seem to have been made towards a compromise. Rumour has it that a potential deal between EU and UK on post-Brexit financial services could come through and, in addition, a compromise regarding the Northern Ireland border backstop might be on its way.

But the negotiating deadlines are passing and the pressure is now, more than ever, on UK and EU authorities to protect cross-border financial stability and on financial services firms to get prepared the best they can.

### Brexit – remaining milestones

- **29 October 2018:** UK Budget UK Chancellor has moved the budget day to allign with Brexit negotiations. All major Brexit Proposals will be delayed until the budget has been passed. This move is to avoid a sudden general election; in the event that Theresa May government faces adverse opposition if proposals are not to the liking of Northern Ireland party

- **13-14 December, 2018:** European Council 2018: Possibly the last practical date for a Brexit Deal to be signed off between EU27 and UK. The withdrawal treaty needs to be backed at an EU summit by a supermajority of leaders of member states in order to reach a conclusive agreement.

- **January-March 2019:** Once a meaningful Brexit Deal is reached - House of Commons vote will be held to validate the EU Withdrawal Treaty. If approved, new legislations prioritising key defeciences will pass into Law. Statuatory instruments suggested by HMT, FCA and PRA adressing financial services regulatory defeciencies will be adopted into the UK regulatory handbook - provided they are not contested by EU ratifications.

- **29 March 2019-December 2020:** Agreements reached before Brexit day on 29 March will decide if it will be a seamless transition or a chaotic one for both sides of the border. Post March, the agreed upon transition period will begin and end on December 2020 - a date that Theresa May is lobbying to extend stating that a longer transition will add to the stability of trade agreements. During transition period; all memeber benefits for UK - other than voting rights will hold.

# 03 Looking ahead

## Fraud reporting: PSD2

In today's increasingly digitalised world, fraud and cybercrime have become prevalent in the finance industry. In response, on 18 July 2018 the EBA published its final guidelines on requirements for fraud reporting as enforced by the Payment Services Directive (PSD2). The guidelines will apply from 1 January 2019. They build upon the first PSD, implemented in 2007 and will be in effect in the EU and EEA. The ECB worked with the EBA in order to create the PSD2 with the target of increasing retail payments' security within the EU. Hopefully, these more stringent regulations will aid in reporting fraud and cybercrime.

The PSD2 requires payment service providers and supervisors to create transparency with regards to their payment infrastructure and customer data assets in order for third parties to develop payments and information services to customers. Therefore, in order to ensure uniformity, the governed bodies must use consistent processes when recording the relevant payment and fraudulent payment transactions data. These changes came into fruition following the comments made to the consulting paper (CP) the EBA published in August 2017. One of the most notable changes is that reporting of a detailed uniform set of data is now required every six months, as opposed to on an annual basis previously. Additionally, the magnitude of the physical regions affected by the draft guidelines proposed in the CP has been decreased. Finally, the ECB and EBA have ensured that the Guidelines support any related reporting standards. Given the forecasted impact of these changes once they come into play, it is likely banks will lose their so called monopoly on customer account information. Therefore, on one hand PSD2 can be viewed as a threat to banks. However, overall it will have a positive impact on the industry and its respective customers as the element of asymmetric information will be mitigated.

## Minimum requirement for own funds and eligible liabilities reporting: PS11/18

On 13 June 2018 the Bank of England (the Bank) published its Resolution Planning Policy Statement, PS11/18, on minimum requirement for own funds and eligible liabilities (MREL). The statement corroborates the PRA's final expectations for MREL reporting. The affected firms include all PRA authorised firms and their qualifying parent undertakings which are subject to interim or end state MREL requirements. Interim internal MRELs are expected to apply from 1 January 2019 for material subsidiaries of the global list of systematically important banks (G-SIBs) and from 1 January 2020 for other firms.

PS11/18 is most impactful on firms notified by the Bank that they are likely to be subject to internal or external interim, or end state MREL which surpasses capital requirements. The policy statement acts as feedback to responses to CP1/18 and its appendices also explain the new SS19/13.

The MREL is not the first anti-crisis measure implemented by a governing body nor will it be the last. The requirement should suffice to ensure that banks have enough liabilities to stop taxpayers from needing to bail them out in case of a crisis. This goes hand in hand with the minimum total loss absorbing capacity (TLAC) which requires G-Sibs to have enough equity to pass losses to stakeholders rather than a government bailout.

# Please get in touch...

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