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BREXIT – 2021 AND BEYOND

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Brexit continues to cast a long shadow of uncertainty across the financial services sector.

EXECUTIVE SUMMARY

The widespread disruption caused by COVID-19 means Brexit has not necessarily been front of mind for many people prior to the recent 'endgame' negotiations between the UK and the European Commission. However, the requirement to meet obligations arising from the UK's departure from the EU persists, and indeed those obligations continue to evolve. Financial Services Organisations (FSOs) will need to build on their existing regulatory compliance framework and Brexit readiness activities in order to minimize business disruption in 2021.

The ever-changing regulatory landscape has resulted in newly empowered UK-based regulators and industry-wide FSO reclassifications. Regulatory equivalence with EU authorities is living up to expectations as a complex, political and increasingly uncertain exercise; leading FSOs to question how intricate regulatory obligations can be adhered to in a timely manner.

COVID-driven implementation delays, coupled with new regulatory powers, have led industry groups to lobby for changes to the introduction of certain EU regulations. e.g. the Clearing buy-in regime under the CSDR regime. Front Office Trading and booking models will also likely be impacted as the trading obligations in 2021 become better known and understood.

Substantial efforts have already been made to adapt to the post Brexit landscape in the shape of:

- new EU entities being established or repurposed
- introducing new booking models
- establishing and testing new regulatory reporting channels
- migration strategies.

However, FSOs have not been able to complete these exercises for a number of reasons. As a result, they will need to refocus their efforts from early in 2021 to address potential commercial and regulatory challenges.

This article summarises key Brexit considerations for UK financial services regulation, and how they will continue to impact FSOs in 2021.

REGULATORY LANDSCAPE CHANGES

In June 2020, a plan was revealed to maintain regulatory standards in the UK financial services industry once the transition period ends on December 31st, 2020. Subsequently, in October of 2020 the UK Government launched an open consultation on the regulation and policy surrounding financial services in the UK. The UK Government's plan addresses considerations from a UK, European and international perspective. The plan's impacts can be grouped in the following areas: updates to UK prudential requirements, and support for UK capital markets, including the management of future regulation.

Updates to UK Prudential Requirements

A new Investment Firm Prudential Regime (IFPR) and updates to the regulation of credit institutions will be introduced by the UK Government's Financial Services Bill. Some key points to note include:

- Implementation of major EU prudential regime (IFR/IFD) compliance initiatives already underway will continue. e.g. Basel III and LIBOR.
- FCA is proposing to reclassify FSOs as Credit Institutions (within CRD/CRR) and Investment Firms (outside of CRD/CRR).
- PRA designated Investment Firms will not be required to re-authorise as a credit institution in the Summer of 2021.
- FCA regulated Investment Firms in the UK must comply with EU legislation that is already in force as of January 1st, 2021. For example, when IFPR is in place, directives such as CRDV and BRRDII will be transferred to UK legislation.

Support for UK Capital Markets

For now, the UK will persist with its current industry led settlement discipline framework. The EU Settlement Discipline Regime (SDR) which applies from February 2021, is not due to be implemented as it currently stands, in the UK.

In October 2020, the UK Government launched a second consultation proposing an approach to the post-EU regulatory framework in the UK. Already HM Treasury is reviewing whether and how to implement EU legislation that comes into force post December 31st, 2020.

Examples of why this area deserves more focus can be seen in both the FCA's proposal to replace the Internal Capital Adequacy Assessment Process (ICAAP), as well as the ongoing transition from LIBOR.

The FCA's proposal to replace ICAAP with a new Internal Capital and Risk Assessment (ICARA) process identifies several similarities between the two processes, however it also changes how FSOs should approach and manage risk.

The transition from LIBOR also creates risk. To address this, the Financial Services Bill will introduce amendments to Benchmark regulation 2016/1011. This will provide the FCA with the power to manage the ongoing transition from LIBOR.

IMPACT ON TRADING

We have already experienced Brexit impacts to trade execution, where trades by UK entities on EU venues need to be routed via another EU entity. The impact of Brexit on Front Office Trading will be seen most where:

- Cross-border capital flows exist.
- £GBP Sterling acts as an international and reserve currency.
- Infrastructure changes will be required to accommodate adaptation of the existing financial services ecosystem which has existed for 50 years in London.

The high level of interconnectivity within financial services suggests that the effects of any exit from the current EU agreement are likely to extend beyond business executed directly with EU clients. The implications have the potential to impact wider portfolios and trading strategies.

At the macro level, as EU related activity is separated from non-EU related activity, we would expect to see the further fragmentation of liquidity, reduced capital efficiency, and cost duplication. Any desk change of this magnitude would likely lead to a reduction in non-EU clients, alongside the related activity previously traded through books held in the UK. This raises questions and issues around trader location, sales strategy and (ultimately) where the majority flow of business will operate/orchestrate from as FSOs continue to pursue bottom-line gains.

To maintain the benefits of their current offerings to clients, the FSO is also likely to continue to move supporting activities such as back-office and compliance work into the EU regardless of whether or not these supporting activities are restricted.

The impact of Brexit will also be felt within the booking model. The FCA has stipulated its openness to different kinds of booking model (including the use of back-to-back and remote booking), provided that the associated conduct risks were effectively controlled and managed. The FCA has stipulated that booking models should comply with the following principles:

- Firms should set out a clear rationale for their booking arrangements, and document them soliciting board approval.
- Risk management should be appropriate for the firm's booking activities including hedging arrangements.
- There should be a broad alignment of risk and returns at the entity level.
- Firms should have adequate systems and controls in place to ensure that booking arrangements are followed.
- Firms should consider whether responsibility for oversight of booking arrangements should be explicit in statements of responsibilities.
- Booking arrangements should not be an impediment to the firm's recovery and resolution.

Consideration must be given to location strategy and the adverse outcome on passporting, risk management (GBP exchange rate risk), mitigate loss/benefit from investment decisions and their impact on the ability to raise capital from EU investors and the new pricing strategies that would need to be factored into any market making/risk taking activities.

SETTLEMENT CHALLENGES

The buy-in regime is one of the most disputed elements of SDR. It is aimed at improving settlement efficiency, however it could have a significant negative impact on both trading and liquidity across asset classes.

From January 1st, 2021 possible Brexit complications to meet EU regulation in this area are likely to occur where there are changes to UK statutory instruments. The expectation is that CSDR will be grandfathered as currently defined, but it remains unclear as to whether the UK will adopt the mandatory buy-in regime.

The UK may ultimately decide not to adopt the buy-in regime under the Central Securities Depositories Regulation (CSDR) and instead just have settlement penalties.

Initiating a buy-in against a failing counterparty will become a legal obligation under CSDR, with limited timing options to complete the process. The payment of the difference between the buy-in price or cash compensation must then also be made by the failing trading entity.

So far, substantial opposition from industry, has contributed to a deferral of the implementation date of SDR to February 1st, 2021, however many believe this extension will not be sufficient to allow time to solve many of the problems.

In the UK, many instruments in OTC and quote-driven markets do not trade on cleared order books, instead they rely on market makers to provide liquidity. This makes the proposed settlement discipline regime a key issue for participants in those markets.

As a result, industry associations are calling for a deferral of the mandatory buy-in regime until the effects of penalties and other measures to promote settlement efficiency are implemented.

The extent to which the UK will deviate from EU regulation is yet to be seen. In time, it is likely to adopt the CSDR's settlement discipline regime, but this is likely to be carefully considered.

ONGOING CLIENT MIGRATIONS

With continued focus on the logistics of migrating clients across systems rather than solely addressing regulatory obligations. While most of the migrations may have taken place within the transfer window, there are material populations of clients and their positions where this has not yet been possible for the following reasons:

- The EU based solutions being implemented are nominally the same as the current UK solutions. However, there are significant customisations being made that are not always fully documented or understood, causing delay as these are analysed.
- In the existing 'as is' UK businesses, it may be the case that the client positions are not well understood end-to-end, due to complexity and/or sensitivity.
- Brexit has had a long duration. As a result, FSOs are reporting that, what initially began as a migration, is now facing other complications and regular reviews. e.g. UMR and KYC.
- Client migration programmes have suffered from significant resource shortages (both numbers and expertise).

One of the outcomes is that the common industry approach to introduce an EU based systematic solution at short notice, is highlighting the gaps in knowledge and functionality in the current model. These gaps will be magnified, with potential commercial and regulatory impacts if they are not addressed.

REGULATORY EQUIVALENCE

Equivalence is looking increasingly like an ephemeral activity. HM Treasury has delegated oversight powers to the PRA, and the Bank of England will replace EU authorities in the role of FMI authority in the UK. Already there are open questions as to how much the BoE and PRA will follow the ECB and EBA approaches.

Reporting obligations need to be reviewed by every FSO to ensure the requirements of which regime requires what reporting, is clearly understood and the necessary changes are in place to support this. One example of this is the securities Financing Transactions Regulation (SFTR).

From 11th January 2021, UK FSOs trading through EU branches will be required to report under both UK SFTR and EU SFTR. A key difference between UK SFTR and EU SFTR is that non-financial counterparties (NFC) in the UK will not be required to report under UK SFTR. However, in the EU, transactions executed by NFCs will need to be reported under EU SFTR from 11th Jan 2021.

Recently, European OTC markets made headlines after ESMA's announcement that all EU firms must maintain their derivative trading obligation (DTO) within EU recognized trading venues, and not on UK-based venues, given the UK will no longer be operating under the terms of the transition arrangements or equivalence.

This impacts the extension of CCP equivalence granted by the EU on UK CCPs. It reinforces ESMA's power to grant equivalence and forces trading onto EU obligations to make it easier to eventually move clearing of derivatives into the EU.

ESMA has decided that since most UK venues have created Brexit-hedged entities inside of the EU, it will mandate DTO trading derivatives on those venues. Many of these venues currently have limited liquidity, leading to higher cost to transact when compared to the liquid UK venue.

The market and participants reaction to the new trading conditions will determine the impact to FSOs, with either some fragmentation of trade activity on separate venues (most of which are wholly owned entities based in the UK), or the loss of business for EU market participant firms based in the UK with UK clients.

In the meantime, the EU will continue to monitor EU venues and look to improve its regulatory reach to enhance euro-denominated clearing with ESMA's scope over the long run.

CONCLUSION

The lasting impact of Brexit will almost certainly not be clear for some time. Many aspects of the future accord between the UK and the EU will remain open until after any temporary extensions have elapsed.

Regulatory cooperation is complex and is likely to become increasingly politicised in the aftermath of Brexit, calling the durability of any regulatory equivalence agreements into question.

So far, FSOs have responded well to Brexit. By migrating the relevant clients and positions to the EU, establishing EU entities, and absorbing the immediate regulatory compliance impacts into their business controls; they have created a solid platform from which to build.

While this is a robust initial response, the reality is that many of the key decisions and actions remain open and are dependent on the outcome of ongoing UK and EU trade and regulation regime negotiations. Solutions will need to be agreed and implemented swiftly in 2021, to address the challenges that will emerge.

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