BREXIT DAY 2:
REGULATORY PRESSURE TO RETHINK THE BOOKING MODEL

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In response to Brexit, some financial services firms have decided to go with the simplest and quickest solution, by implementing a back-to-back booking model. As we introduced in our Preparing for Brexit Day 2 article, under this model business transacted out of the firm's European Economic Area (EEA) entity is transferred back to the UK entity through an internal trade, making it easier to keep staff, risk and liquidity management centrally in London. European regulators are, as expected, against this approach and have mandated a change to ensure the risk of the business is managed locally. As a result, we see the need for firms to consider adapting their current Brexit Day 1 strategy.

The main proponent of a booking model change is the European Central Bank (ECB). In a letter written to financial institutions, the ECB provided a period of three years from autumn 2018 to amend the current back-to-back structure. During this period, there is an expectation that banks will phase out most of the back-to-back business and provide an exact plan and approach to reducing this model within the functions (risk, compliance, people, etc).

Most EEA regulators such as BaFIn (the German Supervisory Authority) have followed this example, setting out specific booking model requirements, with some being more stringent than others. In this regard, BaFin has classed the 'empty shells' as unacceptable and set the expectation of local risk management. In addition, European supervisors have advised that the banking authorization, required by all banks within the EEA, could be refused or revoked if national authorities do not think a firm is genuinely operating from the local entity or does not have a 'meaningful presence' there.

Overall, the back-to-back booking model is not new to the industry, with many firms using it to reallocate the risk of Asian trading activities to the UK – so why is the EU exceptionally strict? The reason for their concern is two-fold: On the one hand, there is an expectation that legal entities are not used as 'shell companies', as this results in a lack of transparency and imbalance between where the business is conducted and where the economic gain is located. On the other hand, they wish to safeguard against potential risks in a crisis. If firms use their EEA entities, often newly created, as 'brass-plated' operations with substantial business undertaken, they would struggle to handle a crisis independently due to insufficient capital resources to cover the downturn.

Therefore, it is evident that a change is required. We see a clear need for firms to reshape their booking models and come up with a refined EEA booking model strategy in the medium and long-term.

MEDIUM-TERM BOOKING MODEL STRATEGY

To comply with the current regulatory provisions, which are not set in stone, it will be imperative for firms to decentralise their risk management function in the medium-term. This can be achieved by implementing a local risk control booking model. Under the local risk control booking model, trades are booked and managed locally rather than the risk transferred back to London.

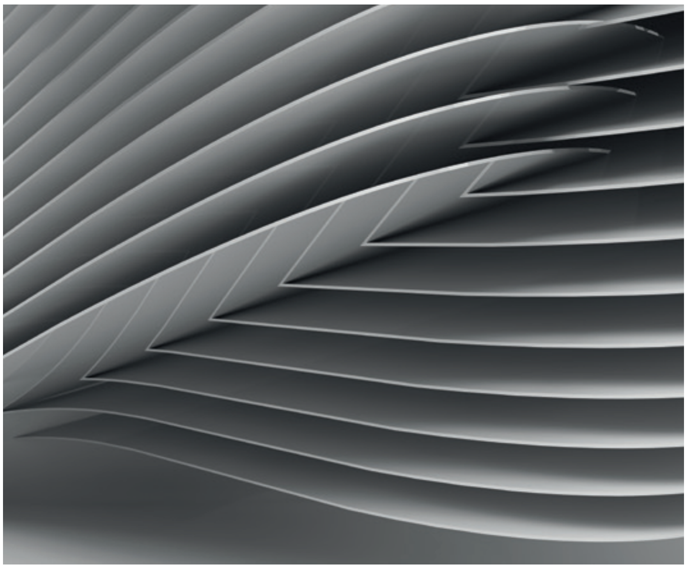
Though this model satisfies the current regulatory requirements by having a fully functioning local entity, there is a significant impact on the organisation's costs due to local capital requirements and the additional resources required.

From a capital requirements perspective, the local entity will need to be fully capitalised to fund trading activity, representing a significant overhead cost to the organisation. Firstly, overheads will rise through the additional liaison required with the local regulator and the additional reporting obligations required to comply with EU and local law, both of which are time-consuming. Secondly, the correct technology needs to be in place to carve out the local entity specific data required to perform the capital requirement calculations and create these regulatory reports. Finally, there may be an additional layer of complexity due to things such as differences in entity credit rating, resulting in an impact on collateral and risk weighted assets (RWA) requirements, as well as jurisdictional market differences, which could make sourcing liquidity more difficult if the local market is less liquid.

In terms of resourcing costs, the entity will need to be fully resourced to face off to clients, manage the risk, perform independent capital, leverage and risk-weighted calculations and perform compliance activities. This duplication of staff across London and the secondary location represents a cost that needs to be carefully considered when defining the medium-term booking model strategy.

LONG-TERM BOOKING MODEL STRATEGY

In the long-term, it may not be enough to implement this sub-optimal local risk control model. An extensive analysis of the booking model will need to be conducted to determine the best long-term model to meet economic and regulatory requirements as well as align to the firm's strategy. The necessary resource, capital and liquidity requirements will depend on the model chosen. Overall, in addition to appropriate risk management at local entity level, additional considerations include the need to ensure appropriate booking model governance and controls as well as ease of position wind-down in a resolution scenario through a clearly defined process.



The abovementioned considerations on governance, controls and wind-down processes need to be built into the model design in order to meet regulatory expectations regarding controls on cross-border trades and bankruptcy scenarios. Despite the time and effort this requires, we encourage clients to view it as an opportunity for booking model optimization. Such analysis could include reviewing booking practices used across the group and could uncover global opportunities for improvement as well. Once completed, this work could result in a more efficient long-term strategy and global booking model.

LOOKING TO THE FUTURE

Planning a strategically optimal booking model now will give financial services firms both opportunity to engage proactively with regulators and national supervisory bodies and give them enough time to implement a strategically optimal model. Simply being reactive to the requests to iterate the booking model as and when they come in could lead to yet another tactical version of the booking model, along with the associated adverse impacts to cost and efficiency. In addition, regulators tend to benchmark according to their first impressions. Firms that are first to remediate are therefore less likely to have their models adversely compared to peers. This will save rework, cost and additional requests from the regulators. All in all, it makes sense to mobilise sooner rather than later to get ahead of the curve.

In our next article, we will consider further both the cost consideration but also focus on the opportunities for firms to challenge the implications resulting from Day 1 planning and explore opportunities to increase revenue. In the meantime, feel free to contact Rehaan Anjum to discuss the implications of Brexit on your business.