Brexit: working with uncertainty

Strategic considerations for financial institutions

April 2018
Summary

This is the sixth in a series of board papers from EY, assessing the potential direction and likely implications of Brexit for the financial services sector in the UK. In addition to our own thinking, the ideas contained in this paper are based on a continual programme of discussions with governments at both political and administrative levels, as well as with firms, regulators, professional observers and analysts from across Europe.

Most boards have now made major material decisions in respect of business model and locations. Many have already started implementation projects – those who are waiting will need to act now if they are to negotiate a potential ‘cliff edge’ Brexit successfully in April 2019.

We publish just after the March EU Council meeting confirmed political agreement to the terms of a transition period and negotiating guidelines for a future framework. This is not the entirety of the Article 50 exit agreement, all of which needs to be agreed and ratified if a transition period is to be confirmed. Among other things, the status of Northern Ireland in the talks and a dispute resolution mechanism still need to be negotiated. Final positions are unlikely to be agreed until October at the earliest, and will then need to be approved by a qualified majority of the EU27 Member States, the EU Parliament and the UK Parliament too.

We note that, whilst a hard exit would be in neither side’s interest, a great effort and a good deal of compromise will be needed to avoid this.

Therefore, our expectation is that, for the majority of financial institutions currently in the UK, Brexit will turn out to be a source of inconvenience as opposed to a disaster, and for the City, it will represent evolution rather than revolution. For financial institutions, there will be a major operational challenge in reconfiguring IT platforms, transferring data and reporting to multiple regulators, whilst optimising their new business model and retaining talent.

Brexit is just one of the forces driving a forthcoming period of unprecedented uncertainty and volatility, which will pose existential risks to most financial institutions. These include the digitalisation of financial services, ageing demographics and the pivot of the global economy eastwards. Developing a world view, crafting a winning strategy in response and managing volatility will be the key board skills required.

We are grateful to all those who have taken the time to contribute to our thinking, and welcome the opportunity to debate and discuss the views presented in this document.

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We have discussed in previous papers that Brexit is a process and not an event. Now that the broad outlines of an overall transitional deal have been agreed, we expect talks to move on rapidly towards shaping a bespoke trade deal including financial services between the UK and EU. The UK Government is targeting June 2018 for an early agreement, but all major components of the deal will need ideally to be in place by September 2018 to meet the EU Council and parliamentary timetables.

For planning purposes, our current broad expectations are:

- There will be a transition phase from the point at which the UK formally leaves the EU (11:00 p.m., UK time, 29 March 2019), during which the vast bulk of the status quo, including passporting (excluding UK participation in EU political institutions or rule making), will remain in place until 31 December 2020. This transition period may need to be extended beyond this date due to the complexity of agreeing a new trade deal.

- In financial services, there will be no immediate significant regulatory divergence, with the vast bulk of EU law ported into UK law post-transition, although it will be gradually and selectively modified in some areas thereafter.

- The interests of financial services in general and the City will be considered, but not as the top priority for UK Government. While, we expect the short-term impact on financial services in the UK to be relatively minor the longer-term consequences are harder to predict. The most significant unknown for all financial institutions will be the indirect macroeconomic impacts of Brexit and the possibility of it contributing to an economic downturn.

- It is very likely that the UK will leave both the single market and the EU Customs Union. There will not be a continuation of financial passporting rights in their current form after the end of the transition period. Visa-free travel in both directions will remain, as will grandfathering of residence or work rights of legal residents, during the transition period.

- There will eventually be mutual recognition for wholesale financial services on the basis of equivalence of outcomes rather than regulatory replication, although the road to this will be difficult and may ultimately be driven by the European Commission’s revisions to its own third-country equivalence regime, rather than any bespoke UK deal. The UK’s position for incoming wholesale firms will reflect its global status and may be more accommodating than the EU27 position.

- London will continue to remain Europe’s premier location for financial services, although its structure and composition will evolve. The practical difficulties, not to mention the potential for significant instability that would arise from attempting to move significant chunks of financial infrastructure to the continent, mean any significant geographic moves should be measured over an extended period of time. Perhaps an equally important question is whether other global financial centres will be able to capitalise on European uncertainty and take business away from the UK and EU27.

- The EU may also have to deal with considerable political and economic volatility, as governments and institutions vie for primacy in defining the future shape and direction of the EU. In addition, the appointment of a new Commission and forthcoming elections to the European Parliament may be critical to its future shape.
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| 23 March 2018| EU Council meeting
Transition deal agreed |
| 26 March 2018| Proposed amendments to keep UK in EU if UK Parliament votes against final deal |
| 3 May 2018   | UK local Government elections |
| 22 February 2018 | Proposed amendments to EU trade bill to keep UK in Customs Union |
| 28 June 2018 | EU Council meeting |
| 18 October 2018| EU Council meeting |
| 29 March 2019| Brexit |
| 31 December 2020| End of transition |

Future framework negotiations
October 2018–March 2019
Ratification of final Brexit deal in UK parliament 'Meaningful vote'?
Regulators find themselves in an unenviable position. With limited direct involvement in the development of political positions and the negotiation, they will have to find solutions to cope with a heavy transition workload. Alongside this, they will need to address the immediate risks, whilst laying the foundations for the future regulatory landscape.

Memories of the financial and Eurozone crises remain fresh and the consequences are still unfolding in several countries. As broad economic growth improves, officials remain focused on addressing residual problems, particularly on the continued clear-up of nonperforming loans and the transparency of balance sheet strength. A significant financial shock resulting from Brexit could put at risk the achievements of recent years. And as the post-crisis global regulatory consensus that guided the reform agenda of the past decade begins to fray, regulators are increasingly moving towards robust, local oversight of activities and risks in their jurisdiction.

This is driving short-term regulatory and supervisory principles, which require businesses to have meaningful management, operational and risk capabilities in jurisdiction. There is also increasingly loud encouragement, particularly on the EU27 side, for firms to move into full implementation, in order to give as much time as possible to mitigate Brexit ‘pinch points’, e.g., of contract continuity and customer re-papering. On the other hand, recognising the volume of work required for both industry and themselves to complete the transition into the new world, EU27 supervisors are looking to exercise a level of discretion about what needs to be in place on day one and what can be built on over a relatively limited time thereafter.

Differing agendas at a national and consolidated European level will also complicate the regulatory environment. The UK authorities have proposed an authorisation route that seeks to minimise disruption to wholesale business, on the assumption of strong levels of ongoing regulatory cooperation, which both sides want but where the extent of reliance on others will be in the detail. A transition period should relieve some of the pressure on compressed programme timescales and allow these questions to be resolved more thoroughly.

Industry is also conscious that, ultimately, what needs to change will depend on the shape of any final agreement – particularly for financial services, whether the continued cross-border provision of services will be permitted or not. The EU’s regime for considering the ‘equivalency’ of third-country standards is the current basis for it to allow such services. But the ‘equivalency regime’ is recognised as variable and inconsistent, and is currently under review and likely to be strengthened as set in the annex of the EU’s draft negotiating guidelines. Nonetheless, a transition period could give sufficient time for equivalency decisions to be made to at least maintain mutual access between the EU and the UK, as is the case for other global centres. The UK is seeking a more complete relationship on the basis of mutual recognition, with that recognition based around the commitment to global standards and achievement of positive outcomes, rather than a detailed replication of rules.

Further, the European supervisory authorities are exercising an additional level of control to ensure consistency of application in EU27 countries. One of the considerations for the post-Brexit world may be more consistency in rule application in the EU.

Whatever the result, mechanisms will need to be established to recognise and manage regulatory divergence over time, as both sides adopt changes to suit their markets. Regulatory cooperation will need to be strong in order to supervise cross-border groups effectively and efficiently.

Such a move towards consistent and aligned, but not necessarily fully standardised, requirements will be needed globally to cover a wide range of multinational risks. Global firms will need to invest to find ways to optimise systems, controls and data to accommodate local requirements, whilst leveraging common platforms where possible.

We do not believe that, in seeking an outcomes-based agreement, the UK will abandon its long-standing commitment to high regulatory standards. The UK has led many of the post-crisis reforms both globally and in Europe, and it still has a very large financial sector relative to the economy. So – and whilst it may move away from standards that it does not view as relevant or helpful to achieve regulatory objectives – it will, in our view, continue to champion robust regulatory standards that are appropriate for a rapidly changing financial world. An example is the UK’s work to support the development of innovative technologies – whilst identifying and actively addressing the concurrent risks – which will help to both enhance customer experience, and reduce administrative and regulatory costs. Agility in developing regulatory policy and practice for these developments will be important for global regulatory cooperation and the international competitiveness of financial centres.
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| Equivalence                               | ► The purpose of equivalence in financial services is to ensure financial stability whilst maintaining an open and integrated market.  
► It allows two jurisdictions with different rules to recognise each other’s standards to facilitate cross-border exposures and trading, by checking whether their regulations achieve the same outcome.  
► Each side sets its own criteria for approval and the terms for access, making equivalence decisions unilateral.                                                                                                                                                                                                                                                                                                                                                     | ► This is considered as a reserve option if the UK and the EU fail to agree a bespoke agreement on financial services.  
► Any agreement on equivalence may increase uncertainty for firms, as equivalence agreements can be withdrawn as easily as they are granted.                                                                                                                                                                                                                                                                    |
| Mutual recognition within the EU          | ► The principle of mutual recognition stems from Regulation (EC) No 764/2008. It defines the rights and obligations for businesses that wish to market their products in another EU country; therefore, products approved in one country can be sold in all EU Member States, even when national rules differ.  
► EU institutions can enforce standards and adjudicate disputes with powers to overrule government in local markets.                                                                                                                                                                                                                                                                                                                                                           | ► The EU is moving beyond mutual recognition in some sectors, including financial services, and towards a Single Rule book – to provide a single set of harmonised rules.                                                                                                                                                                                                                     |
| Mutual recognition in trade deals         | ► Mutual recognition in trade deals, more commonly known as mutual recognition agreements (MRAs), promote consistency in checks and testing to allow smoother trade.  
► They allow the conformity assessment to be performed by the trading partner (e.g., third-country regulator trusted to test if a product meets EU standards).                                                                                                                                                                                                                                                                                                                                                           | ► They save time and costs because a product needs to be tested only once.  
► However, they do not recognise if a third country’s standards are adequate.                                                                                                                                                                                                                                                                                                                                                     |
| UK’s mutual recognition model             | ► This would give the UK freedom to set rules whilst retaining access to the EU market if standards across the UK and EU are sufficiently aligned.  
► The UK would maintain ‘substantially similar’ standards that would allow similar outcomes and be consistent with good practices.  
► Access would be restricted only if and when the EU or the UK decides to diverge significantly and would be subject to dispute resolution policies independent of the parties.                                                                                                                                                                                                                                                                  | ► The UK would have input to decision-making.  
► Both sides can discuss rules changes and handle disputes.  
► This may be deemed unacceptable by the EU as it could be seen as keeping the benefits of being in the single market.                                                                                                                                                                                                                                                                                                          |
Brexit will be just one of the major forces shaping the structure and nature of financial services in the current decade. Just as the political elements of Brexit will be conducted within a complex network of potentially significant changes within Europe, so a volatile roster of environmental changes will affect financial services. These include, in no particular order:

► The pivot of the global economy eastwards
► The demographic challenge in Europe
► The emergence of new significant competitors
► The opportunities and threats posed by technological change
► The change in public perception of financial services providers
► The damage to traditional profit models inflicted by ‘unconventional’ monetary policy and economic stimulus initiatives by central banks
► A new complexity and stringency in the regulation of financial institutions
► A rapidly changing international tax environment, especially the significant corporate tax reforms recently introduced in the United States

For certain classes of business and types of institution, the whole business model itself is being called into question, and survival and reinvention are the key strategic priorities.

Key challenges for financial institutions will include:

**FinTech:** the convergence of technology and financial services is bringing major change to the competitive landscape and essential change for some players. The impact of blockchain in intermediated markets is yet to be seen but, if able to realise its potential, it could dramatically re-shape the roles played by many traditional firms. The entry of major technology and media corporations into financial services, often indirectly, will reinvent whole markets, with payment infrastructures being an obvious starting point. Competition for retail customers will intensify on the basis of low-cost, highly personalised offerings.

**Pensions and savings:** declining and ageing populations in much of the developed world present enormous social challenges for nations and governments, and equally present significant threats and opportunities for financial services providers. The long period of low yields is driving a relentless regulatory focus on cost but the pressure of an ageing populations on public finances and traditional pension schemes are creating both opportunities and competition for pension providers and wealth and asset managers. Whilst a backdrop of the wealthiest ever generation enter retirement and governments seek new savings solutions for the working generation.

**Financial reporting:** a combination of new technology, new requirements and regulations and an evolving public transparency agenda will lead to new forms of public financial reporting that will enable new metrics to be available to regulators, government, preparers and the investor community.

**Wealth management:** growing wealth in society creates new opportunities for private banking, and retail and institutional wealth management clients. It is accompanied by growing debates about international tax planning and the propriety of certain products and approaches. Some international financial centres (IFCs) may have to re-evaluate their entire business models in the light of shifts in international tax law and public opinion.

**Governance:** financial institutions have yet to regain public trust fully following the financial crisis. Consequently, political and consumer pressure for tighter control, supervision and the restraining of financial institutions continues. These forces will place as much – maybe more – strain on the business model as the technology, political and market forces discussed in this section.
There is still much that is uncertain about Brexit and the City, and some boards believe it prudent to plan for the worst possible outcome for their particular institution. While still possible, we attach a low probability to a ‘no deal or cliff edge’ Brexit. We also believe that, whilst one or two particular institutions may be disproportionately and adversely affected, for the majority of financial institutions based in London, and indeed for the City itself, Brexit will be more of an inconvenience than a disaster.

The most significant challenges will most probably be indirect rather than direct, namely the macroeconomic effects on the UK economy overall, and the application of future UK immigration policy with respect to both the EU and elsewhere.

We believe that the City will continue to be the financial hub for the European continent and will remain a tier-one global financial centre. It will deploy its considerable entrepreneurial talents and unmatched professional infrastructure to build powerful responses to capitalise on such fundamental shifts as the pivoting of international trade power eastwards and the rapid growth of all things FinTech. As always, its membership, activities and processes will change over time, but we expect this to be gradual rather than dramatic, and for positive and negative changes to largely balance each other out.

In some quarters, there have been calls for an immediate and radical post-Brexit divergence of UK financial regulation from that of the EU27 in order to create a dynamic, flexible and loosely regulated financial services powerhouse. We think this is highly unlikely, not least because many senior figures in UK financial services regulation are resolute and on record that this is not a favoured direction of travel. This is partly because these same regulators had a big hand in crafting Europe’s current rules and believe that close alignment between the UK and Europe based on mutual recognition will be in everybody’s best interests, not least for enhanced financial stability.

Nevertheless, gently and over time, we expect some degrees of difference to emerge. These might include the implementation of Solvency II, where the UK is believed to favour easing risk margin and reporting arrangements; proportionality where the UK has indicated it may wish to have greater differentiation of supervision between wholesale and retail firms, and between large and small firms; and removal of bankers’ bonus caps, which UK regulators claim to be counterproductive but which will be highly contentious with the average British voter. There will also be a fierce debate between those who would relax regulation in pursuit of greater international competitiveness and those – principally regulators with strong memories of the crisis – who prize systemic stability above all else.

As mentioned throughout this paper, boards will need to consider the wider impacts that environmental changes will have on their business – Brexit should not be viewed in isolation. In this world, first-class management in financial institutions will be at a greater premium than ever.
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