A bank’s guide to Brexit success
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Management Summary

There are less than 22 weeks to go until Brexit will become effective. Not knowing yet, how the final Brexit framework will look like, major changes can be expected.

Even if politicians and regulators on both sides of the channel agree to minimise and absorb any impact to prevent financial turbulence, the remaining EU-27 may not be willing to allow the UK to become a strong offshore financial hub in such close proximity to the EU.

As a result, BearingPoint expects major implications in the following areas:

- Proximity and intensity of customer relationships
- Execution of securities and derivatives strategies and end-to-end business for products (placement) over trading, risk management to settlement operations
- Execution of payment transactions
- Variation of banking regulations starting with licensing and ending up in fulfilment of regulatory reporting requirements
- Organisational shifts due to relocation, but also with respect to the upcoming generational change that might cause a decrease in productivity whilst cost will dramatically increase

Brexit presents clear challenges for the EU banking industry and the supply of banking services across the EU. Being in the Brexit journey about more than a year until March 2019 has transpired for banks that there is a significant transformational activity involved as banks, regulators and clients are working parallel to form and execute their plans in preparation for the UK’s departure from the EU-27 area. Banks are already making steps forward of minimizing the impact of a potentially ‘hard’ Brexit. Still the current ability to service the single market, based on the current standards of success, won’t be feasible to be replicated in the remaining timelines provided. Regulatory challenges will mandate both the banks and the regulators to agree on a realistic and pragmatic approach to facilitate the structural and transformational changes required within a short time period.

In addition, once the relationship between the UK and EU-27 is known and fixed, banks will have to work further to address the operational and organisational challenges arising from the migration of certain functions, as well as implement strategic long-term solutions to service clients and to facilitate an orderly transition. Furthermore, this is adding to the war for talent and the need of digital transformation to service the changing client needs to the list of considerations and decisions financial institutes will have to take sooner rather than later.

The immediate consequence of a Post-Brexit banking landscape, whatever the deal between EU and UK will look like, will be the end of the passporting regime and thus the end of EU passporting system, which has been the back bone of the European single financial services market.

BearingPoint provides an overview of some of the key challenges banks are facing, as well as a guide to address the more operational and organisational decisions to be made in a simple step by step process.

Be aware (of desired measures from client to regulator perspective) take Realistic measures, manage Expectations well coherently express your thoughts identified and well prioritised Implications to successfully perform your own Transformation
Background of Financial Regulation in the UK – the UK perspective

While busy launching digital transformation initiatives, the European financial services industry was taken by surprise when the UK parliament invoked Article 50 to begin the process of leaving the EU following the referendum in 2016. With London being the financial hub of the EU, the outlook of losing market access (“passporting”) implies substantial changes to the business models of many banks with operations in the UK. Numbers quantify the magnitude of this change: the trade body, TheCityUK1, estimates that 70 percent of the market for euro-denominated interest-rate derivatives and 90 percent of European prime brokerage are written in the City. The Bank of England estimates, that £26 trillion of outstanding uncleared derivatives contracts could potentially be affected.

As the due date of March 29, 2019 is looming, banks are left with very limited time to develop action plans that take an uncertain Brexit negotiation outcome into account. This challenge poses a substantial threat to the digital transformation initiatives, that clients nowadays insistently demand. Moreover, a Brexit induced reallocation of resources could imply that other projects are put on hold or even become obsolete. In that context, EU-27 banks may have a competitive advantage over foreign banks as they have a smaller dependency on London. As a matter of fact, recently passported foreign banks are relocating and applying for a bank license in the EU. In any case, many market players will also experience Brexit-related transitions at the same time. We likewise expect transition effects among those who support banks, such as law firms, clearinghouses, consultants, IT and other service providers who choose to follow their clients to the EU-27 area.

Currently branches of EU firms operating in the UK have a wide range of possible business structures and activities:

1. Firm passports into the UK (either via a branch or on a cross-border services basis)
2. EEA firm markets funds in the UK
3. EEA credit institutions set up as a UK subsidiary and take deposits in the UK
4. Insurers that passport into the UK

All financial institutions are authorized (licensed) by the FCA (Financial Conduct Authority) but some institutions (and all funds) are solely FCA-regulated and supervised, either indirectly under their passporting arrangement or directly. In this case, FCA regulation involves both conduct and prudential risk supervision.

Other firms – deposit takers (credit institutions) or insurers – are regulated by the FCA (for market conduct and business standards) and also the PRA (Prudential Regulation Authority, for prudential risk supervision).

The UK government has stated that it aims to maintain the status quo of EU directives and regulations for financial services at the point when the UK leaves the EU. This means adherence/compliance with MiFID II/CRD IV/EMIR etc. but applied directly under UK law instead of EU legislation (known as “onshoring”).

Regulators’ opinion about post-Brexit landscape

Both the FCA and the PRA (Prudential Regulation Authority) are preparing for inward passporting branches of EU banks and investment firms so that they are able to continue operating in the UK during any transition period and beyond. The EU Council has agreed to a Brexit transition period until the end of 2020. Both UK regulators intend to preserve continuity for financial institutions, and the UK Government will ensure that a legal backup solution is prepared should UK legislation (permitting this continuity) fail to get through the UK legislative process.

Even though the FCA and the PRA wish to preserve continuity throughout Brexit, they have expressed a position that some existing branches may be required to convert to a subsidiary in the UK. Furthermore, both UK regulators are proposing that companies do this as a “fail-safe” in case EU/UK trade negotiations result in a “no deal”.

The status of EU financial institutions’ UK branches post-Brexit will depend on two factors:

1. The PRA’s and/or the FCA’s view of the adequacy of its home country’s regulation
2. A branch’s significant level of activities that might affect UK financial stability

The logic around adequacy of the home state’s regulation is the same as for non-EU international financial institutions with branches in the UK:

- If EU regulators are deemed equivalent to the UK regulator, then EU bank/investment firms that have a UK branch will be regulated by the EU firms’ home country supervisor.
- If the UK leaves the EU with no reciprocal agreements regarding regulatory equivalence, then UK regulators will decide on a case-by-case basis whether a home state regulator of the EU parent institution is equivalent to the UK regulator.

The logic regarding the branch’s substantial level of activities that may affect UK financial stability is detailed below and is dictated by the changes to the PRA’s authorisation process.

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1 TheCityUK: Continuity of cross-border financial contracts post-Brexit
2 Source: Statement by UK Chancellor 20 December 2017
The PRA’s change in authorisation process and its implication for EEA based banks operating in the UK post-Brexit

At present, branches are mainly overseen by their home supervisory authority and can repatriate equity overnight; subsidiaries are directly overseen by the PRA and must retain equity and liquidity within the UK. It is important to highlight that the Bank of England’s approach to bank and insurance branch authorisation is based on the presumption that the supervisory cooperation with the EU will continue following Brexit.

Under the passporting regime, the PRA assumes that the home states’ supervisors have equivalent objectives and regulatory standards. In line with applications for branch authorisation by non-EEA banks, the PRA requires the whole firm (entity) to meet the following equivalent threshold conditions:

- The home state supervisor’s regulatory regime is sufficiently equivalent to meet outcomes-based international standards
- Delivered results must be consistent with the PRA’s objectives
- The PRA requires adequate assurances over resolutions

A new authorisation and supervision approach addressing banking activities in the UK market post-Brexit has been set up by the Prudential Regulation Authority (PRA) together with the Financial Conduct Authority (FCA). This also affects branches of European Economic Area (EEA) banks currently operating under passporting rights in the UK market. Affected banks are required to apply for PRA authorisation for their UK branches either as a full UK banking subsidiary or as a third country branch.

Third country branch or UK subsidiary

Apart from the PRA’s requirements and authorisation process, banks may consider a transition from a third country branch to a separate legal entity. Consequently, the change of supervisory authority would impact regulatory reporting. If a branch considers increasing its business activities and operations, i.e. transforming into a subsidiary, the FCA and the PRA would be supportive of this overall transformation process. As a result, the bank is directly supervised by the Bank of England and the PRA. This means that while UK subsidiaries need to complete statistical and supervisory reporting to the Bank of England, branches do not or may need only to submit a summary of this information via the Branch Return.

There are two obvious implications for branches that choose to apply authorisation as a subsidiary UK bank: Firstly, despite being an independent legal entity, the subsidiary must continue to deliver required data to the European headquarter bank for group level reporting purposes. Secondly, is that large parts of European regulatory reporting requirements are implemented according to UK national law. After Brexit, the current assumption is that transposed EU rulings would still be the applicable law in substance, but under UK legislation. Consequently, the reporting requirements under EU Implementing Technical Standards remain for both branches and subsidiaries with the only difference being that branches are incorporated in the parent institution’s results. Effectively, the main change is that subsidiaries must create national UK reports instead of their own domestic reports.

Whatever banks have in mind, the UK regulators have promised to provide extensive support in order to maintain and attract incoming EEA banks, either as a branch or as a subsidiary. However, the first priority for UK legislators is to maintain the status quo for the branches which currently make use of passporting rights. The second priority is to assist in potentially transforming from a branch into a subsidiary.
The PRA also expects new branches of international banks operating in the UK to focus primarily on wholesale banking activities. The PRA may require firms with significant retail banking activities to operate as subsidiaries. However, the general intention of the PRA is to leave it up to the banks to decide whether they want to become – or remain being – a subsidiary or convert to a branch. However, passing a pre-defined size threshold would require banks to set up as a subsidiary under direct UK regulation.

The PRA may require general wholesale branches to adhere to additional regulatory requirements or to operate as a subsidiary under the following conditions:

- If the firm holds more than an average of £15 billion total gross assets including those traded or originated in the UK but booked remotely to another location
- The firm’s critical functions are undertaken within the branch located in the UK
- The firm’s overall complexity and inter-connectedness of the business undertaken in the branch may be taken into consideration, if, for example, it provides significant operational services or is otherwise interconnected to a systemically important UK bank

Figure 1: PRA’s approach to branch authorisation and supervision post-Brexit
On the move to continental Europe

The discussion around the challenges of Brexit for the financial sector does not only focus on EU-based banks accessing the UK market today on a cross-border basis from the EU, but also on British and international banks accessing the European market, which will be tremendously affected too. Brexit poses several compliance challenges to non-EU banks (American, Swiss, Japanese etc.) as well as British banks after 29th of March 2018. These have been benefitting from the passporting rights and might lose the ability to generate business in the EU via their presence in London. More than 50 international institutions are at an advanced stage in their application for a banking license to operate in an EU financial hub (Frankfurt, Paris, Dublin, Amsterdam etc.), that hopes to maintain the current benefits of operating in a single European market. Many of the banks are full-fledged CRR-Institutes (Capital Requirements Regulation) operating directly under the supervision of JST (Joint Supervisory Teams) including a local national competent authority and the European Central Bank. The EU institutions work in cooperation with the competent local authorities, which are keen to accelerate the application process and have appointed dedicated staff to interact with the financial institutes. Furthermore, the supervisory authorities are setting up clear criteria to deter the creation of “shell branches” or “letter box” solutions. Applicants should therefore meet the following requirements:

- Setup a fully developed internal risk management function
- Ensure compliance of outsourcing with critical front- and back-office processes
- Risk, compliance and internal auditing processes must be staffed sufficiently and be well-supported by adequate technology infrastructure. Full scale sourcing of these activities in a third country, e.g., in the London headquarters, will not be accepted
- Direct control and monitoring of management to avoid concentration of conflicting roles and to ensure effective and adequate segregation of duties

Even if in many cases the application process can be facilitated through an existing branch or subsidiary in the EU, it is clear that institutions will need to make a major effort and have sufficient resources to meet the comprehensive application requirements. Supervisory authorities and financial institutes are already aware that implementation projects will last far beyond the deadline of March 2019.

The challenge of a cross border merger: a regulatory perspective

Mainly UK based firms, providing services on a cross border basis, are affected by the loss of access of the EU financial services market. London offered an easy-to-operate entry for foreign banks into the European financial market via passporting rules for a wide range of services, from wealth management to corporate and trading business. In order to continue to take full advantage of the single market, institutions can carry out cross border mergers (CBM), particularly if an institution already has an EU subsidiary into which the UK business can be incorporated. The difficulty does not lie in defining what should be done, but in the implementation of the approach under a tight timeframe and under the current level of uncertainty. CBMs already pose one of the most complex merger cases from a legal viewpoint. Looking at it from a regulatory perspective, banks are facing many challenging questions:

- Depending on the systematic importance of the institution, a direct supervision by the European Central Bank may be mandatory
- An initial comprehensive assessment (asset quality review) will need to be prepared and scheduled in compliance with the supervisors’ expectations
- Stress test exercises must be performed in accordance to a new set of rules based on the supervisors’ criteria
- Assessment and documentation of all the mandatory reports need to be carried out; additionally a gap analysis has to be conducted. For example, if the EU subsidiary increases in size due to the CBM, it may have to shift from a simplified FinRep to a full FinRep, which can impact the required granularity of the reporting data. It also opens the option of an enrichment of the data based on an analysis of the data model and data flow.
- For liquidity reporting (i.e., large exposure) it may be critical to disclose the partner elimination (consolidation) and the intra-group exposure, depending on the availability of the data in one or more sources
- Own funds reports must be created with a transparent distribution of collaterals
- Reports such as the Pillar III Disclosure (even if already available in the “UK” library) will have to be adapted to the new operating entity
- Special consideration should be given to the AnaCredit reporting as it raises the point at the onset of data availability and data quality (BCBS239)
- Statistical reports should be locally specific to the institutions’ national regulator in the new country
Automation will be key to delivering timely, top quality data for regulatory requirements as the information will be scrutinized and supervised in accordance with the implementation of the target business and operating model. Therefore, it is a paramount for institutions to identify sustainable and scalable solutions, supported by innovative and agile technological infrastructure.

**Operational transformation challenges**

Brexit is not just a question of securing continued market access. Setting aside any legal and regulation issues, during the transition:

a) performance and production must be maintained at a high level

b) operations following a successful transformation, should be optimised and managed by qualified and knowledgeable experts. Irrespective of the final outcome of either a hard or soft Brexit, from the BearingPoint perspective, there are four separate focus areas that need to be understood and addressed:

1. Assess the post-Brexit operational implications in business activities, with a focus on securities and derivatives as well as payments services:

   Brexit will require a substantial operational transformation, particularly in relation to the relocation of certain business functions, such as sales and trading, to the EU-27 area. This is the right time to assess how synergies can be achieved with respect to the implementation of IT and operational processes that will lead to a successful digital transformation.

   The first step is to articulate the AS IS state with information on the key elements of its business environment, such as strengths, weaknesses and opportunities versus those of competitors. The holistic business model shall apply a “value chain” perspective on the entire organisation, offering to the management an alternative look on the internal and external relationships that constitute the foundation of how the company operates on a daily basis.

   The Bank has to focus on its core business with a clear view on its offerings, approaches, target markets and used infrastructure. It has to operate according to regulatory requirements, which requires to adopt and amend necessary internal and external reporting. Banks should define Brexit related measures with an emphasis on maintaining and growing market share. We identified two major financial service areas, where we expect changes: within the capital markets (securities and derivatives trading), and payment services.

   After Brexit, banks can offer services related to the trade of securities and derivatives either from the UK or from the EU. If provided from the UK, this can only be conducted under a third-country regime or via cross-border services in accordance with each EU member state law. If, services are offered from the EU, if then a subsidiary or a branch should be established in an EU country and local authorisation and passporting rights (under MiFID II) should be obtained. Another possibility to service EU customers is via direct authorisation in the EU member state to permit the conduct of regulated activities.

   The third-country regime raises concerns regarding the unpredictability and the duration of the political process of recognising a country’s regulatory system as equivalent. Provision of services under the third country regime is restricted by other EU regulations including data protection laws and is uncertain regarding access to market infrastructure services like trade venues, CCPs, CSDs etc. In addition, not every regulation provides a third country regime granting cross border rights for doing business in every service area.

   Securities and derivatives service areas, which have been granted passporting rights will require a new redefinition of the firms’ operating model to ensure uninterrupted provision of financial services from UK firms to EU customers. Companies would need to transfer all or a part of their business to an existing or newly established EU subsidiary in case of missing equivalence decision by the European Commission.

   For Payments services, access to the Euro payments infrastructure, i.e., Target2 and SEPA, is vital to execute all business operations. If a “Brexit bank” intends to transfer its payment operations to Continental Europe and is currently not able to operate Target2 and SEPA payments, there are two ways to establish this access generally:

   1. Select, implement and operate an appropriate tailor-made payment system
   2. Use a payment service provider for obtaining access to the payment infrastructure and to operate payments processing with sufficient market know-how

   In both cases, to stay competitive in the payments market, optimal cost structures are needed while transaction pricing for payments - due to the high degree of automation - is on average at a very low level. With respect to the remaining time until Brexit becomes effective, the second option might be the more feasible one to achieve on time.
Additionally, new requirements to secure the internal payment infrastructure as well as dealing with technological challenges, will affect cost structures. In this instance, a service provider might be the right starting point or even be an alternative for operating Euro payments today, short-term and in the near future.

In this context one should take the opportunity to look at the current operating model for optimising Euro payments, or even digitalising them to improve the future fit. For these amongst other reasons, we think it is the right time to revisit IT and operational processes that lead to a successful digital transformation.

2. Manage the transitional organisational and financial impact of Brexit compared to competitors, who, due to their decisions or “historic” set-up, do not need to transform due to the transition. This would leave capacity to focus on executing their most important strategies, e.g. improve their customer-directed digitalisation process:

Whilst the competition, which is not affected by Brexit, can focus fully on the further digitisation of its customers business, Brexit banks must primarily address Brexit, but at the same time promote the digital transformation of the organisation. As a result, initiatives in the context of change in operations and, where appropriate, in customer business, must be chosen with care in order to keep budget and resources targeted. Institutions should concentrate on digital initiatives based on an overarching digital strategy focusing on the entire value chain; starting with customer demand which may reduce costs and, in a best-case scenario, increase innovation parallel so as not to fall behind competitors. Building a common understanding of the organisation’s current state, both of its internal operations and its position within the market, is essential to set the context for the transition and to gather and accurately interpret information received.

Brexit banks need to stabilize production and keep internal performance high, especially in times of uncertainty. Lastly, it is important to synchronise stabilisation and optimisation initiatives so as not to overload the organisation, especially resources tied up in both. If not possible, banks have to strategically choose their measures based on well founded, transparent decisions.

3. Intensify and tie up customer contacts and interaction by delivering state-of-the-art products and services that add value to the customer-bank relationship:

The trust-based customer-bank relationship is affected when a bank undergoes substantial change. This is as true for clients with respect to the digital transformation (e.g., data security, service changes) as it is for the challenges arising due to potential changes in the regulatory environment. Banks are advised to intensify their client retention activities while redefining their relationships with them in the digital age.

Besides, they have to increasingly address the changing needs of their customers. Communication with apps, real-time status tracking of given bank orders while serving 24/7 online availability, are some examples of customer must-haves. Even in corporate and investment banking, it is time to address real client requirements on a more personalised way according to our latest updated study “Digital desires in the corporate banking business of tomorrow” (study currently available at our homepage in German language).

Brexit is not high on the customer’s agenda – as long as they are not affected themselves. They look for state-of-the-art banking solutions and market access, even while Brexit is ongoing. Subsequently, the need for innovation increases as the EU market shrinks but the number of players in the market remains the same.

4. Determine and manage the implications on management and staff derived from strategic Brexit positioning with respect to operational model change and, even more, market driven digitalisation start with client management at the interface to customers and end with support functions to consider the impact of change:

Apart from human resources related measures, banks should implement a functioning governance system early to avoid any possibility of an organisation losing its focus on people. Brexit and digital transformation-related operational changes are particularly constrained among HR-intense business functions. EU and -non-EU managers and staff must be matched with the post-Brexit operating model, organisational structure as well as service and office locations; personnel flexibility should not be taken for granted.

At the same time, Brexit has exacerbated the war for qualified professionals, making recruitment and retention of experienced staff more difficult than ever. This creates the need for measures that span from the promotion of loyalty inside the workforce up to staff development activities to cope with the changing market environment. Especially in times of talent scarcity, there should be new employee reward models that not only provide financial incentives but also further promote the image of the bank. The culture of a bank and the work-life balance are as important as financial reward from a productive and loyal standpoint, especially among the younger generation. If banks manage to recruit the right talent, it is equally important to foster the integration of employees with proper measures. These measures should be anchored in the organisation itself to assure a long-lasting positive effect on employees.

In the following chapter, we provide an action plan which allows banks to build a holistic strategy to address more prominent issues as a result of Brexit, be it soft or hard.
In this checklist, BearingPoint provides a step-by-step plan that will help your organisation take on the operational challenges with respect to Customer Relations Management, Operations & IT Management and Human Resource Management. By highlighting the key activities among the front, middle and back office, the guide enables you to embrace the Brexit challenge from an operational point of view. At the same time, it significantly accelerates the digital transformation by breaking it down into manageable tasks, thus making it more concrete.

**BearingPoint’s post-Brexit action plan**

In this checklist, BearingPoint provides a step-by-step plan that will help your organisation take on the operational challenges with respect to Customer Relations Management, Operations & IT Management and Human Resource Management. By highlighting the key activities among the front, middle and back office, the guide enables you to embrace the Brexit challenge from an operational point of view. At the same time, it significantly accelerates the digital transformation by breaking it down into manageable tasks, thus making it more concrete.

![Diagram showing the steps of the action plan](image)

**Figure 2: Brexit roadmap to organizational transformation**
Outlook

The clock is ticking for Brexit negotiations and time is running out to facilitate any changes following any ‘soft’ or hard scenario.

Whilst a Brexit deal is still under negotiation and businesses are not provided with a clear post-Brexit picture, it has become apparent that in a post Brexit world banks and financial services organisations in general will have to find alternative ways to stay competitive. Front office, sales and partially operations functions might be deemed necessary to move to another EU financial centre, however that will create room and capacity for these organisations to focus on alternative investments, diversification of their portfolio as well as simplification and rationalisation of their corporate structure. Whilst the first will offer new revenue streams by targeting niche or emerging markets, the latter will help organisations to quickly accelerate in a post-Brexit era.

A simplification of legal entity structure will quickly lead to some cost reduction and early benefit realisation. Moreover, with the progressive strengthening of the FinTech sector, banks will be bound to enable transformation through technology. Client offerings predominantly for retail clients will be revolutionised to offer best in class and a world leading customer experience. With that in mind the transformation activity and internal decision making is not to be overlooked. Financial institutions and most importantly banks will have to not only coordinate the transformation efforts for the transition of activities in a post Brexit world but to also prepare the ground and facilitate the creation of a “new” bank ready to embrace the digital agenda, service the client needs for a digital bank whilst keeping abreast with future regulatory changes and shifting legislation frameworks.
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About BearingPoint

BearingPoint is an independent management and technology consultancy with European roots and a global reach. The company operates in three units: Consulting, Solutions and Ventures. Consulting covers the advisory business; Solutions provides the tools for successful digital transformation, regulatory technology and advanced analytics; Ventures drives the financing and development of start-ups. BearingPoint’s clients include many of the world’s leading companies and organizations. The firm has a global consulting network with more than 10,000 people and supports clients in over 75 countries, engaging with them to achieve measurable and sustainable success.

For more information, please visit: www.bearingpoint.com