LEGAL ENTITY TRANSFORMATION
IN A BREXIT WORLD

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Britain's decision to leave the EU has left the financial sector in a state of uncertainty. The simplified legal entity structures brought about following the 2007-08 financial crisis are now under threat as banks seek to determine the best ways of continuing to operate across all European regions post-Brexit. Failure to acknowledge and prepare for these changes could render financial institutions unable to properly service clients in particular countries and in turn lead to a significant loss of income, or in a worst-case scenario, make it impossible for them to operate in a chosen region.

Historically, the globalisation of the banking world has been driven by geographical expansion, accompanied by a proliferation of legal entities. The financial crisis put an end to much of this with a call for increased transparency and larger levels of capital within certain banking entities. This led many banks to opt for legal entity simplification to not only remain regulatory compliant, but also cut costs. Now however, banks are faced with creating new legal entity structure designs to deal with the uncertainty of the Brexit negotiations.

Following the trigger of Article 50 in March 2017, the two-year negotiation period is underway. Banks need to start preparing now for the three key scenarios:

- Soft Brexit with continued access to the single market
- Hard Brexit with agreement and grace (transition) period
- Hard Brexit with walk out

One particularly important issue is that of 'passporting', a practice which currently enables financial institutions to service the whole of the EU from one base within the EU. Banks are regulated by their home EU country with only a 'light touch' from regulators within the other EU countries in which they operate. This agreement is expected to disappear under the terms of a hard Brexit, meaning that banks will be faced with cross-border challenges, including limits to cross-country trading, additional regulation and increased costs.

Another consequence is that under the terms of the second Markets in Financial Instruments Directive (MiFID II), the designation of third-party regime, which allows financial institutions to operate under the equivalent regulation in a particular country, is not always applicable to all products and countries.

In order to address these challenges, banks – even non-EU banks currently using London as a hub - will need to design and implement new legal entity structures, taking into account the various possible outcomes. The key things to consider are:

- Design and implement an interim 'keep the lights on' structure which would allow the business to continue operating with skeleton capabilities in case no deal and no grace period is agreed.
- Prepare for both hard Brexit scenarios, outlining an interim plan and a strategic fully-fledged solution to implement the appropriate structure once the final terms are known.
- All business areas may be affected, including front-to-bank office, support functions, logistics, client migrations, licence approvals, access to markets, capital requirements and regulatory requirements.

BREXIT SCENARIOS

While there are several possible outcomes for the UK's departure from the EU, the UK is initially expected to request an interim solution, allowing for the continuation of passporting rights and ongoing access to the customs union, until all institutions can implement the changes needed to operate in the post-Brexit world. By contrast, the EU 27 are believed to be more focused on agreeing the exact terms of the UK's departure and the impact it will have on citizens' rights. Even in the best-case scenario, it is unlikely that the EU27 will agree on the trade terms before the details of the separation are agreed. As a result, negotiations are likely to be lengthy and slow and it is widely anticipated that as the two-year negotiation period comes to an end, it will be extended.

Market access under the different Brexit scenarios

Brexit Type	Passporting	Customs Union	Third-Party status Available
1. Soft Brexit	Yes	Yes	N/A
2. Hard Brexit with agreement	No	No	Yes, partially
3. Hard Brexit with walk-out	No	No	No

1 A soft Brexit with continued access is the optimal scenario and includes retaining passporting rights and access to the customs union. Since the agreement and its terms are unlikely to be known until the end of the two-year negotiation period, banks need to implement an interim plan that 'keeps the lights on' without making any drastic changes before the final details of the agreement is known. This avoids excessive upfront costs and helps firms to retain the flexibility to manoeuvre quickly if the worst-case scenarios do not come to fruition.

2 A hard Brexit with an agreement and grace (transition) period means the UK officially leaving the single market and customs union and accepting and agreeing the terms of the separation, along with all the details around the rights and obligations to trade, as well as (at least) an outline agreement for some kind of long-term trade deal. There would be a grace period for countries, regulators and banks to agree on trade deals, implement post-Brexit solutions, agree on licenses, change regulations and, where necessary, achieve third-party status.

3 A hard Brexit with walk out is the worst-case scenario for the banking sector. If this happens, the UK would leave the EU with no deal at all, meaning that a full implementation plan would need to be enacted immediately. The UK would leave the single market, losing its ability to passport, and questions would remain over the possibility of achieving third-party regime status. In effect, UK banks would be treated as US banks or any other non-EU firm and would have to follow due process to gain third-party regime status.

What firms will need to do to continue operating post-Brexit

Non-EU firms using the UK as a hub: set up subsidiaries

Non-EU firms with EU branches: upgrade branches to subsidiaries

EU firms with HQ in the UK: upgrade any EU branches to subsidiaries

EU firms with branches in the UK: upgrade UK branches to subsidiaries to be able to serve UK clients

LETTERBOXING

One strategy many banks were believed to be considering was setting up a skeleton staff within the EU and maintaining their entity and operation in the UK. This is a strategy utilised by some offshore investment funds, who for taxation reasons allow skeleton decision-making offshore whilst maintaining the bulk of their staff within the UK. This is referred to as letterboxing.

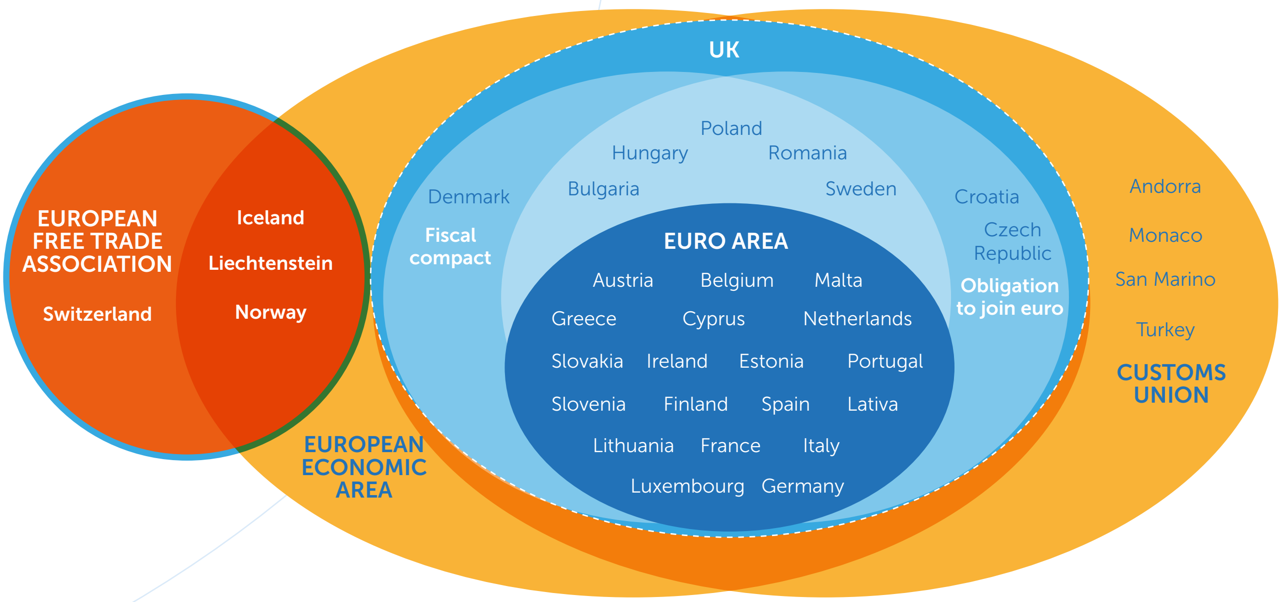
The European Securities and Markets Authority (ESMA) has already highlighted they will take a harsh view of letterboxing and the potential risks this poses to the EU financial system. ESMA will focus on new entities created within the EU, where key operations are delegated to parents in London. They have warned national regulators to 'effectively supervise' any UK firms which relocate to the continent in the wake of Brexit.

ESMA chairman Steven Maijoor said: "The EU27 have a shared interest in building a common approach to dealing with relocating firms that wish to continue to benefit from access to EU financial markets. Firms need to be subject to the same standards of authorisation and ongoing supervision across the EU27 in order to avoid competition on regulatory and supervisory practices between member states. Effective and efficient supervision are essential to support the Capital Markets Union."

Maijoor may have a battle on his hands to keep the EU27 from not competing with each other. Nordea, a global systemically important bank (G-SIB), has recently announced plans to relocate to Finland from Sweden, citing a more favourable regulatory regime and expected cost savings approaching $1.3 billion, according to media reports in Bloomberg.

Brickendon believes it would be a very optimistic position for any financial institution to rely on using passporting rights through a letterbox subsidiary should no deal be agreed between the UK and the EU. Having said that, there could be room for negotiation to offshore some of the operations back to the UK, provided that a financial institution is already compliant with ESMA and local regulations, and there is a substantial and justifiable business model for the new or enhanced subsidiary.

Fig 1: Where would the UK sit in a post-Brexit world?



Source: Department for Exiting the European Union: Policy paper - The United Kingdom's exit from, and new partnership with, the European Union (Updated 15 May 2017)

PASSPORTING IMPACT

To better understand the manner in which financial services can operate across the EU, it's worth highlighting that under the passporting arrangements there's no such thing as a single passport that would allow cross-sector servicing. Instead, and in order to gain access to the member states' markets or the Single Market, a combination of specific passports is required depending on the product and service.

The impact that the loss of passporting rights will have on UK-domiciled banks within the EU can potentially be counterbalanced by the use of the equivalent or third-party regimes. This is where the EU would recognise the UK's regulators as being equivalent to those operating in the EU. However, it is important to note that:

- This is as much a political question as an operational one and it is likely that the EU and UK regulatory regimes will diverge over time. Equivalence is therefore more of a fluid rather than a static concept and one that will require close attention for firms intending to rely on equivalence to continue to access markets.
- Both equivalence and third-party regimes are NOT always available under various EU legislation. For example, MiFID II supports the provision of third-party regimes, but CRD IV (Capital Requirements Directive) does not.
- Whilst they in theory provide an option for banks outside the block to operate within it, they do NOT provide the same level of access or services, and in many cases can be quite limiting.

The examples below highlight the complexity of relying on the equivalency or third-party arrangement and the impact to some types of firm:

Investment Firms

- MiFID II sets out the rights and obligations of investment firms for the provision of cross-border investment services. Under the third-party regime, having lost passporting rights, investment firms would, if compliant, be able to provide investment services to professional clients. However, they would not be able to provide investment services to retail clients, either directly or by setting up branches across the border.

Credit Institutions

- CRD IV and MiFID II set out a combination of rights and obligations for credit institutions so they can:
  - Provide cross-border banking (CRD IV) and investment services (MiFID II).
  - Set up branches for the provision of banking (CRD IV) and investment services (MiFID II). CRD IV has NO provisions for banking services under the third-party regime and as a result, credit institutions that have lost their passporting rights would NOT be able to provide banking services or set up branches to provide banking or investment services in all member states.

From just the above two examples, it is clear that the loss of passporting rights would mean increased complexity and cost for firms to service the same clients and this would be ongoing. Banks may be required to change their business models, including discontinuing products or services that are niche and for which the ROI doesn't justify the higher costs, or redesign their product services to enable different legal entities to serve different products.

LEGAL ENTITY RESTRUCTURING

Having established the potential effects Brexit could have on the banking sector, it is clear that institutions need to prepare themselves for a range of outcomes to avoid any interruptions in operations.

Changing legal entities poses a raft of complexities, from ensuring compliance with regulators in the target EU country to assessing the associated legal changes that will impact the bank. Contracts that have been drafted with clients and vendors need to be reviewed and prepared not only for the new entity, but also to consider potential changes to the applicable laws governing the relationship between the parties.

The main things to consider are:

New operating model	• minimise capital requirements and operational changes, whilst meeting regulatory requirements and ensuring the appropriate licences are obtained • review operations, middle-office and technology processes to assess what needs to be migrated to the new entity • involve finance and HR departments from the outset to ensure financial obligations and resourcing challenges are properly addressed
Legal implications	• review legal documentation of derivatives contracts to determine re-papering requirements • identify contractual points that might trigger a breach, amendments or cancellations of contracts • consider changes in applicable law and jurisdiction referenced in legal documentation • assess the insolvency regime applicable to these contracts following Brexit
Capital requirements	• ensure sufficient capital is in the right place to operate effectively under the new Capital Requirement Regulations (CRR) and consider turning individual branches into fully-capitalised subsidiaries to achieve compliance • be aware that moving capital between the existing entity structure and a new or resigned entity will potentially fragment the liquidity position of the bank, leading to greater capital charges and driving up funding costs • reassess any previously-validated models used for calculating capital to ensure compliance in the new country
Regulatory implications	• ensure ongoing compliance with existing EU legislation until a final decision on Brexit • consider the knock-on effects for other legislation, such as ring-fencing, the new EU General Data Protection Regulation (GDPR) and the requirement for non-EU and the requirement for non-EU G-SIBs and other eligible organisations with two or more entities in the EU to establish an EU parent entity • seek clarification whether UK banks with retail operations in other EU countries will be able to be retained post-Brexit, and what level of service they will be able to offer customers from a ring-fenced Brexited UK bank
Migration	• be aware of the tight Brexit timetable - it can take years to plan and migrate trading activity between entities • plan data and client migrations to allow the subsidiaries to stand alone after the transition • upgrade technology and infrastructure to support any new entities and their respective regulatory requirements

THE IMPACT

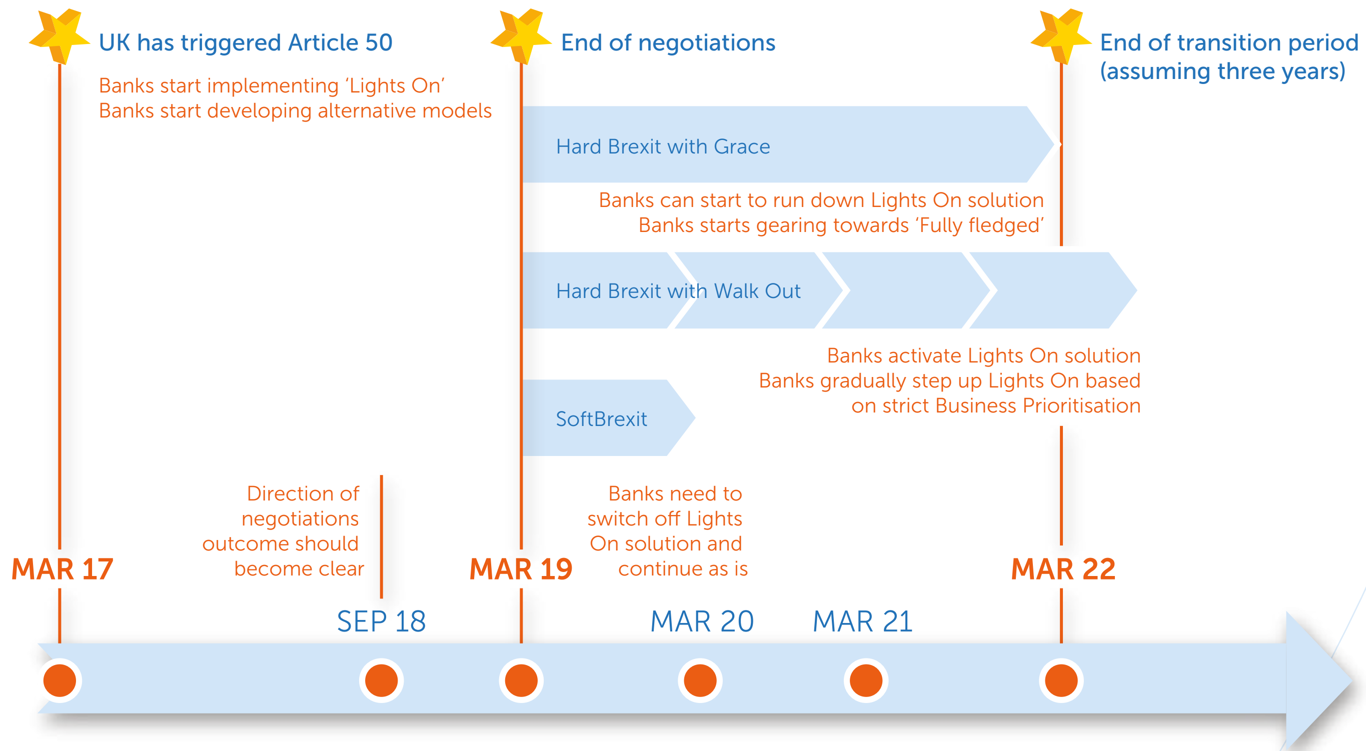
A hard Brexit will impact three main groups:

1. UK banks losing passporting rights, rendering them unable to service EU clients or access markets in the EU; secondly,
2. EU27 banks losing passporting rights, rendering them unable to service UK clients or access UK markets; and thirdly,
3. non-EU banks (currently using the UK as a hub to access whole of the EU) losing passporting rights, rendering them unable to continue operating in the EU.

Many banks have already made their intentions known in the media, with Deutsche Bank reportedly considering moving its business away from London to Frankfurt and many US banks, such as Morgan Stanley and Bank of America, believed to be examining whether to move divisions and capital out of London to another rival hub.

The extent to which financial institutions are impacted by Brexit still remains to be seen, but this will depend in most part on two areas: firstly, the European spread of each individual bank's services (a domestic-focused bank will be less impacted compared to a pan-European bank); and secondly, the current legal entity and branch structure of the bank.

Fig. 2 Brexit timeline vs implementation solutions



BRICKENDON CONSULTING APPROACH

Step 1 Impact assessment → Step 2: Operating model analysis → Step 3: Scenario-based solution models → Step 4: Transform to the new model

Uncertainty around the Brexit negotiations is anticipated to continue until the last six months of the Article 50 timeline. This means adopting a wait-and-see approach is not an option.

Banks should follow a four-step model to identify the impact on their organisation, analyse their operating model, prepare scenario-based solution models and transform their organisation to the new model. Brickendon's significant expertise in areas including target operating model, solution architecture, risk and regulations, complex programme management, and data and client migrations mean we are well placed to help in every step of this transformation.

Step 1: Impact assessment

- Review existing legal entity structure and analyse presence in different jurisdictions
- Assess strategic products and client base to identify the passporting impact on each offering

Step 2: Operating model analysis

- Review booking models for all impacted products
- Map trading and operational activities to the most suitable locations based on Brexit scenarios
- Be aware that one solution may not suit the whole organisation

Step 3: Scenario-based solution models

- Consider all possible Brexit scenarios and design appropriate models for a) a skeleton solution to keep the lights on in case no deal is reached, and b) a fully-fledged solution that can be implemented depending on the conditions of the deal
- In the event of a hard Brexit, the target legal entity model design should:
  - Ensure continuity of products and services aligned with the respective business model
  - Cater for the new capital requirements at a product level
  - Consider changes in contracts with clients, vendors, trading venue and clearing houses
  - Take into account other factors associated with changing location

Step 4: Transform to the new model

- Seek license approval from the regulator in the target jurisdiction
- Keep new model proposals to the regulator as simple as possible to get quicker response and approval
- Simplify and centralise technology across entities to minimise the migration impact on clients
- Provide consistent communications and guidance to clients throughout the transformation process, ensuring all impacts are explained, including re-papering of trading agreements, and how clients need to interact with exchanges and regulators
- Allow sufficient planning and resources for client migrations and people relocations
- Plan various scenarios for the migration of contracts and positions, depending on the guidelines from regulators. Migrating all positions vs. running down existing contracts will have different tax, operational and accounting impacts

CONSEQUENCES OF NOT ACTING NOW

Failing to act now to assess the impact the UK's pending departure from the EU could have on your business is fatal. The key is to know your current business and devise a new legal entity structure that enables you to continue operating and servicing your clients whatever the outcome of the Brexit agreement. For each institution, the impact will vary, but there is no doubt that preparation is the key.

Starting to put an interim structure in place now will put you in a good position to move quickly once the final outcome is known. Failing to prepare, places your business in a vulnerable position and could leave you unable, at very short notice, to conduct business with your major clients, leading to a loss of income, reputation, and ultimately your business model.

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ABOUT US

Brickendon is an award-winning global transformational management and technology consultancy specialising in innovative solutions that save our clients time and money. Our aim is to deliver transformational change across our three key offerings of Advise, Change and Do, through our five practice areas: Data, Quality & Test, Risk & Regulation, Strategy and Digital. This helps ensure our clients see positive results in weeks, not months or years.

Employing domain experts with over 10 years' respective experience in specialist sectors, Brickendon is built on providing lasting, cutting-edge solutions designed to improve profitability, efficiency, competitiveness and innovation across the financial services sector. We are passionate about what we do and thrive on transforming companies to increase their competitive edge.

Started in London in 2010, the driving force behind Brickendon's global strategy is transforming the traditional consultancy model. We now have multiple offices across Europe and the US, including London and New York.

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