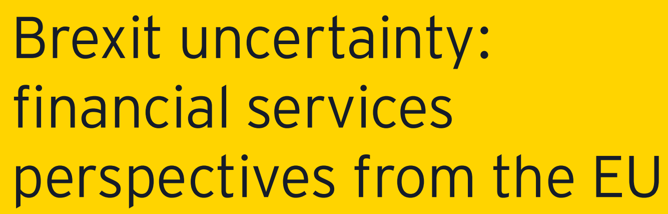

Brexit uncertainty: financial services perspectives from the EU

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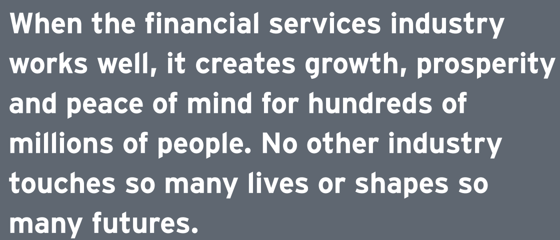

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Introduction

This is the ninth in a series of board papers from EY that assess the impacts of Brexit on the financial services (FS) sector.

With less than two months remaining until the UK is next due to depart the EU, the uncertainty around Brexit shows no immediate sign of abating. Outcomes will be determined by UK domestic politics and further negotiations.

After three years of this uncertainty, most FS firms are well-advanced in building new European structures. Focus is gradually switching from Brexit contingency to regular operations and optimisation in new jurisdictions. Whilst efforts have been focused on serving clients seamlessly, regardless of political outcomes, the consequences and considerations have been complex. The impact on businesses of a highly competitive environment (both for clients and talent), and a complicated and fragmenting regulatory system and ever-changing global pressures, provides continuing short- and longer-term challenges.

In this latest piece of thought leadership, we look at how firms are adjusting to life in the four cities that our analysis discloses have witnessed the greatest amount of new activity. We look at how Dublin, Frankfurt, Luxembourg and Paris have been impacted by Brexit, the mood on the ground in each city, and the issues that firms are focusing on.

We also look at how these shifts have impacted London and the rest of the UK, and what the future might hold there.

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Brexit scenarios

For those trying to plan for the future, predictions for both UK domestic politics and Brexit negotiations remain almost impossible. In short, the UK and its Parliament remain divided on Brexit, with positions perhaps becoming more entrenched after three years of post-referendum uncertainty on the subject. Feasible outcomes range from the UK leaving the EU on 31 October with no deal to the UK deciding to remain in the EU.

What is clear is that a no deal Brexit remains a credible and realistic outcome that firms should continue to prepare for. We consider the mechanics of six possibly overlapping scenarios below.

1. Deal

The UK and the EU both sign off on a Withdrawal Agreement before 31 October.

There is some question as to whether such a deal could be ratified by 31 October, even if agreed in principle, so a short Article 50 extension may still be necessary. The currently negotiated Withdrawal Agreement includes a transition period to at least the end of 2020 (with a possible extension to the end of 2022), which would maintain EU law (including the right to passport FS) in the UK. Negotiations on a new relationship between the UK and the EU would need to happen during the transition period.

2. No deal

The UK and the EU cannot agree a deal by 31 October or after an extension, and the UK either does not seek an Article 50 extension or is not granted one by the EU (all EU Member States would need to unanimously back such an extension).

Whilst a significant amount of effort has gone into preparing for no deal across sectors and by UK and EU27 governments, the scale of any immediate adverse consequences remains difficult to predict. It could also be some time before the UK and the EU get back to the negotiating table to discuss a trade deal or other cross-border issues, such as FS equivalence determinations. Financial authorities across Europe will be monitoring firms and markets carefully for any issues, including looking for impacts from no deal consequences in the real economy.

3. Revocation of Article 50

The UK is entitled to revoke Article 50 unilaterally if it wishes to remain in the EU.

Such a revocation would need to be approved by the UK Parliament, which would almost certainly only wish to do so after a referendum or general election had confirmed a change in the UK electorate's view that the UK should leave the EU.

4. Extension of Article 50

The UK seeks an extension of Article 50, and every EU Member State agrees to the extension.

An extension of up to two years could be unanimously agreed by the UK and each EU Member State, but the politics of this look very difficult for both the UK and the EU without a major shift in one or both sides' positions. A UK general election or a second referendum might be reason for a shorter extension, or both sides could agree to a short extension to prepare fully for no deal.

5. A second referendum

The UK Parliament could legislate to hold a second referendum, but the question and timing would be subject to much debate. The Constitution Unit's report on *The Mechanics of a Further Referendum on Brexit,* published by the University College London (UCL), has estimated that a second referendum would need at least 22 weeks, meaning it would be impossible to hold it before 31 October. An Article 50 extension would certainly be needed.

6. A general election

The next general election is scheduled for 5 May 2022 but, given the UK Government's small working majority and potential for further Brexit impasse, an election can be held earlier via one of two methods:

- A vote of no confidence in the Government by the House of Commons by simple majority. A request for a vote would nearly always be accepted from the Leader of the opposition, but the Speaker can also accept requests from others. If a new government that commands the confidence of MPs cannot be formed within 14 calendar days, a general election is triggered at least 25 days later.
- A motion for a general election is agreed by two-thirds of the total number of seats in the House of Commons (currently 434 out of 650). An election would happen at least 25 days later.

It would be possible to hold a general election before 31 October if it was triggered in early September, but the timing would be tight. Holding a general election before the UK left the EU might well require an Article 50 extension.

No deal: scenario planning and impact on business optimisation

Whilst FS firms have prepared for a no deal scenario, many are using inefficient and temporary contingency plans because of the short-time scales and continuing uncertainty. Optimisation will need to follow once the long-term level of UK-EU market access becomes clearer.

In the event of no deal, optimisation may follow quickly. Overnight, UK firms would lose their ability to passport services and branches into the EU. Neither would they have any EU equivalence determinations to fall back on, putting them at an immediate disadvantage to some other markets, such as the US, Singapore and Hong Kong.

The timescales around moving on from a no deal Brexit also look challenging. Along with possible political fallout, the EU's mechanisms for coming to new trading arrangements are complex, requiring unanimity and individual approvals from certain Members States' parliaments.

All of this suggests further significant restructuring in the aftermath of no deal and many firms having to face a dual regulatory environment as they manage their new and existing operations.

Ahead of any Brexit scenario firms should consider:

- Readiness of their operations.
- Transfer of clients and products.
- Market disruption and volatility.
- Working with new Authorities.

We provide a more comprehensive list of considerations on page 10.

Jurisdictional analysis and comparison

Firms from across FS have been working hard to build new or enhance existing capabilities to ensure that they can continue serving clients across the EU in a scenario where they can no longer passport services or branches from the UK.

The diagnostic work undertaken in understanding how businesses would be impacted has resulted in different approaches. Some have undertaken heavy restructuring to optimise for a no deal model, whilst others have employed a lighter touch, putting in place temporary apparatus to deal with a no deal scenario, with a view to optimisation when the long-term EU-UK relationship becomes clearer.

France

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Following the choice of Paris as the new host of the European Banking Authority (EBA) in November 2017, Paris has become a popular location to set up, or expand existing operations for firms, including 14 banks.[1]

Many firms that have selected Paris for either of these purposes have prepared for a no deal scenario by relocating the appropriate activities and staff ahead of the initial deadline of 29 March. Following the extension of Article 50, some of this relocation has been suspended until the political situation has been clarified.

A lack of experience in local regulatory rules and practices, which differ from those experienced in the UK, has caused challenges in the reconciliation in reports between entities. In addition to this, firms that have moved ownership to their subsidiaries have not necessarily reflected these changes in their management structure, causing issues for senior leadership. Firms have also had challenges in testing their operating models on legacy systems, leading to some inefficiencies.

European and National Competent Authorities have pressurised financial institutions to ensure they have local resources in place, particularly for key business functions, which has resulted in a battle to attract the best local talent. There has also been an increase in the number of secondments and resources that have been brought in from other locations.

Day 2 analysis and planning is key to how organisations will respond to Brexit, regardless of the decision from the UK. There is a need to optimise operational models to handle the potentially increased workload in Paris because of the ongoing uncertainty and the unknown outcome. Currently, there is a reluctance to transform and plan strategically for day 2 due to cost considerations — some firms have closed their Brexit programme and are working to meet deadlines to get things over the line rather than planning proactively.

Germany

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As the centre of the financial services sector in Germany and the seat of the ECB since the late 1990s, Frankfurt has attracted a sizeable portion of banks relocating away from London, including those with headquarters in the US, Switzerland, Japan and China.

Eighteen banks[1] have publicly stated their desire to set up or expand existing operations. In the case of the former, the scrutiny from the regulator has been to focus on the expertise and resources that are staffing this new entity. In the case of the latter, it is still unclear how they will expand operations as decisions on a Brexit deal or the possibility of a no deal Brexit continue to be delayed.

The European Central Bank (ECB) has already started to cover some banks under the Single Supervisory Mechanism (SSM), irrespective of balance sheet size (usually a minimum

[1] Based on the targeted monitoring of 222 firms by the EY Brexit Tracker

threshold of €30bn), ahead of a confirmed Brexit date. Whilst this approach by the ECB has been a surprise to many firms, regulators have offered a more flexible approach to those that have been clear with their plans and proactive in dialogue from the outset.

Whilst banks have retained some of their most senior officers in Frankfurt, they have been supplemented by internal transfers from London or other locations, poaching staff from local banks, and recruiting from professional services firms. Native Germans working in Anglo-Saxon countries have provided an extra talent pool. Commuter arrangements have been viewed negatively by the regulator, and moving permanently is often seen as a prerequisite for approval. Transferring staff at Associate or Vice President (VP) level has been the most challenging in the absence of traditional expatriate deals.

Many firms have chosen to move only a part of their client base, and the process has been made simpler by the low volume of clients transferred to the new entity.

FS firms continue to be welcomed by the local government and regulators, although not at the expense of loosening governance standards or regulations. The Prime Minister of the local state of Hessen, has recently embarked on a marketing tour covering London, New York, Hong Kong and Singapore, to convince global management of Frankfurt's ability to absorb more business in the case of Brexit.

Ireland

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Dublin has seen movement in all sectors, where 29 firms[1] are considering or have confirmed the relocation of operations.

There has been a significant inflow of international FS institutions into Dublin across the banking, capital markets, wealth management and insurance sectors. Some of these firms had a small or speciality presence prior to the Brexit vote, and have utilised entities and experience to expand their authorisations to allow them to implement new business models from the Irish jurisdiction.

The Central Bank of Ireland (CBI), working with the SSM for significant institutions, has applied a consistent and robust regulatory approach and process, during which it set out a rules-based structure and the expectation that all new firms will consistently meet all the local regulatory requirements from the time of authorisation. Firms are adapting to the style and requirements of both regulators and have been focused on a number of challenges.

A key challenge for all has been the application process, which has required extensive senior management involvement and proved to be time-consuming, resource-intensive and sometimes complex, as firms have had to redefine their business and new European operating model to the satisfaction of both their group and the regulators. This has required firms to provide a significant amount of detailed information, timely explanations and answers to probing questions regarding booking models, governance, risk frameworks, outsourcing and resourcing, to name just a few.

Most of the significant firms are now approved and almost through the process of getting operationally ready to take on client business. Resourcing the new roles has been a hot topic in Dublin, and we have witnessed a healthy repatriating of Irish professionals, inflow and secondment of talent from major overseas financial centres, and a significant movement of capable candidates from FS players already based in Ireland.

Another significant challenge for a number of firms has been the fitness and probity process of gaining the regulators' approval for key people management control functions. High expectations of seniority, experience and competency have been applied and should stand the sector in good stead as Dublin develops its new status as a major European financial hub.

[1] Based on the targeted monitoring of 222 firms by the EY Brexit Tracker

Although the leave mechanics for Brexit still need to be decided, most firms have now moved into business-as-usual mode regarding their Irish or European entity. Immediate day to day focus is now revolving around completing their business, functional and regulatory commitments with a major concentration on servicing clients across Europe. For significant institutions senior teams across the organisation are preoccupied with preparing for their initial regulatory test of comprehensive assessment and Asset Quality Review. Most firms are doing these regulatory tests for the first time, which is likely to be a challenge as they will be quite different from what most experienced previously regarding the level of detail and the style deployed by the European regulator.

The regulatory challenge has been immediate for new firms, as supervisory aspects kick in instantly upon authorisation and new management teams have already been receiving invites from the regulator to engage on topics such as conduct, outsourcing, the Senior Managers Regime and the InterBank Offered Rate (IBOR).

Luxembourg

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A total of 23 firms[2] have publicly announced they are relocating to Luxembourg, with the jurisdiction proving particularly popular for asset managers. We have also seen a number of banks, insurers and payments providers move here.

Firms have found the process of submitting applications to the Luxembourg regulators (the CSSF and the CAA) to be efficient and straight-forward, with the authorities permitting firms to submit applications in English, with 37 of the 39 Brexit-related applications received by the Commission de Surveillance du Secteur Financier (CSSF) now approved.

Firms have been drawn by an established FS sector and the flexibility of authorities to limit the disruption of a no deal Brexit (for example, UK-based payment institutions and electronic money institutions can continue to serve clients for a period of 21 months).

The FS sector in Luxembourg employs 50,000 people, providing new entrants with an experienced FS workforce. However, there remain challenges in hiring staff in more technical roles, such as actuaries or risk officers. To counter this, firms have transferred executives to Luxembourg from other locations. Firms have also invested heavily in client migration teams to ensure a continuous transition to help guide clients through the process.

UK nationals who start their employment ahead of the UK's leave date will retain their right to work. For UK nationals arriving in Luxembourg after the UK's withdrawal, a residence permit will allow them to engage in FS activity.

Some firms have benefited from transfer pricing rules, which apply on a case-by-case basis. These may lead to deductible payments to compensate for transfer activity such as goodwill.

Luxembourg boasts strong economic figures, including low unemployment. FS is a key part of this strategy and the economy.

[2] Based on the targeted monitoring of 222 firms by the EY Brexit tracker; broader analysis by Luxembourg for Finance cites 58 firms relocating (8 banks, 31 asset managers, 13 insurers and 6 payment firms)

European Authorities expectations:

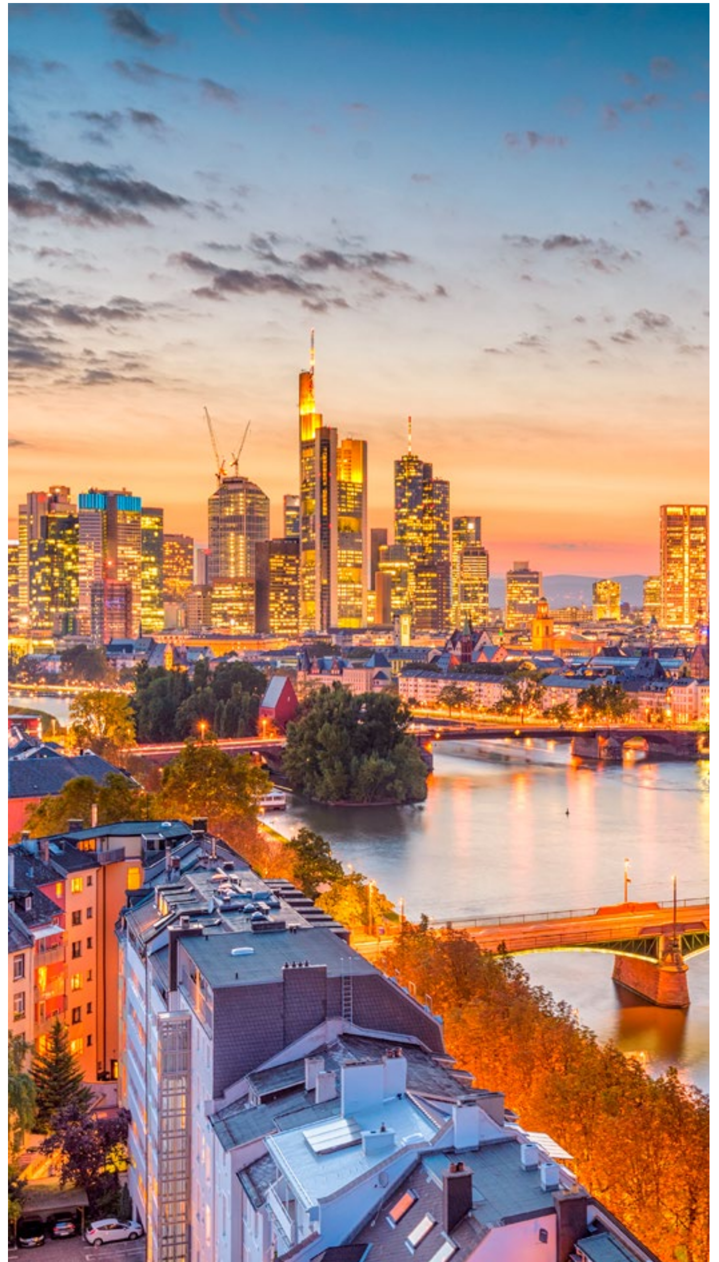
Banks:

Across the EU, firms will be subject to both EU and local requirements. For banks in the Eurozone, the ECB through the Single Supervisory Mechanism is now driving a common agenda for banks. Their top three priorities are:

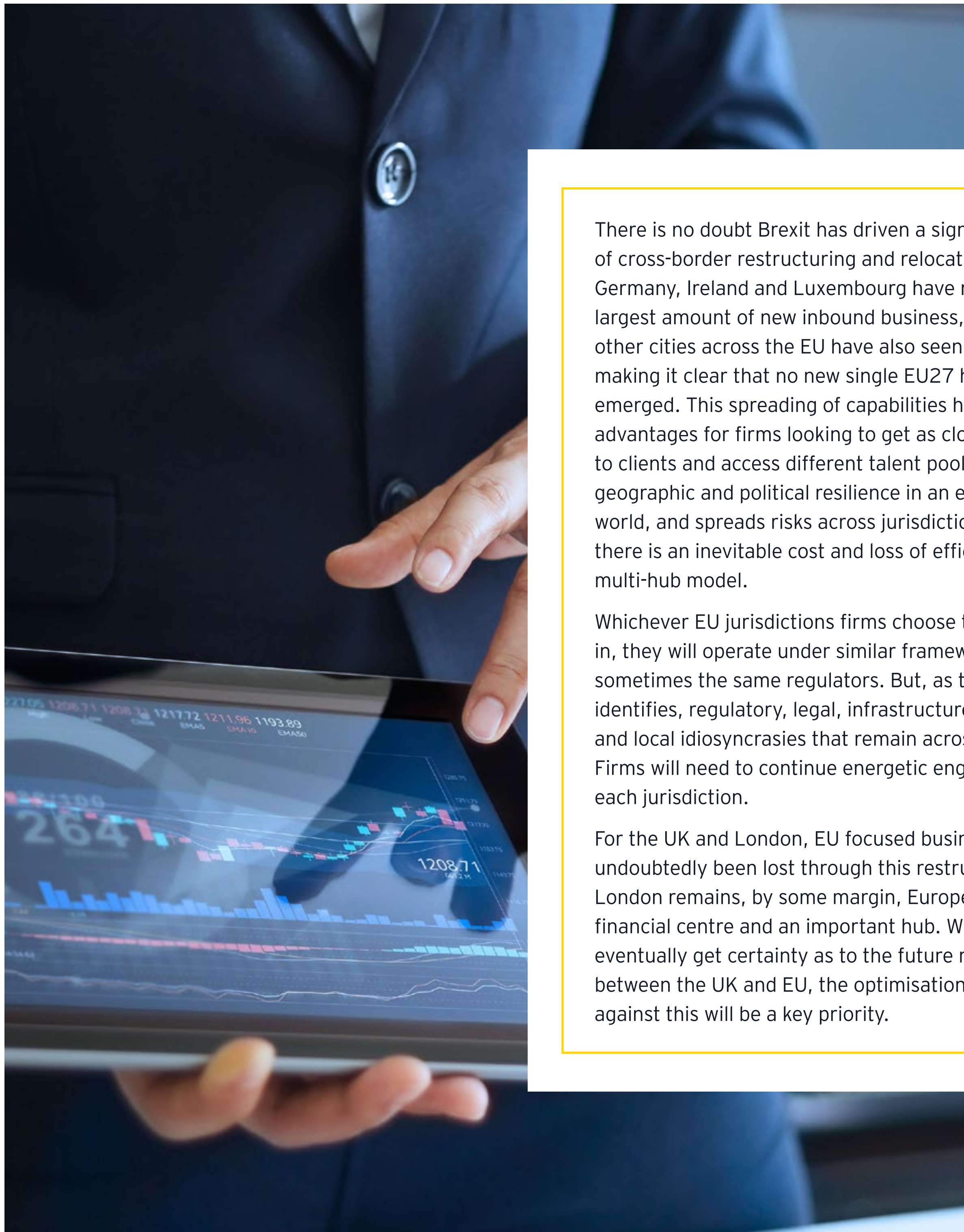
1. Governance – with a focus on outsourcing to other group entities. This is relevant for all functions, including IT, operations, risk and finance.
2. Local management teams – the regulator has been very clear that teams on the ground must have the right capabilities, capacities and levels of empowerment to ensure operations are not mere execution facilities for third countries.
3. Engagement – focus on resources and management attention on the Supervisory Review and Evaluation Process (SREP) is expected and will form a key lens through which firms are assessed.

Insurance and Wealth & Asset Management:

The European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) do not have direct supervisory powers over firms in EU member states, their Brexit related policy statements have expressed similar priorities.



Conclusion



There is no doubt Brexit has driven a significant amount of cross-border restructuring and relocation. France, Germany, Ireland and Luxembourg have received the largest amount of new inbound business, but several other cities across the EU have also seen moves, making it clear that no new single EU27 hub has yet emerged. This spreading of capabilities has some advantages for firms looking to get as close as possible to clients and access different talent pools. It builds up geographic and political resilience in an ever-changing world, and spreads risks across jurisdictions, although there is an inevitable cost and loss of efficiency to a multi-hub model.

Whichever EU jurisdictions firms choose to operate in, they will operate under similar frameworks and sometimes the same regulators. But, as this paper identifies, regulatory, legal, infrastructure, people and local idiosyncrasies that remain across the EU. Firms will need to continue energetic engagement in each jurisdiction.

For the UK and London, EU focused business has undoubtedly been lost through this restructuring. But London remains, by some margin, Europe's global financial centre and an important hub. When we eventually get certainty as to the future relationship between the UK and EU, the optimisation of business against this will be a key priority.

Checklist for boards

1 Operational resilience

- Have you established and documented a global strategy framework?
- Have you identified and mapped your global business services?
- Have you managed dependencies through your ecosystem?
- Have you simulated various scenarios to determine impact tolerances?

2 Client outreach

- How are you managing client queries relating to products and services across multiple entities?
- How are you maintaining consistent client data across entities during the transition?
- Have you established a robust cross-border control framework?

3 People considerations

- Are your systems robust enough to identify and manage your commuter population to ensure tax, social security, regulatory and compliance risk is managed and mitigated?
- Do your current regional staff have the support and skills required to execute on a regional office build out successfully, and have the knowledge to operate under a new regulatory environment?
- Are you aware of the restrictions that will apply to your short-term business travellers to the EU from the UK?

4 Scenario planning

- Are risk tolerances, thresholds and limits appropriately calibrated?
- Have you incorporated downturn scenario financials into risk appetite? Are you monitoring the changing risk profile in a downturn against thresholds and limits to make timely adjustments?
- What financial profile (e.g., income statement volatility and reserves) does the board and shareholders expect to see during a downturn and at the bottom of the cycle? What can be done to adjust this profile?
- Are you utilising and structuring large volumes of data that are easily available and can be used in decision-making processes?
- Are your staff, skillset, governance and communication ready for a range of Brexit outcomes?

5 Tax

- Have you assessed your potential UK exit tax exposure by reference to tax, transfer pricing and valuation principles?
- Is documentation in place to ameliorate risk?
- Have you socialised identified issues with tax authorities?

6 Tactical to strategic (day 2)

- Have you considered your post-Brexit growth strategy looking at future client strategy and the underlying operating model? Will target clients differ from those traditionally prioritised by the UK?
- How do you optimise both efficiency and client experience related to on-boarding processes in the new operating model?
- Have you considered how your presence across the globe will need to be tailored for the new UK-EU relationship and have you considered how you will optimise the operating, booking model and cost structures, given the expected fragmentation?
- Have you considered whether your post-Brexit corporate and operating structure, particularly against the backdrop of any evolving regulatory requirements, is fully optimised for corporate tax (including transfer pricing) and Value Added Tax (VAT) purposes and, if not, have you worked out how best to tackle it?
- Have you started to assess how your talent strategy will be impacted by the new immigration system from 2021, both to avoid pitfalls and understand business friendly policies in the new landscape?

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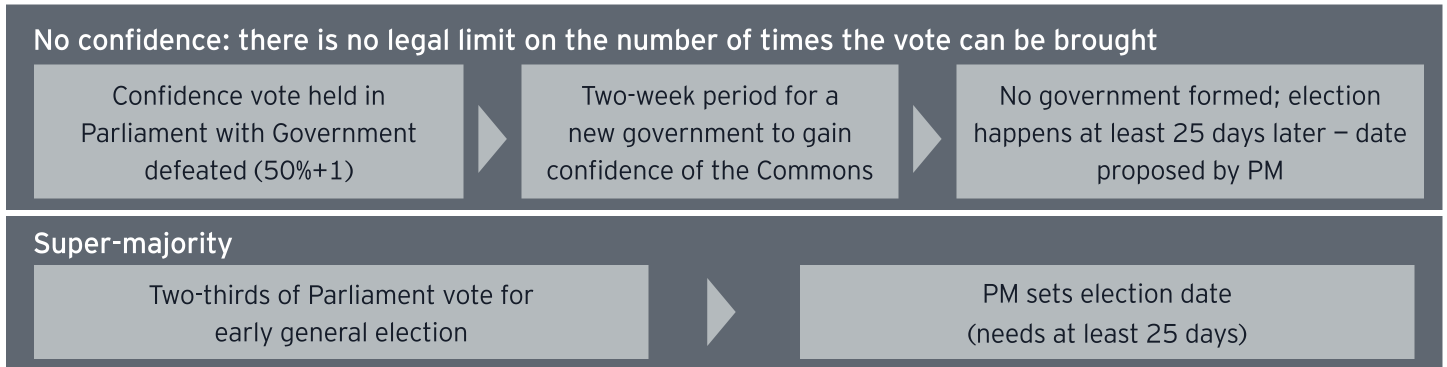
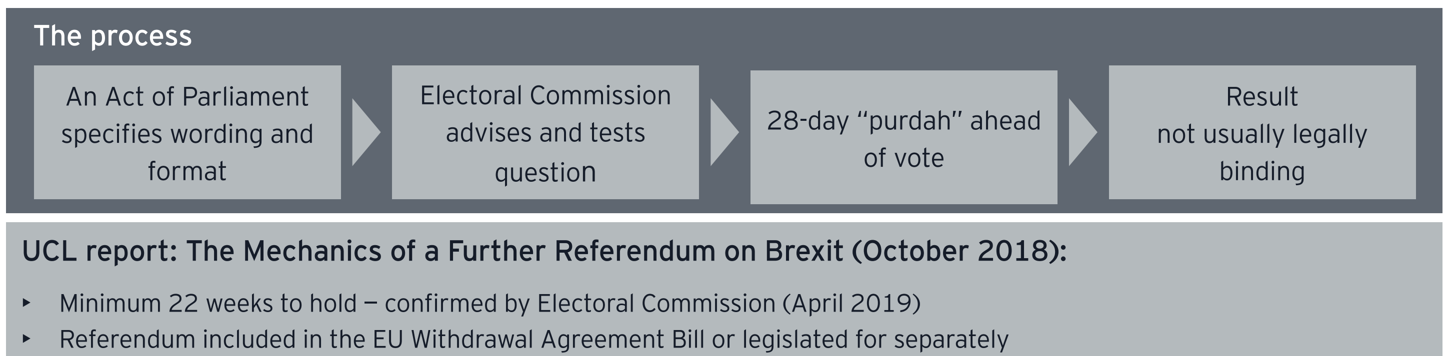
Appendix: Potential mechanisms and timescales

Appendix 1: General election



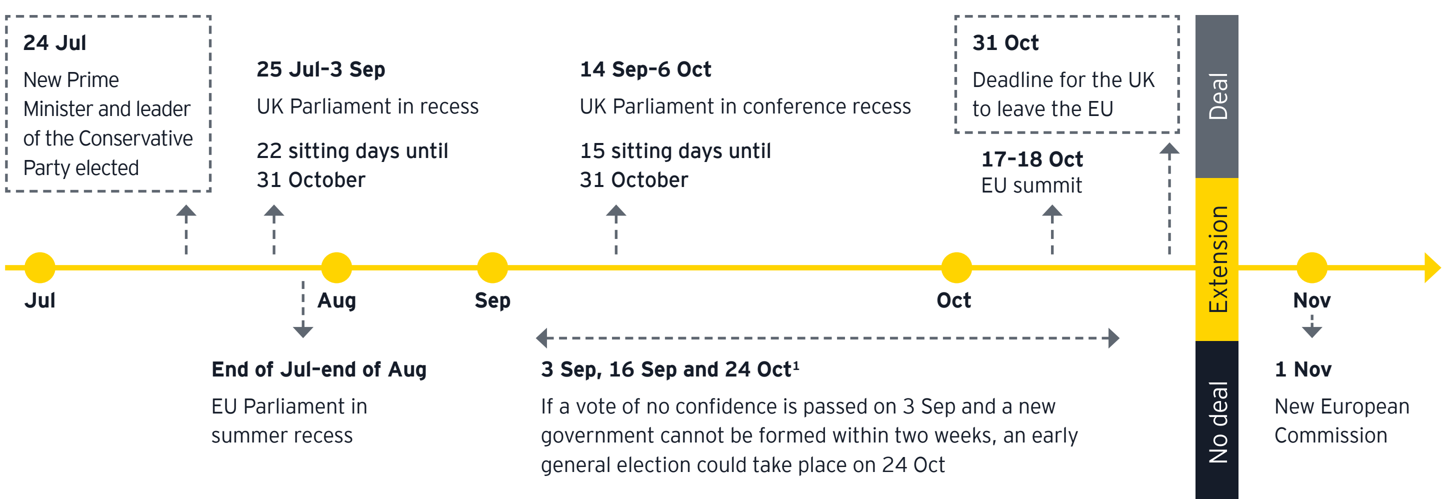
Appendix 2: Process for second referendum



UCL report: The Mechanics of a Further Referendum on Brexit (October 2018):

- Minimum 22 weeks to hold – confirmed by Electoral Commission (April 2019)
- Referendum included in the EU Withdrawal Agreement Bill or legislated for separately

Appendix 3: Brexit calendar*



* Subject to change.

[1] Speculative dates to indicate the length of time between a vote of no confidence being passed and an early general election taking place.

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EYG no. 003638-19Gbl

ED None

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