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Brexit: Is Equivalence a Solution for Banking?

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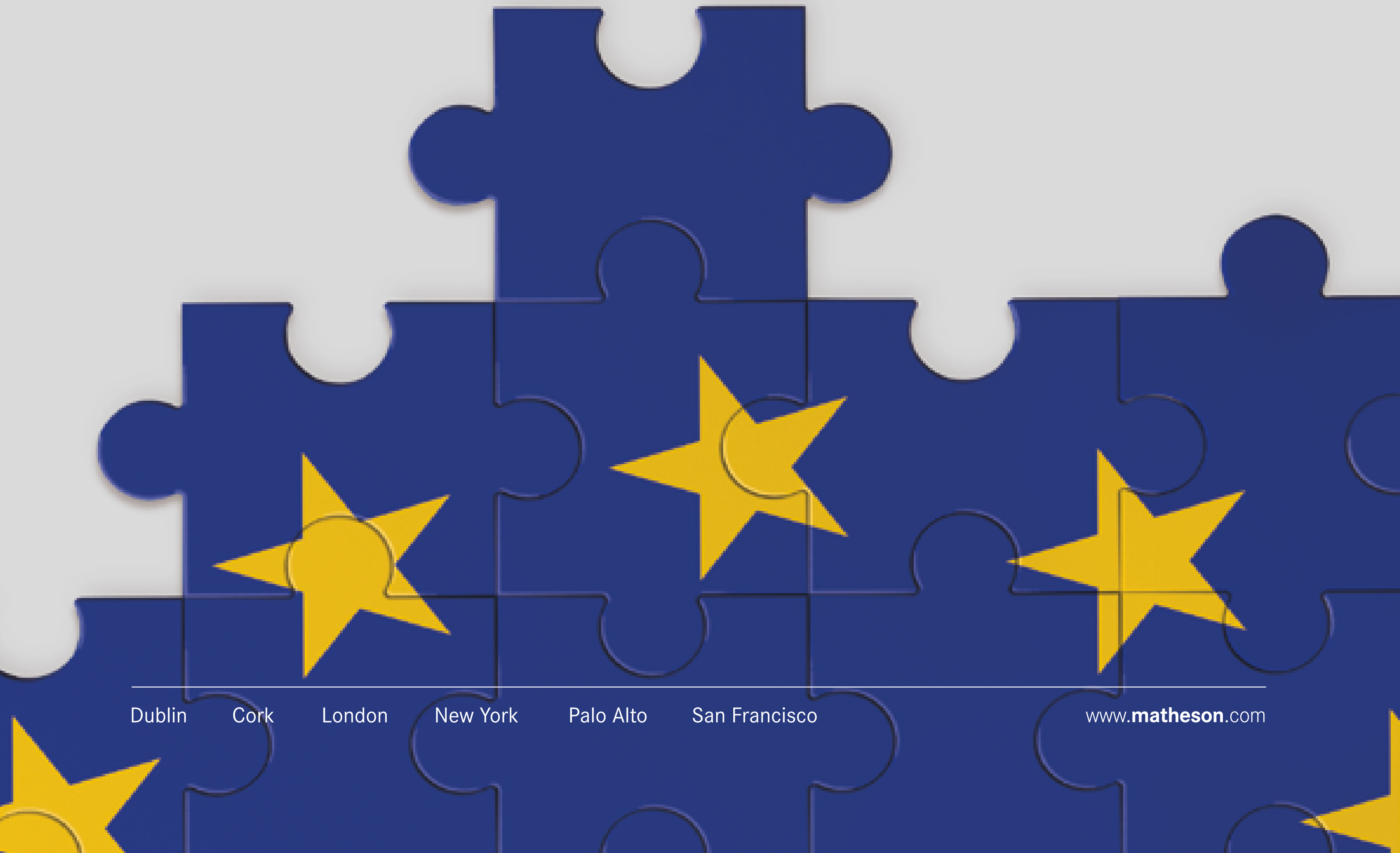

Brexit: Is Equivalence a Solution for Banking?

We have considered in a broader context whether the European Union ("**EU**") equivalence framework provides an appropriate basis for the future relationship between the EU and the United Kingdom ("**UK**") – see our paper "**Brexit – Is Equivalence a Solution for Financial Services?**". With the prospect of no agreement being reached by the end of the transition period becoming increasingly likely, our view (as outlined in the above paper) with respect to equivalence generally is that the existing equivalence framework does not provide an acceptable, long-term, sustainable solution for the UK-based financial services industry as a whole to access EU markets. Predictability, stability and transparency are key for financial services firms to implement their distribution, marketing and growth planning in the medium to long-term and the existing regime does not offer these benefits.

In this paper, we consider whether equivalence offers any solutions specifically for the cross-border banking market. As for many other sectors, Brexit presents various challenges, in particular for UK banks accessing EU markets and clients upon the potential expiration of the financial services passports of those UK banks on 31 December 2020.

We have also prepared papers summarising the expected legal impacts arising from no agreement on financial services being reached by year end for each of the areas of: **insurance**, **derivatives clearing**, **investment funds**, **MiFID firms**, and **fintech and payments**; together with an analysis of equivalence as a viable or relevant mechanism in each case.

Licencing Issues and Assessing the Relevance of Equivalence Provisions

Once the UK becomes a "third-country" from the perspective of EU law, and on the assumption that no comprehensive agreement is reached on the continued provision by UK banks of banking services within the EU, UK banks will be restricted from engaging in certain banking and investment banking activities in the EU. In Ireland, under the Central Bank Act 1971 (the "**1971 Act**"), a person may not carry on banking business or hold himself out or represent himself as a banker or as carrying on banking business or accept deposits or other repayable funds from the public without the requisite licence to do so. For third-country banks, the requisite licence is a third-country branch licence issued under section 9A of the 1971 Act.

This dual prohibition ("carrying on business" and "holding out") presents a difficult challenge for third-country banks seeking to offer services to Irish clients, including any UK banks that are seeking to administer legacy books of Irish business. "Equivalence" – at least within the current legal infrastructure regulating EU banking activity (mainly the Capital Requirements Regulation ("**CRR**") and Capital Requirements Directive ("**CRD IV**")) will not provide those UK banks with a means of access to the EU or Irish banking market. Equivalence provisions in the EU bank regulatory framework are currently used primarily to facilitate licenced *EU banks* in dealing with global corporate and supervisory structures, in addition to assessing their global exposures. There are many different equivalence provisions contained in CRR and CRD IV and a table of the main provisions that we have identified is set out below. None of these, however, provides access to the EU market to take deposits or engage in regulated activity on the basis of any "equivalence" determination. Instead, they deal with very technical aspects of the regulation of global banking groups – for example, Article 81 of CRR, which deals with the inclusion of minority equity interests held by credit institutions in their CET1 calculation. Article 81 provides that, where the European Commission ("**Commission**") has made a determination of equivalence in respect of the relevant third-country, minority holdings in subsidiaries that are intermediate financial holding companies established in third-countries may be factored into the CET1 calculation of an EU bank. Thus, the current banking regulatory provisions relating to equivalence are:

- generally beneficial from the perspective of the EU institution / EU competent authority and not the third-country bank;
- not sweeping provisions allowing third-country banks to access EU markets - instead they are specific and tailored to relevant provisions such as calculating a particular exposure type, allowing for disclosure of specific information or allowing or discounting capital from own funds calculations; and
- not a means by which any third-country bank can carry out specific regulated activities in the EU.

It has been reported that the UK has sought a "*comprehensive, permanent equivalence decision*" in respect of the UK and in a much broader sense than is provided for in respect of other third-countries. Such a notion was rebuffed by the EU's chief negotiator, Michel Barnier, noting that "*there will not be general open-ended or ongoing equivalence negotiations on financial services*". In any event, such an "equivalence decision", in order to be useful, would have to be radically different to anything currently provided for under EU law and would in effect have to treat the UK as within the EEA for the purposes of relevant legislation. It would certainly, in the bank regulatory context, at a minimum require amendments to CRD IV and CRR to introduce a general equivalence framework as well as conducting the equivalence determination process itself and would therefore be a multi-year process.

It being understood, therefore, that equivalence will not provide a basis for continuing access to the EU market by UK banks post-transition, what are the significant bank regulatory and legal issues arising from Brexit that remain unresolved at the time of writing?

Establishing EU Subsidiaries – Substance and Outsourcing

In the early days following the Brexit vote, there were fears that UK banks might seek to obtain European licences by opening small subsidiaries with limited EU personnel and substance, but with large parts of the 'real' activity being outsourced back to the UK. Both the European Banking Authority ("**EBA**") and the European Securities and Markets Authority ("**ESMA**") on the one hand, and the European Central Bank ("**ECB**") Single Supervisory Mechanism ("**SSM**") on the other, have, through their opinions and pronouncements regarding 'shell banks' and booking models, made it clear that this will not be tolerated (see 2017 and 2018 EBA opinions on Brexit and the ECB guidance on booking models).

In this regard, the EBA warned that:

> "*When relocating activities after Brexit, UK institutions may decide to set up structures in the EU that rely to a large part on outsourced services, provided by the UK parent institution or other group entities, and try to relocate only a very limited number of staff to EU subsidiaries or branches. To this end, competent authorities should ensure that outsourcing is not used with the intention of stripping the institution's corporate substance and of setting up only a legal vehicle with the sole purpose of benefiting from an EU passport*."

The EBA, ECB and local competent authorities have placed increasing focus on substance requirements, including ensuring, in outsourcing-heavy business models, that robust controls are in place to ensure compliance with the EBA's guidelines on outsourcing requirements. The EBA has also emphasised the need for sufficient resources – in particular in respect of control functions such as finance, risk, compliance and internal audit – to be retained within the EU legal entity, including having the ability to "insource" the relevant activities, where required:

> "*…institutions must retain an appropriate organisation to oversee and manage the relationship with the service provider (third party or internal service provider) and in particular have control functions in place that manage the risks related to the outsourcing contracts and outsourced activities. Institutions must be able to insource any outsourced activities within an appropriate timeframe*."

The ECB – which is the entity now responsible for authorising all banks in the Eurozone – has also taken a strict approach, not only with regard to the activities of EU subsidiaries and branches of UK institutions, but also with regard to the activities of UK branches of EU institutions post-Brexit. It has outlined its regulatory expectation (although without making the legal basis for this explicit) that UK branches of EU / EEA credit institutions should service UK, and not EU / EEA, business (see ECB FAQs on Brexit).

In Ireland, the Central Bank of Ireland ("**Central Bank**") took a robust approach to substance requirements very early following the UK's vote to depart the EU in 2016. The Central Bank requires that the so called "mind and management" of every firm authorised by it be located in Ireland. As such the Central Bank needs to be satisfied that the key personnel responsible for the day-to-day management of any Irish subsidiary and its activities will be physically located in Ireland. There are no express guidelines in terms of the specific numbers required by the Central Bank, as this will generally depend on the nature, scale and complexity of the business.

The Central Bank proved to be prescient in anticipating where the EBA, ESMA and ECB would arrive at on this point - and many are now relieved that they do not have to further adapt their Irish plans and

structures or to include greater substance than they were originally led to believe would be necessary. The vast majority of UK groups that require an EU authorisation to continue providing banking services after December 2020 have already obtained that authorisation or restructured their activities as required in order to do so. But a key risk to those newly established operations in the coming years will be supervisory scrutiny of their activities, and in particular their reliance on their UK group services entities or affiliates, to determine whether these arrangements continue to meet with EU authorities' substance expectations (which are themselves likely to "ramp up" with time). Each newly established entity in Ireland will need to be careful to operate within the confines of the conditions of authorisation imposed on them by the Central Bank and within the business plan and programme of operations approved in the course of the authorisation process, ensuring any material deviation therefrom is done only with regulatory approval.

For those (relatively few remaining) UK financial entities with material numbers of EU clients that have not sought, or are not likely to have obtained by year end, EU authorisations, the legal landscape is complex and needs to be analysed on state-by-state and business-by-business basis.

Management of Legacy Books of Business and Possible Engagement with EU Clients from the UK

For those UK banks that have not already established subsidiaries in other EU member states, typically we have seen the suspension by such banks of new business with EU clients. However, certain UK credit institutions have wished to retain a limited level of engagement with existing EU clients and in particular the ability to administer legacy books of business. All such circumstances have to be assessed on a fact-specific basis, but there are some general themes that recur in this context:

- **Pure Administration**

  We have explored with certain UK banking clients their ability to manage existing loans, deposits and other financial products on a legacy basis, whereby new business is restricted but existing business is managed in a wind-down scenario. There are clear issues to be managed here, including operating within the 1971 Act prohibitions and ensuring no other licencing issues, such as those arising under the Central Bank Act 1997, relating to credit servicing and retail credit provision, are inadvertently triggered.

- **Characteristic Performance in the UK and Reverse Solicitation by EU Clients**

  An argument which can be made in order to continue a certain level of engagement with EU clients is where business is carried out with those clients entirely within the UK (or otherwise within third-countries) and without any marketing or promotional activities being undertaken within the EU ("reverse solicitation"). Again, this must be assessed on a fact-specific basis, and a key assessment factor in this regard is *where* a regulated activity takes place, which, in an era of online service provision and remote operations, is increasingly less obvious. The Commission's *"Commission Interpretative Communication on the Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive"* of 20 June 1997 (the "**Commission Communication**") contains some useful principles when determining where a regulated activity is being performed. Ultimately, the key test for determining where a service takes place is where the "*place of characteristic performance of the contract*" is located, the characteristic performance of the service being the "*essential supply for which payment is due*".

UK credit institutions will need to tread carefully in this regard, noting potential legal hurdles in each jurisdiction where their clients are located. From an Irish perspective, the prohibitions in the 1971 Act need to be carefully managed and marketing / promotional activity in Ireland needs to cease. Detailed legal and factual analysis of existing books of business and future business models is generally necessary before any UK financial entity can rely with any confidence on these concepts on a "go-forward" basis.

- **Safe Harbour (Investment Banking Activities)**

  With regard to UK banks' investment banking activity (and specifically not any deposit-taking, lending or related services), there is a potential avenue for the continued provision of investment services to Irish per-se professional clients and eligible counterparties if the bank can satisfy the conditions of the so-called "safe-harbour" exemption, provided under the European Union (Markets in Financial Instruments) Regulations 2017, transposing the EU MiFID II Directive in Ireland. However, the availability of similar exemptions differs across the EU, such that this may not be a viable model for the provision of investment services to institutional clients and counterparties in all circumstances. Obtaining local advice in each market is therefore essential.

Choice of Governing Law and Dispute Jurisdiction

Many industry sectors have traditionally chosen English law as the governing law for documents and financial products, and we are presently seeing a growing trend away from English law as the end of the Brexit transition period looms. This is because the Recast Brussels Regulation (which accommodates the automatic recognition and enforcement throughout the EU of judgments obtained in a member state) will not apply to benefit UK judgments after the end of 2020. Some UK commentators have suggested that, by acceding to the Hague Convention on Enforcement of Judgments of 2019, UK judgments can be placed in a position that is almost equivalent to EU judgments, but it is far from clear that this will be the case. Therefore, the post-Brexit situation may well provide new opportunities to promote Irish law as the only remaining English language and common law jurisdiction in the EU.

Legislation	Provision	Nature of Relief or Requirement
CRR	**Article 81** - Minority interests that qualify for inclusion in consolidated Common Equity Tier 1 capital	Minority interests in respect of CET1 instruments in subsidiaries may be factored in where the subsidiaries are intermediate financial holding companies in a third-country that are subject to prudential requirements as stringent as those applied to credit institutions of that third-country and where the Commission has made an equivalence finding in respect of those prudential requirements.
CRR	**Article 82** - Qualifying Additional Tier 1, Tier 1, Tier 2 capital and qualifying own funds	Qualifying AT1, T1, T2 capital and qualifying own funds comprise the minority interest, AT 1 or T2 instruments, as applicable, plus the related retained earnings and share premium accounts, of a subsidiary where an intermediate financial holding company in a third-country that is subject to prudential requirements as stringent as those applied to credit institutions of that third-country and where the Commission has made an equivalence finding in respect of those prudential requirements.
CRR	**Article 107** - Approaches to credit risk	Exposures, as calculated by EU institutions, to third-country investment firms and exposures to third-country credit institutions and exposures to third-country clearing houses and exchanges can be treated similarly to exposures to an EU institution where the third-country applies prudential and supervisory requirements to that third-country entity that are at least equivalent to those applied in the EU.
CRR	**Article 114** - Exposures to central governments or central banks	When the competent authorities of a third-country which apply supervisory and regulatory arrangements at least equivalent to those applied in the EU assign a risk weight which is lower than that indicated in paragraphs 1 to 2 of Article 114 to exposures to their central government and central bank denominated and funded in the domestic currency, EU institutions may risk weight such exposures in the same manner.

Legislation	Provision	Nature of Relief or Requirement
CRR	**Article 115** - Exposures to regional governments or local authorities	When competent authorities of a third-country jurisdiction which applies supervisory and regulatory arrangements at least equivalent to those applied in the EU treat exposures to regional governments or local authorities similarly to exposures to their central government and there is no difference in risk between such exposures because of the specific revenue-raising powers of regional government or local authorities and to specific institutional arrangements to reduce the risk of default, EU institutions may risk weight exposures to such regional governments and local authorities in the same manner.
CRR	**Article 116** - Exposures to public sector entities	When competent authorities of a third-country jurisdiction, which apply supervisory and regulatory arrangements at least equivalent to those applied in the EU, treat exposures to public sector entities in accordance with paragraph 1 or 2 of Article 116, EU institutions may risk weight exposures to such public sector entities in the same manner.
CRR	**Article 132** - Exposures in the form of units or shares in collective investment undertakings (“**CIUs**”)	EU institutions may determine the risk weight for a CIU in accordance with paragraphs 4 and 5 of Article 132, inter alia, in the case of third-country CIU, the following conditions are met: (i) the CIU is managed by a company which is subject to supervision that is considered equivalent to that laid down in Union law; (ii) cooperation between competent authorities is sufficiently ensured.

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Legislation	Provision	Nature of Relief or Requirement
CRR	**Article 212** - Requirements for other funded credit protection	Life insurance policies pledged to the lending institution can qualify as eligible collateral where the company providing the life insurance is subject to supervision by a competent authority of a third-country which applies supervisory and regulatory arrangements at least equivalent to those applied in the EU.
CRR	**Article 391** - Definition of an institution for large exposures purposes	For the purposes of calculating the value of large exposures, the term “institution” includes a private or public undertaking, including its branches, which, were it established in the EU, would fulfil the definition of the term ‘institution’ and where it has been authorised in a third-country that applies prudential supervisory and regulatory requirements at least equivalent to those applied in the EU.
CRR	**Article 400** - Exemptions	Competent authorities may fully or partially exempt exposures, including participations or other kinds of holdings, incurred by an EU institution to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as those undertakings are covered by the supervision on a consolidated basis to which the institution itself is subject, in accordance with the CRR, the Financial Conglomerates Directive 2002/87/EC or with equivalent standards in force in a third-country.
CRD IV	**Regulation 114** - Assessment of equivalence of third-countries’ consolidated supervision	Where an EU institution, the parent undertaking of which is an institution, a financial holding company or a mixed-financial holding company, the head office of which is in a third-country, is not subject to supervision on a consolidated basis under Article 111 of CRD IV, the EU supervisor will assess whether the institution is subject to consolidated supervision by a third-country supervisory authority which is equivalent.

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Concluding Comments

For the reasons explained, the concept of equivalence is not adequate, under current legislation, to provide UK credit institutions with continued broad access to the EU market (and as a consequence, is unlikely to be useful as a basis for EU firms to access the UK market in a reciprocal manner). The potential negative impacts of a "no deal" Brexit remain therefore very real. Firms need now to dust off those Brexit plans and prepare to "road test" them, while any firm that has not yet put in place robust arrangements to address market access and contract continuity needs to urgently review its position.

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Please get in touch with your usual Matheson contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this paper.

Full details of Matheson's Financial Institutions Group, together with further updates, articles and briefing notes written by members of the team, can be accessed at www.matheson.com. Further Brexit-related updates, articles and briefing notes may be accessed on our Brexit Forum.

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