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The UK regulation of EEA banks post-Brexit – some clarity on how the PRA rule-set will apply to firms that avail themselves of the temporary permissions regimes

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Executive summary

On 25 October 2018, following the publication of the draft secondary legislation creating the temporary permissions regimes (**TPRs**) for 'inbound' EEA firms and investment funds which provide services in or are marketed into the UK, the Prudential Regulation Authority (**PRA**) published two consultation papers (CP25/18[1] and CP26/18[2]). These cover, among other things, the PRA's approach to banks and insurance companies in the TPR. This briefing summarises those elements of the CPs which are relevant to EEA banks.

The PRA's approach to the regulatory ruleset for the TPRs differs in a number of respects from that of the Financial Conduct Authority (**FCA**) in its consultation paper CP18/29 (discussed in our earlier briefing). The PRA has proposed taking a tougher line in imposing the requirements applicable to third country firms on TPR firms, subject to relatively limited (and as yet ill-defined) transitional relief.

The two PRA consultations run until 2 January 2019. Given the challenges firms will face to implement the requisite changes by March 29 in the event of a hard Brexit, it will be critical to reach a position on the PRA's expectations by Christmas: we would urge firms to open lines of engagement with the PRA as early as possible.

[1] Published jointly with the Bank of England
[2] Updated on 2 November to include technical standards relating to the Financial Conglomerates Directive

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Background

In December 2017, the UK Government confirmed that it would bring forward legislation to set up a TPR for inbound passported EEA firms and investment funds to enable them to continue their activities in the UK for a limited period after Brexit. The aim of the TPR is to reduce the risk of harm associated with an abrupt loss of permissions by enabling firms that passport into the UK to undertake new business that falls within the scope of their existing permissions and to service existing business. It is also intended to allow relevant EEA-domiciled investment funds[i] to continue to be marketed in the UK to new and existing investors.

Once the EU (Withdrawal) Act 2018 (**EUWA**) received Royal Assent at the end of June 2018, HM Treasury commenced work on the secondary legislation required to ensure the UK continues to have a functioning financial services regulatory regime in the event of a 'hard' Brexit where no transitional period is ratified. This has included the publication of the statutory legislation creating the TPRs for EEA firms (including credit institutions) which passport (whether on an establishment or services basis) into the UK under the Financial Services and Markets Act 2000 (**FSMA**), including those types of firms who also have top-up permissions (**TP firms**) – the "EEA Passporting Rights (Amendment, etc., and Transitional Provisions) (EU Exit) Regulations 2018[ii]" statutory instrument (**SI**) was laid before Parliament in September.

Whilst the TPR SIs include provisions to make the required changes to the UK's legal framework (the **legislative ruleset**), the question of how the regulators' rulebooks (the **regulatory ruleset**) will apply to firms in the TPR has been left for the regulators to devise and articulate. It is for this reason that the publication of the consultations is to be welcomed. With only five months until a possible 'hard' Brexit, clarity on how rule-set changes are to be dealt with during the regime is critical.

Temporary transitional tool – the legislative ruleset

On 8 October, HM Treasury confirmed it will bring forward legislation to allow regulators to grant some flexibility in applying new legislative requirements under the EUWA. The power will enable the PRA to amend the effect of the onshored EU legislative ruleset (such as the Capital Requirements Regulation and European Market Infrastructure Regulation). In the context of UK banks, the PRA indicates in CP25/18 that it is considering exercising the transitional powers in a broad way to delay the application of onshoring changes that would otherwise result in firms needing to take action before exit day to comply with them, with certain limited exceptions. It is not clear that, to the extent that the PRA is responsible for onshored EU legislation affecting EEA banks post-Brexit (for example aspects of MiFIR), transitional relief will be provided.

Firms will need to assess how the changes brought about by the onshoring and amendment of the EU legislative ruleset will affect them and may wish to approach the regulators where the changes are material.

Overview of how the TPR will operate

In relation to incoming EEA credit institutions and incoming EEA insurers, the PRA confirmed its approach to branch authorisation and supervision back in March 2018 and requested that firms contact the regulator - please refer to our bulletin for more detail. Under the SI:

- firms will need to notify the PRA that they intend to use the TPR. It is not yet clear what mechanism will be used to notify the PRA, or any timing or content requirements associated with the notification process: the PRA has informally indicated that it will contact affected banks and that the notification process will be administrative only;
- the notification window will close no later than exit day. Once the notification window has closed, firms that have not submitted a notification will not be able to use the TPR. The FCA has indicated that details of firms with temporary permission will be shown on the FS Register;
- firms with top-up permissions will need to submit a Variation of Permissions (VoP) application rather than an authorisation application; and

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– if firms no longer wish to continue business in the UK they will be able to apply to cancel their temporary permission. The FCA has indicated that an SI may be produced to legislate for the wind-down process for affected firms. The Government has also committed to generate an SI dealing with contractual continuity – ie permitting legacy contracts to be serviced by EEA firms which cease to be authorised. This is yet to be published.

The CPs do not provide further information on the process whereby EEA banks may enter the TPRs.

The PRA's general approach in applying the regulatory rule-set to TP firms

In contrast to the FCA, which has proposed a highly detailed set of rules determining the application of its regulatory ruleset to TP firms, the PRA proposes a more straightforward approach, based on the fact that TP firms will become third country firms from the point they enter into the TPR.

Branches

TP firms operating UK branches:

- will be required to comply with **all of the requirements to which third country firms are subject**, subject to possible transitional relief;
- transitional relief is currently under consideration in respect of the following areas:
  - PRA remuneration rules where they go beyond minimum CRD IV requirements; and
  - certain reporting obligations where they involve the segregation of branch data and the reporting and review of this data where this is not already required.

Services firms

TP firms operating on a services basis will be subject to **a more limited set of rules** that could apply to a third country firm without a UK branch. Chapter 7 of CP 26/18 indicates that these include parts of the:

- Fundamental Rules
- Auditors
- Change in Control
- Close Links
- Fees
- General Provisions
- Information Gathering
- Interpretation
- Notifications and
- Use of Skilled Persons
- various Parts setting out the Senior Managers and Certified Persons (**SMCR**) requirements
- Parts relating to the FSCS.

In contrast to the position for branches, the CP does not propose transitional relief other than in relation to the SMCR requirements.

We have indicated below the relevant parts that apply based on analysis of the proposed revised rules in the consultation: this illustrates that there are other areas of the Rulebook that will apply that are not mentioned in chapter 7.

All guidance on the rules set out above will also continue to be relevant.

SMCR

The PRA has proposed applying the SMCR on the same basis to TP firms as it does to third country firms. This would entail both branches and services firms appointing an SMF 19 with respect to the UK business, and in some cases other SMFs.

To accommodate the need for new senior managers to be registered as a result of their change in status, the SI provides a discretionary power for the regulators to deem senior managers approved following the submission of their application on a temporary basis. The PRA proposes to direct firms in the TPR to apply for SMF approval using an adapted form of Short Form A and a short form statement of responsibilities. Firms will have a 12 week window from exit day in which to submit applications, within which relevant personnel will be deemed approved: thereafter they will be within the transitional regime until the application is determined.

The PRA indicates that it will also apply the certification and regulatory references regimes to all TP firms, and is considering whether to grant transitional relief to services firms from the certification, conduct and regulatory references requirements.

Depositor protection

As a result of Brexit, UK branches of incoming EEA firms will no longer automatically be within the scope of the relevant Home State depositor protection regime. It is expected that deposits taken by services firms from a place of business within the EEA will continue to benefit from the relevant Home State depositor protection regime.

In order to ensure that eligible depositors with accounts with incoming branches remain protected, the PRA proposes to provide FSCS protection to such depositors from exit day, with no transitional relief. This will oblige branches to:

- put in place new disclosures and acknowledgements (including stickers and posters) for new customers following exit date;
- make disclosures to existing customers as to the changes in depositor protection within two months following exit date;
- provide staff training on the change in depositor protection;
- meet the UK Single Customer View (**SCV**) reporting requirements; and
- pay FSCS levies.

The systems changes necessary to provide information to the SCV are likely to be particularly challenging for branches.

How will application of the rule-set differ as between branch and services firms?

After exit day, the ruleset applicable to TP firms will change to that applicable to third-country firms, subject to the transitional provisions mentioned above. TP firms that operate in the UK on a cross border basis (services firms) will see the biggest change, as a number of requirements will apply to TP firms in the same way whether they operate in the UK through a branch or cross border. The table below summarises the main ruleset changes for TP firms[3].

PRA Handbook / obligation	Branch impact	Services firm impact[4]
Fundamental Principles	Apply in full (rather than on a limited basis)	Apply in full

[3] Note that the table is based on the position for a firm which has no top up permissions.
[4] Note that a services firm will most likely need to become a branch or a subsidiary once TPR ceases to apply.

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PRA Handbook / obligation	Branch impact	Services firm impact[4]
Allocation of Responsibilities	Apply in full	Apply to activities in the UK; possible transitional relief
Auditors	Apply in full	
Certification	Apply to UK branch	Apply to activities in the UK; possible transitional relief
Change in Control	Apply in full	
Close links	Apply in full	
Conduct Rules	Apply to UK branch	Apply to activities in the UK; possible transitional relief
Depositor Protection	Apply to UK branch deposits	Do not apply
Dormant Account Scheme	Apply to UK branch deposits	Do not apply
Fees	Possible change to basis of calculation of fees	Apply
Financial Conglomerates	Apply in full (note that various exclusions exist from the substantive requirements of the module for third country firms)	
Fitness and Propriety	Apply to UK branch	Do not apply
General Provisions	Some minor changes (disclosure)	Apply
Housing	Apply in full	
Incoming Firms and Third Country Firms	No change	
Information Gathering	No change	
Internal Governance of Third Country Branches	Apply in full	Do not apply
Management Expenses in Respect of Relevant Schemes	Apply in full	Do not apply
Notifications	Apply in full	
Permissions and Waivers	No change	
Related Party Transaction Risk	Apply in full	
Regulatory Reporting	Apply: likely changes to reporting	Apply: new reporting obligations

PRA Handbook / obligation	Branch impact	Services firm impact[4]
Remuneration	Apply to UK branch: UK superequivalent requirements to apply; subject to possible transitional relief	Do not apply
Senior Management Functions	Apply to UK branch	Apply to activities in the UK; possible transitional relief
Senior Managers Regime – Applications and Notifications	Apply to UK branch	Apply to activities in the UK; possible transitional relief
Senior Managers Regime – Transitional Provisions	Apply to UK branch	Apply to activities in the UK; possible transitional relief
Use of Skilled Persons	No change	

Contrast with the FCA approach to TP firms

The approach that the PRA has proposed is radically different from the FCA's proposals. Differences include:

- the FCA generally proposes only to preserve those requirements which implement EU directives; the PRA has chosen to apply its rules generally;
- the FCA is offering substituted compliance for those rules which implement EU directives; the PRA does not;
- the FCA has sought to preserve the application of existing rules which are deleted at the point of Brexit; the PRA has not.

This will make implementation particularly challenging in those areas where common requirements are currently applied by both regulators – for example systems and controls requirements, which are applied by both the PRA in a prudential context and the FCA in a conduct context.

Practical comments

The PRA's approach will involve the assumption of a large number of obligations at the point of Brexit. It seems likely that firms will wish to push back both on the volume of requirements that apply – particularly to services business – and the timing for their application.

As part of contingency planning for a hard Brexit, firms will need to prepare a gap analysis and an implementation plan which takes account of the changed FCA and PRA ruleset and makes the necessary changes to policies, processes, disclosures etc. As many firms undertake both branch and services activities in the UK, they will need to analyse the proposed requirements taking into account both branch and services business. (Interestingly, some of the new requirements would not apply to services business where the relevant firm has a branch – eg the SMCR requirements – whilst in some cases the requirements will apply both to branch and services business.)

Given the limited time available to firms, it will be important to feed back early on the proposals, seek clarity on the proposals (for example whether they will be treated as lead regulated firms for reporting purposes) and to understand the PRA's approach to transitional relief well in advance of Brexit to finalise and operationalise the implementation plan. It is

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likely that some hard choices may be needed to prioritise resourcing to make sure that the most important aspects of the PRA's expectations are met (the FSCS arrangements are likely to be most important here).

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