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The changes continue: UK financial services authorisation and supervision post-Brexit

January 2018

Following the European Council's confirmation on 15 December 2017 that sufficient progress had been made to move to the second phase of Brexit negotiations, we saw HM Treasury (**HMT**), the UK authorities and the European Insurance and Occupational Pensions Authority (**EIOPA**) make a number of statements and publish supporting documents setting out their proposed post-Brexit framework for financial services authorisation and supervision. These policy developments will be of particular interest to European firms operating in the UK.

The coordination was clearly intended to show a thoughtful and measured approach by the UK government and regulatory authorities demonstrating to the EU and beyond the UK's commitment to maintaining stability, certainty and transparency for international banks, insurers and central counterparties operating in the UK. Whilst the government will ensure there is a legislative framework to minimise the potential for any cliff-edge at Brexit, the regulatory authorities are proactively revising their policies to reflect the implications of the likely loss of passporting for relevant firms and, in the context of branch authorisation and supervision, broadly reflecting the current approach to supervision of third country banks.

We have summarised the proposed approaches for international banks (including designated investment firms), non-UK CCPs and third-county insurance branches/subsidiaries below:

Applicable firm	Impact	Actions
EEA banks & designated investment firms operating (currently or in the future) a UK branch or providing services into the UK.	**Wholesale activities:** Such firms will need to seek PRA authorisation to carry on PRA-regulated activities through the UK branch. The FCA's consent to authorisation will be required and the regulators will work closely together through the process.	– Early engagement with the regulators is strongly encouraged. Applications for authorisations permitted from January 2018. – Comments on PRA consultation paper 29/17 required by 27 February 2018.

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Applicable firm	Impact	Actions
	Significant retail activities: Consistent with current policy, those bank branches that undertake, or plan to undertake, significant retail banking activities must apply for authorisation as a subsidiary.	
EEA banks & designated investment firms operating in the UK through a subsidiary.	No change anticipated although the PRA will keep the policy under review to assess whether any changes would be required.	Not applicable.
UK branches of non-EEA banks & designated investment firms.	No impact expected as a result of these proposals.	Not applicable.
Non-UK CCPs.	Recognition of non-UK CCPs to fall within the BoE's remit following Brexit. The "Dear CEO" letter represents the BoE's preparatory work to ensure a smooth transition.	Begin engaging with the BoE for pre-application discussion by replying to the "Dear CEO" letter as soon as possible.
Third-country insurance branches/subsidiaries	Proposed additional requirements to be imposed in the PRA's assessment of third-country branches applications for authorisation. Failure to meet the additional requirements could result in the third-country insurer being required to seek authorisation for a subsidiary instead of a branch.	Comments on PRA consultation paper 30/17 required by 27 February 2018.

The Bank of England's updated approach to authorisation and supervision

On 20 December 2017, the Bank of England (BoE) announced that, in the context of Brexit and as the UK redefines its relationship with the EU, the Prudential Regulation Authority (PRA) would consult on an updated approach to authorising and supervising international banks and insurers wishing to operate in the UK. The PRA also published a related "Dear CEO" letter to banks, insurers and PRA-designated investment firms undertaking cross-border activities between the UK and the rest of the EU, with a view to ensuring that any required authorisation process can proceed in an orderly manner. Separately, the BoE published a "Dear CEO" letter concerning non-UK central counterparties (CCPs), explaining how it envisages non-UK CCPs will be recognised to provide services in the UK after the UK has withdrawn from the EU.

The publications relevant to international banks, insurers and CCPs are considered in more detail below, but it is worth bearing in mind that the foundation of the PRA's approach is an assumption that there will continue to be a high degree of supervisory cooperation between the UK and the EU. On that basis, EEA banks may apply for authorisation to operate as a branch in the UK provided they are not conducting material retail business. In the event that such cooperation does not materialise, the PRA may re-assess its approach.

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The BoE states that keeping the UK's financial system open to foreign institutions is in the best interests of the UK, EU and global economies. Moreover, the PRA's view is that the ability for firms to branch into other countries is an important part of an open world economy, which in turn benefits the UK economy. As the UK withdraws from the EU, the BoE expects the UK financial system to remain very large and become more complex over time, reducing visibility to supervisors of overseas firms operating in the UK, which could place greater demand on PRA supervision and pose challenges to effective resolution. The proposed approach is intended to meet these challenges.

Subject to the outcome of the negotiations, it is expected that EEA firms currently operating branches in the UK on the basis of single market directive passports will need to be authorised to operate in the UK post-Brexit. The PRA therefore expects to consider authorisation of such firms on the basis of the proposed updated approach.

International banks – the PRA's proposed approach to branch authorisation and supervision

Consultation paper 29/17 and the accompanying draft Supervisory Statement set out the PRA's proposals for a new approach to branch authorisation and supervision of 'international banks' – i.e. all PRA-authorised deposit-takers and designated investment firms operating in the UK that are part of non-UK headquartered groups and to those international banks that may seek PRA authorisation in the future. The proposals contain a general approach, applicable to all branches, as well as additional expectations for significant retail and systemic wholesale branches. Whilst described as a new approach, the proposals do not, represent a substantial departure from the PRA's current approach to supervision of third country banks.

General approach

The draft Supervisory Statement introduces three key elements that focus on wholesale banking:

- the importance of the branch to the financial stability of the UK – its systemic importance – as a determination of the way in which the PRA would supervise international banks that undertake wholesale activities in the UK through a branch;
- the importance the PRA attaches to the supervisability of an international bank that operates in the UK in deciding whether to allow branching into the UK. In this respect, the PRA would place:
  - particular consideration on the quality of supervisory cooperation with the home state supervisor, with higher cooperation expected for international banks undertaking wholesale activities that are determined to be systemically important (systemic **wholesale branches**);
  - for systemic wholesale branches, a greater emphasis on the degree of influence and visibility the PRA has over the supervisory outcomes for the firm as a whole and the wider group, as far as relevant to the safety and soundness of the firm and necessary to achieve the PRA's objectives of ensuring financial stability;
- if the PRA is unable to gain sufficient assurance over the supervisability of systemic wholesale branches, the likelihood is that that PRA would impose specific regulatory requirements at branch level. If this provides to be ineffective, the PRA would likely be prepared to authorise the firm only as a subsidiary.

The PRA also requires the whole firm to meet the PRA's Threshold Conditions, that the home state supervisor's regulatory regime is sufficiently equivalent to meet outcomes-based international standards and deliver appropriate outcomes consistent with the PRA's objectives, and for the PRA to have adequate assurances over resolution.

The new approach is not expected to have any implications for current operations of any of the non-EEA banks currently operating in the UK as branches; for example, from countries such as the US, Switzerland and Japan.

Approach to significant retail activities

In general the PRA will not permit branches to undertake retail banking activities beyond de minimis levels – this is intended to mitigate risks to UK financial stability. In determining that level, the PRA will consider the value and types of account, the number of customers, substitutability and planned growth. In addition to these factors, the PRA is mindful of the impact that branch operations may have on the Financial Services Compensation Scheme (**FSCS**). If the branch were to fail and the FSCS were unable to recoup the amount it paid out via the bank insolvency procedure

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from recoveries, ultimately there would be a liability to the UK financial system. Given this, the PRA will not in general be content for a branch to undertake deposit activity where the total potential liability to the FSCS in relation to covered deposits is in excess of £500 million.

It is worth noting that where an international bank is required by the PRA to establish a subsidiary, it does not automatically mean that the BoE, as resolution authority, will also require the firm to adopt a partial transfer or bail-in resolution strategy. In other words, such subsidiaries will not automatically be considered to be of such systemic importance that they cannot be allowed to go insolvent.

Approach to systemic wholesale branches

The PRA intends to identify wholesale branches as systemically important where their size, complexity and interconnectedness indicate that the failure of the firm could have significant consequences for financial stability in the UK.

As its starting point, the PRA will have regard to the size of a firm's UK footprint in deciding whether to determine a wholesale branch as systemically important, specifically whether it exceeds an average of £15 billion total gross assets. Where a group maintains more than one UK branch the PRA will aggregate the UK footprint of those branches to assess the overall significance of the UK branches of the group. In calculating the figure, the PRA will take account both of assets booked onto the balance sheet of the branch and assets traded or originated in the UK but booked remotely to another jurisdiction.

In addition to the expectations set out above, the PRA also expects the degree of cooperation with the home state supervisor to increase in cases of systemic wholesale branches – for example, regular structured engagement via a college or bilateral meetings, joint supervisory work with the home state supervisor, prompt information exchange and the development of appropriate crisis management frameworks.

Timing

The deadline for comments on the consultation paper is 27 February 2018, and the PRA is proposing that the new approach takes effect after the completion of the consultation period and following publication of the final Supervisory Statement. In particular, for those EEA firms that are currently branching into the UK under the passporting regime, and which are intending to apply for PRA authorisation in order to continue operating in the UK after the UK's withdrawal from the EU, the PRA will apply the new approach set out in the final Supervisory Statement in assessing the firm's application. Authorisation under the new regime would come into effect after the UK withdraws from the EU.

It is worth bearing in mind that these proposals have been designed in the context of the current UK and EU regulatory framework. The PRA will have to keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including those arising from any new arrangements with the EU.

International insurers – the PRA's proposed approach to branch authorisation and supervision

Similar to CP 29/17, consultation paper CP 30/17 and its accompanying draft Supervisory Statement sets out the PRA's proposed approach to authorising and supervising third-country insurers that carry on (or are considering carrying on) insurance business in the UK through a branch or by forming a subsidiary. The proposals are relevant to all existing and prospective insurance firms carrying out regulated activities, but not headquartered, in the UK that are not able to benefit from passporting. The proposals contain the details of the existing regime in place in respect of a third-country insurance branch/subsidiary and the proposed additional requirements that the PRA would like impose in its authorisation assessment of such entity and the overall supervisability of that entity in the UK.

The scale of the UK branch activity covered by the FSCS

The FSCS is the last resort provider of compensation to eligible policyholders in the event of an insurer (authorised by the PRA) becoming insolvent. Whether a third-country insurer was operating in the UK through a branch or a subsidiary, the potential cost to the FSCS for an insurer default would be the same. The PRA states that the level of FSCS-protected liabilities is a strong indicator of the risk of a branch to both policyholders and FSCS levy payers (i.e. levies on insurers writing FSCS-protected business).

The levies imposed on insurers writing such business are used to cover the cost of compensation. The levies are

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subject to an annual limit and if the amount of compensation exceeds the annual limit, the FSCS has a borrowing protocol in place with HMT for access to the National Loans Fund. In light of this, the PRA expects a greater level of supervisory oversight for these firms and the PRA has a greater ability to mitigate risks in subsidiaries as it has access to a wide range of supervisory tools and legal powers.

In the consultation paper, the PRA suggests that where a third-country branch has £200 million or more of insurance liabilities covered by the FSCS, that branch should instead seek authorisation as a subsidiary so that the PRA can exercise greater regulatory oversight over that entity. The PRA notes that £200 million is not a "hard threshold" and welcomes views on alternative approaches to defining the threshold.

The impact of a branch failure on the wider insurance market and financial system

The PRA notes that if an insurer's FSCS liabilities are below the proposed threshold of £200 million of FSCS liabilities, there is still a possibility that it could pose a significant threat to the financial stability of the UK. For example, in retail business, it is stated that the PRA generally has a lower tolerance for failures in annuity and long-term business than some other non-life or reinsurance products. This reflects the importance to many policyholders of continuing to receive benefits from annuity and long-term policies over a long timescale.

In order to address these risks, the PRA proposes to consider additional factors to assess a third-country branch's potential impact on financial stability, including:

- availability of substitute products that would offer a policyholder a similar level of protection;
- branch's position in the market, particularly assessing the size of the market share in a niche market;
- level of connectivity of a branch in the industry it operates within: for example, the extent and complexity of inter-firm transactions; and
- significance of the UK operations of the third-country branch compared to the amount of business within other jurisdictions.

It is important to note that in respect of the proposed additional factors summarised above, the PRA does not expect any existing third-country branches currently operating in the UK to be deemed sufficiently significant to the wider insurance market and financial system for it to be required to subsidiarise.

Timing

As is the case for CP 29/17, the deadline for comments on CP 30/17 is 27 February 2018 and the PRA expects the final Supervisory Statement setting out the additional requirements to be considered alongside the existing regime. The PRA states that the proposals have been designed in the context of the current UK and EU regulatory framework. As above, the PRA will have to keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including those arising from any new arrangements with the EU.

PRA "Dear CEO" letter – planning assumptions

Further to his April 2017 letter regarding Brexit contingency plans, Sam Woods (CEO, PRA) has written to banks, insurers and designated investment firms that undertake cross-border activities to acknowledge the complications and disruptions that both UK and EU firms will face on exit and to set out a number of planning assumptions that firms can use as part of their Brexit preparations.

The key message of the letter is that in the absence of continued passporting rights post-Brexit, firms currently exercising those rights to establish a branch or provide services into the UK (inbound firms) will need to seek PRA authorisation to carry on PRA-regulated activities in the UK. The PRA is clear that the scale of the authorisation challenge is significant and therefore encourages inbound firms to engage with the regulator for pre-application discussions now, to the extent those discussions are not already on-going.

In addition, the "Dear CEO" letter:

- confirms that firms may submit applications for authorisation from January 2018, and the PRA will then review timelines and assumptions as the political process moves forward;
- highlights that the PRA is consulting on updating its approach to supervising international banks and notes that it is based in part on an assessment of the degree of equivalence of the home state regime in meeting international standards and delivering appropriate outcomes consistent with the PRA's

objectives, and of the level of cooperation with the home state supervisor;

- notes that the outcome of the negotiations between the UK and EU is relevant to how existing EEA branches are supervised post Brexit and that it is therefore premature for it to reach a final view. However, given the progress to date in the Brexit negotiations, for the present firms may plan on the assumption that the PRA's updated expectations and requirements (in particular, as regards regulatory cooperation) will be met, and therefore that they may apply for authorisation as branches unless they are conducting material retail business;
- confirms that the PRA's policy approach to significant retail banking activity will remain consistent and that those bank branches that undertake such activity to apply for authorisation as a subsidiary; and
- welcomes HMT's announcement regarding a temporary permission regime and contractual continuity, both of which are considered below.

The PRA expects the planning assumptions to be updated regularly as the political process progresses.

BoE "Dear CEO" letter – non-UK CCPs

The BoE letter (which was sent by Sir Jon Cunliffe, BoE Deputy Governor, Financial Stability) sets out how the BoE envisages non-UK CCPs will be recognised to provide services in the UK post Brexit.

As discussed below, recognition of non-UK CCPs will become the responsibility of the BoE under new powers to be granted by the government. The BoE understandably states that UK market participants that use non-UK CCPs need to know before Brexit whether those CCPs will continue to operate in the UK, so that they can plan accordingly. The BoE is therefore undertaking preparatory work with a view to ensuring a smooth and transparent process and addressing their letter to CCPs which are currently recognised by ESMA to operate in the EU (and those that have applied to ESMA), to understand whether the firm intends to continue operating in the UK.

The BoE expects a non-UK CCP to apply for UK recognition if it intends to do any of the following after the UK's withdrawal from the EU:

- provide clearing services to clearing members or trading venues established in the UK;
- be used by market participants to satisfy any mandatory clearing obligations that apply under UK domestic law; or
- be deemed a 'Qualifying CCP' under UK domestic law for certain capital requirements purposes.

It is anticipated that the government will propose that, immediately following the UK's withdrawal, UK domestic law requirements for recognition of non-UK CCPs will in essence be the same as the current requirements under Article 25 of the European Market Infrastructure Regulation (EMIR).

HMT's Written Statement

In conjunction with the BoE and the regulator's announcements, the Chancellor of the Exchequer, Mr Philip Hammond made a written statement to the House of Commons which confirmed that the government will, if necessary, bring forward legislation to enable:

- a temporary permissions regime – thereby allowing EEA firms and funds to undertake new business within the scope of their permission, enable them to continue performing their contractual rights and obligations, manage existing business and mitigate risks arising from a cliff edge as regards a loss of passporting; and
- contractual continuity – such legislation would ensure that contractual obligations not caught by the temporary permissions regime could continue to be met.

In addition to the above, HMT confirmed that secondary legislation will be brought forward to ensure that the UK authorities will be able to carry out functions currently undertaken by applicable EU authorities. This announcement follows on from a letter dated 12 December 2017 in which the Economic Secretary outlined to HMT how the European Union (Withdrawal) Bill should be used to domesticate EU financial services legislation and the responsibilities of the European Commission and the European Supervisory Authorities (**ESAs**). In relation to the role of the ESA, HMT confirmed the following:

- BoE – the Bank will be given functions and powers in relation to non-UK CCPs and non-UK central securities depositaries. To the extent required, the government will also provide for a temporary regime to enable the BoE to permit these firms to continue operating for a limited period of time post exit.

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- FCA – the regulator will be given functions and powers in relation to UK and non-UK credit rating agencies (**CRAs**) and Trade Repositories, including any powers necessary to manage the transition post-exit.

Unsurprisingly, the Chancellor concluded the statement by confirming that, whatever the outcome of negotiations; financial stability so as to avoid market disruption would remain a key area of cooperation between UK and EU regulators.

FCA Statement on EU withdrawal

Whilst the FCA welcomed the progress in negotiations, particularly in relation to a proposed transitional period during which it anticipates that firms will be able to continue to benefit from passporting, it noted that additional information could only be provided once negotiations have progressed further. As a result, the focus of the FCA's statement was on the proposed temporary permission regime announced by HMT.

- FCA solo regulated firms – the FCA confirmed that those firms wishing to avail themselves of the new regime would need to notify the regulator prior to exit day but that a formal application for authorisation would not need to be submitted. Further details are expected shortly but the FCA will continue to work closely with home state regulators of EEA firms and the European Supervisory Authorities.
- UK firms servicing EEA clients – the FCA will provide more information as negotiations on the second phase progress; however, they expect such firms to continue to prepare for a range of scenarios and to continue discussions with relevant EU regulators.

As regards the FCA's new role in relation to UK and non-UK CRAs and Trade Repositories, it confirmed that it is working closely with both the UK government and affected business to ensure a smooth transition into the new regime.

EIOPA opinion on service continuity in insurance in light of EU withdrawal

In the context of insurance, it is interesting to note that a day later, EIOPA issued an opinion to supervisory authorities and insurance undertakings as a reminder to take necessary steps prior to the withdrawal from the EU for the possibility of the loss of the passporting regime. EIOPA states that in the absence of taking mitigating actions prior to withdrawal, insurance undertakings will usually not be able to ensure the continuity of service with regards to cross-border insurance contracts, which may prevent them from fulfilling such contracts. This would expose policyholders and beneficiaries to significant uncertainty, the protection of whom is the main objective of insurance supervision under Solvency II.

EIOPA has established a cooperation platform for supervisory authorities to exchange information on Brexit related topics, including cross-border business and the EU27, and analysed possible options to ensure service continuity, including:

- the transfer of insurance contracts of UK undertakings with policyholders in the EU27 to an insurance subsidiary established in an EU27 Member State;
- the transfer of insurance contracts of EU27 undertakings with UK policyholders to an insurance subsidiary established in the UK;
- the establishment of a third country branch in the UK or in the EU27 Member State of the policyholder, and
- with regard to UK undertakings in the legal form of a European company, the change of domicile of the company to an EU27 Member State.

EIOPA notes that some options may need to be combined for particular insurance undertakings and the appropriateness of all the options will depend on the situations of the affected entities.

Separately, the opinion sets out actions which supervisory authorities should take to ensure continuity of service, to ensure that insurance activities are not carried on without authorisation and in respect of such matters, ensure that insurance undertakings with cross-border insurance contracts develop realistic contingency plans.

Practical impact

Whilst the UK authorities have been keen to highlight that their 20 December 2017 announcements do not constitute a substantial policy shift in their approach to supervision of branches or non-UK CCPs, European

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firms operating in the UK should not presume that time is on their side, particularly if they are yet to engage with the regulators. Whilst HMT's proposal to create a temporary permission regime may be helpful, firms should not view this as an integral part of their Brexit planning – both the BoE and the PRA have made clear that the potential temporary regime should be viewed as a fall back option only.

The regulators have been explicit about the scale of the authorisation challenge and reiterated the 12 month statutory time line for processing authorisations – given the volume and possible complexity of the applications; it is likely that the regulators will need the whole of this statutory period. Firms are being encouraged to engage as soon as possible with the regulators. In preparing for the process (particularly any pre-application meetings), firms will need to be clear on the key elements of their regulatory business plans not only for immediately post Brexit but also for the medium and longer term. Details on the scale of retail business, assets, booking arrangements and planned growth will need to be articulated clearly.

In respect of the insurance matters discussed in this update, the UK regulators are on notice of the potential additional responsibilities they may have transferred to them from the ESAs and the European Commission upon withdrawal from the EU. However, from both a UK regulator perspective and an insurance firm/third-country insurer perspective, the latest insurance opinion and proposals identify a number of matters which insurers/regulators should be planning for if they are not doing so already (i.e. a post-Brexit world where no passporting regime exists).

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