ALLEN & OVERY

Brexit day 1 readiness for European banks and investment firms: risk, legal and compliance changes for EU firms under EU law

We examine some of the ways in which a hard Brexit will affect the EU legal and regulatory obligations of EU financial services firms facing or using UK clients/counterparties/market infrastructure.

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As we near a potential hard Brexit, UK, EU and international banks and investment firms continue to plan for the exit of the UK from the EU single market. From a legal and regulatory perspective, the primary order of change is the loss of passporting. In our experience EU firms are now generally well prepared for this.

Second order issues then follow in two areas. The first is changes to UK legal and regulatory obligations arising from Brexit – these primarily derive from the UK legal and regulatory regime arising from Brexit. The UK authorities have prepared a considerable volume of materials 'onshoring' and making various changes to EU law: as a result EU firms with UK branches are generally aware of the UK legal and regulatory changes that will occur on Brexit date and have been putting in place implementation plans. Our experience is that EU firms which provide cross-border services into the UK without a branch are generally a little less well-prepared.

The second is changes to EU legal and regulatory obligations arising from Brexit. Here, unlike in the UK, there is very little legislative change associated with Brexit – the EU has limited itself to the passing of legislation providing limited transitional relief enabling the continued use of UK CCPs and CSDs for a period post-Brexit, and limited changes to EMIR. Notwithstanding this, the change in status of UK clients, counterparties and market infrastructure from EU to third country status has considerable consequences for the regulatory obligations of EU market participants which deal with them. Further, because (unlike the UK authorities) the EU authorities have largely declined to offer transitional relief associated with those changes in status, a large number of changes will take effect immediately at the point of Brexit.

This paper draws attention to a few of the major areas of change we have identified that will affect EU firms, focusing on EU legal and regulatory obligations. Some, but not all, of those changes could be cured by equivalence decisions from the EU or from competent authorities. The examples below are intended to illustrate that EU firms will have substantial compliance work to do to enable them to meet their – largely unchanged – EU law obligations post-Brexit in connection with activities which involve the UK. This paper does not purport to give a complete overview of all changes. There are a myriad of further changes which could affect EU firms. Firms should take legal advice on their position.

CREDIT RATINGS AND BENCHMARKS

Use of UK credit ratings and benchmarks. Brexit has the effect that UK credit ratings cease to be eligible for use under the Credit Rating Agency Regulation (including for prudential purposes) unless the credit rating is endorsed in the EEA. Similarly, under the Benchmarks Regulation, following the lapse of the transitional period provided for by the Regulation, benchmarks cease to be eligible for use in the EU unless the relevant benchmark is endorsed, or its administrator recognised, under the Benchmark Regulation. EU firms which are supervised users under the Benchmarks Regulation will need to ensure that UK administered benchmarks they use are eligible from the end of the transitional period.

PRUDENTIAL REQUIREMENTS: CAPITAL REQUIREMENTS REGULATION

Brexit has the effect that UK clients, counterparties, affiliates, securities and market infrastructure cease to benefit from the various preferential prudential treatments afforded to them whilst the UK has been in the EU. Some key examples are as follows:

CCR: exposures to CCPs. From expiry of temporary recognition of the UK CCPs on 31 March 2020 they will cease to be QCCPs and be subject to substantially increased risk weighting requirements for house and client positions.

Risk weighting: standardised approach. Absent an equivalence determination, exposures to UK institutions will become part of the corporate exposure class for credit and counterparty risk, resulting in changes to risk weightings. UK covered bonds will also cease to be eligible as covered bonds and will be risk weighted in the same way as non-covered bonds.

Risk weighting: IRB approach. Under the standardised approach UK sovereign exposures (including to PSEs) will cease automatically to benefit from a 0% risk weight. As a result, under the IRB approach a 0% risk weight will no longer be available. Exposures to UK institutions that have balance sheet of under EUR70 billion will become subject to an additional 1.25 correlation multiplier under the IRB RWA calculation.

Credit risk mitigation: unfunded CRM: eligibility. UK institutions will become ineligible to provide unfunded CRM.

CVA: affiliate exposures. Derivatives (and in some cases securities financing) exposures to UK affiliates will lose the benefit of the CVA exemption.

*Liquidity coverage ratio (**LCR**)*. UK covered bonds will cease to have the benefit of preferential treatment for LCR purposes.

DERIVATIVES TRADING: EMIR

Use of UK CCPs. Should the EU not roll over the temporary recognition of UK CCPs (due to end on 30 March 2020) EU firms will cease to be able to receive clearing services from UK CCPs. In addition, EU firms will be unable to discharge the clearing obligation by clearing positions on a UK CCP.

Status of UK exchange-traded derivatives. Absent an equivalence determination UK exchange-traded derivatives will be OTC derivatives at the point of Brexit, with knock-on consequences for counterparty categorisation and the application of the clearing and risk mitigation obligations with respect to such derivatives.

Loss of intragroup exemptions. EU firms which trade derivatives with UK affiliates will lose the benefit of their intragroup exemptions from clearing requirements at the point of Brexit: firms will need to reapply for these.

Loss of pension scheme exemption for UK pension schemes. EU firms which deal with UK pension schemes will lose the benefit of the EMIR exemption for pension schemes.

Loss of preferential status of UK instruments and counterparties under margin requirements. The EMIR margining requirements confer preferential status on EU instruments and counterparties in certain respects. These will cease to apply to UK instruments and counterparties from the point of Brexit. Examples include the (in)eligibility of UK UCITS and of UK banks to hold cash margin.

SECURITISATION: SECURITISATION REGULATION

Ineligibility of UK STS. The Securitisation Regulation introduced a framework for the preferential capital treatment of Simple, Transparent and Standardised (**STS**) securitisation. UK STS securitisations will not be recognised for purposes of the EU rules, resulting in less favourable capital treatment.

Risk retention. UK investment firms acting as sponsors will not be eligible risk retainers under the EU framework from Brexit.

MARKETS: MiFID II AND MiFIR

Share and derivatives trading obligations. As has been well-flagged, the share and derivatives trading obligations will cease to be capable of being met by trading on UK venues post-Brexit. This issue is compounded somewhat by the dual application of the requirements to UK branches of EU firms.

RETAIL SALES OF FINANCIAL INSTRUMENTS: UCITS AND PRIIPS

Post-Brexit, UK UCITS funds will be treated as alternative investment funds under EU law and fall to the more stringent marketing regime under the Alternative Investment Fund Managers Directive. UK Key Information Documents produced following Brexit will also be ineligible for sales to EU retail investors under the PRIIPs Regulation.

These examples are merely illustrative of the kinds of compliance issues that will arise on day one should the UK leave the EU without a transitional deal agreed. EU firms cannot be complacent. Even though EU law will remain largely unchanged, post-Brexit, there are a myriad of changes which could affect firms. Firms should take legal advice on their position. We stand ready to assist, please call your usual A&O contact or any of the contacts listed &

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