Building a better working world

International Financial Services in Ireland

A Brexit progress report

In the aftermath of the Brexit referendum, Dublin's financial services sector is emerging as one of the top choices for major global banks as their EU hub. Despite this, the Central Bank of Ireland stated in its mid-year report that it has not yet received any new banking licence applications – so where are global banks at in this process, why is it taking so long, and what can this tell us about possible post-Brexit outcomes?

As financial services organisations in London seek alternative paths into the EU, at least 19 banks have publicly declared plans to establish or expand legal entities in Ireland according to the most recent EY Brexit tracker. Others have declared for Frankfurt, Paris and Amsterdam.

Yet, not a single financial institution has lodged a formal Brexit related banking application with the Central Bank of Ireland (CBI). Why? In this piece, we look at why financial institutions – with a particular focus on banks and large investment firms – need a licenced entity within the EU, what they need to do to get those licences, and what challenges they may be facing.

Once the United Kingdom withdraws from the EU on 29 March 2019, unless a new agreement between the EU and the UK is negotiated, banks licenced there will no longer have access to the 'passporting' mechanism, which allows banks to locate an entity in one EU member state and then operate throughout the EU. This will impact major British banks, as well as financial institutions in Asia, the US and Switzerland who have headquartered their EU banking in the UK over the last 30 years.

These financial institutions are being asked by both UK and EU authorities to make plans now if they wish to ensure continued access to the EU markets and clients.

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Cormac Kelly, Advisory leader for International Financial Institutions and Brexit at EY in Dublin, said: "We're facing a period of protracted uncertainty, and the challenge for organisations is that they can't wait for the final negotiated outcome to act. It's important to make strategic decisions and put in motion appropriate plans with a purpose, using all available information.

These decisions should be made on a 'no regrets' basis – we don't have the benefit of hindsight, so instead organisations should make the best decisions they can here and now to be ready for a post-Brexit environment."

Discussions around the future of the financial services sector by politicians will only take place once citizens' rights, Ireland/UK border and the exit bill negotiations have progressed significantly.

Did you know...?

According to the EY October 2017 Brexit tracker for financial services:

13 organisations have confirmed that they are moving some staff or operations to Dublin compared with 12 for Frankfurt and 6 for Luxembourg

25% or 56 of 222 tracked companies have named a location in Europe that they are moving some operations or staff to

3% or six organisations have said that more than 400 jobs could move

As of the time of going to press, no agreement around a transitional period after the 29 March 2019 deadline has been reached. As a result, financial institutions are having to plan for a 'hard Brexit' scenario where the United Kingdom loses access to the single market, and no transitional period occurs.

Depending on their existing infrastructure and footprint in Europe, banks are developing plans to establish European operations with headcount and infrastructure in an EU jurisdiction with Dublin emerging as a real option for many.

The prudent path to a post-Brexit environment

Financial institutions need to ensure that they have been granted the appropriate licences and are fully ready to operate and service clients by 29 March 2019. Considering there are now just 18 months left, integrated planning and understanding the critical path is a must for all organisations.

Aidan Walsh, International Banking Sector Leader at EY in Dublin, said: "Since we do not know whether there will be transitional arrangements, to avoid a disruptive cliff-edge the wisest approach is to prepare for the outcome that the UK might become a third country from the viewpoint of the EU regulator on 29 March 2019. As significant resources are allocated to post-Brexit locations, events take on their own momentum"

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Over the coming months many decisions will have to be made around

- legal entity and governance structures
- risk and booking models
- location of talent
- technology infrastructure setup and testing
- real estate
- taxation and VAT
- cross-border booking model arrangements.

This exercise will be a significant undertaking, and it will require significant programme governance, resourcing, reporting and funding. All this at a time when budgets are being analysed and stretched to accommodate other regulatory initiatives including ring-fencing, MIFID, IFRS, AML, and Conduct; which may be putting pressure on – or even impeding – banks decision-making processes

Building out a Brexit programme

A key challenge with a relocation programme for a major bank is that it is all-encompassing in nature. It can impact and involve most of the banks functional units and requires the detailed engagement of subject matter experts to understand, define and articulate the implications of changing business and operating models. Documenting this in detail will be necessary to facilitate the establishment of a new entity structure where the bank is being treated as a third country.

Based on EY Ireland's experience of this journey with clients to date there are three typical phases of the Brexit process.

- **Phase 1:**
  Deciding on a Brexit strategy

The first phase involves deciding on your Brexit strategy for European customers based in the UK and performing a high level impact and options analysis. This should consider which business areas, legal entities, clients and staff are impacted and what initial options can be considered. A jurisdictional analysis and decision would normally occur at this stage, as well as initial contact with and introduction to the potential local regulators. At the end of this phase, a decision should be made on which locations your organisation will establish or expand entities in.

- **Phase 2:**
  Licence application & entity design

This phase primarily focuses on getting a licence application drafted and completing the regulatory authorisation process. In Ireland, this will involve engaging in an exploratory exercise with the regulator which involves deep-dive sessions to inform and educate them on every detail of the expected organisation and operation to be established. This should include building a detailed and integrated plan, mobilising the organisation and designing in detail the new operating model including policies, process, people and technology for the new entity and business to be operated in Europe through Ireland.

- **Phase 3:**
  Establish, migrate & execute

The third phase is all about execution. It incorporates the establishment of the new organisation and deploying the infrastructure, processes and people to carry out the "business as usual" and support functions. Client migration and ensuring operational readiness in time for March 2019 will be the key focus and challenge.

How long is this going to take?

EY clients have described the process of applying for a banking licence and migrating the business to a new country as complex, time-consuming and resource intensive. Organisations should take care to understand that it is not a common occurrence, especially for a new ECB or Single Supervisory Mechanism ("SSM") regulated entity. It requires a combination of educating and informing the regulator on who your organisation is and what and how they conduct their business.

It involves explaining the detailed aspects of your entity structures, the business conducted, governance, booking and operating models and a clear understanding of the financial – funding, capital and risk – plans you have for establishing and migrating clients over to the new bank. EY is strongly urging financial institutions aiming to establish or expand legal entities in Ireland not to underestimate the timeline for the process.

EY is supporting global banks that have chosen Dublin as their European post-Brexit location in engaging with regulators, and discussing the need for a new or expanded licence to ensure they are authorised to operate within Europe.

Cormac Kelly said: "The CBI has said they welcome having preparatory discussions with banks interested in establishing or increasing their presence in Ireland. These discussions are encouraged on issues around the application as soon as you have defined the fundamental elements and narrowed down any options of your transformation or re-organisation plan."

The approval process for a new banking licence is likely to take at least six months.

This period may be shorter where the bank asks for an extension of an existing license, as long as the national framework allows for such an extension and that there are no supervisory concerns. By law, a decision to grant or refuse an authorisation can take 12 months.

However, for the approval process to begin, the regulator must receive a complete application. The process of submitting a comprehensive and considered application, including the right level of regulatory engagement, can take much longer.

The length of this process is highly dependent on the complexity of the institution's business, as well as the effort the institution puts into explaining their organisation, and demonstrating their commitment to establishing the new entity in line with robust governance and risk management principals.

The process starts with an introductory meeting where you present your organisation and the proposal for the nature and scope of the new bank set-up. If no red flags are raised at this point, the meeting normally concludes with an agreement to enter the exploratory stage and to arrange deep dive sessions on a range of important and technical areas.

EY International Financial Services team: (l-r) Sinead Colreavy; Robert Callaghan; Aidan Walsh; Cormac Kelly; Orla O'Connor and Anne Marie Curtin

The challenge at this stage can be accumulating all the necessary information from across the organisation and completing the impact analysis and initial design and completing all the internal conversations and preparations to gain alignment and buy-in. This can take months, particularly as some of the changes in the business and structures will challenge the current structures and organisational models.

Gaining the regulators understanding and agreement on the proposal and the new organisation design allows the organisation to formally start the application drafting phase.

The extent of the deep dives sessions may vary by organisation but organisations should expect to be asked to provide detailed overviews of the following areas:

- Overview of the Parent or Group to which the applicant belongs
- Consolidated supervision of Parent or Group entities if any
- Ownership structure and legal structure
- Applicant's objectives and proposed operations
- Corporate governance arrangements, fitness and probity of key personnel
- Risk oversight
- Capital, funding and solvency projections for the next 5 years
- Financial information and projections
- Business continuity and outsourcing

The CBI may ask for additional information as they progress with the application process and the market evolves to post Brexit world. Submitting a high quality application at the outset is crucial to make sure the application is processed as smoothly as possible.

The application should make an organisation's implicit structures explicit and understandable for the regulator. It is not a simple case of the first organisation in the queue will be the first to get a licence – the clear, appropriate and complete applications will proceed most quickly, and ultimately they will get authorised first. It is very likely to be a "best in – first out" scenario.

Ratcheting up your risk and regulation model

In the euro area, banking supervision is conducted by the ECB and the National Competent Authorities (NCAs) – within the framework of the Single Supervisory Mechanism. In Ireland, the NCA is the Central Bank of Ireland (CBI). While banking licence applications are made to the CBI, the final approval and granting of the licence is made by the ECB.

The European Central Bank (ECB) is the formal granting authority for a banking licence in Ireland. In general, the CBI will engage with the applicant firm to complete the authorisation process with final approval coming from the ECB.

However, in the case of entities which are categorised as 'significant financial institutions' the ECB will engage in the authorisation process. The CBI and ECB regulators will want to get to know and understand fully how the organisation works and how it will manage its European footprint.

Aidan Walsh, International Finance Partner at EY said: "The ECB require a substantive EU corporate presence – including 'hearts and minds' – in the jurisdiction where the new legal entity will book and manage its risk-taking activities."

A clear understanding and articulation of how risk is accepted, distributed, managed and mitigated within the Group must be shared with the regulator. They will want to understand the role of the local entity within the Group's risk policies and how group solutions are appropriately adapted and approved for the local legal entity.

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This corporate presence should include senior risk management with the strength, capability and understanding to exercise independent oversight of the risks of the proposed legal entity.

The regulator has continuously stated it will not approve licence applications where it is evident that the new entity does not hold decision-making capabilities. The ECB and CBI have said clearly that they will not allow EU "shell-companies".

Rising to the challenge

Our experience with clients to date has shown a number of consistent challenges arising during the application process. Below we examine this 'hit list' of challenges and what institutions need to consider.

- **Governance: Independence over enterprise**

The establishment of an independent governance structure for the European institution with a compliant local board; a competent and sufficient management team; a suite of locally approved policies; and processes which don't solely rely on the enterprise or group structures

- **Substance: Capability, capacity and responsibility not just FTE**

Shell organisations will not be accepted by the regulator, nor is there an expectation that everyone needs to be in a single location. The issue is not only about employee numbers – it is about having competent substance in the entity – although the number of Full Time Equivalents (FTEs) may used as a benchmark.

Substance is also about making sure that the right calibre of senior decision makers exercising oversight of the European institution are in the jurisdiction and focused on running that institution in an acceptable manner to the regulator.

Outsourcing is a major topic to be covered with the regulator, requiring a clear articulation on how group services in hubs are adequately managed by the new entity.

The key requirement is to ensure that the new European entity has clear oversight and governance of the service provided and have the capacity within the entity to manage and administer them.

- **Booking model: Risk management versus risk transfer**

A decision on how risk is retained and managed or transferred in the European entity is key to the booking model structure; deploying back to back models across the new entity was never going to be a single solution.

Balancing the model and adopting back to back models per asset class where and if appropriate to optimise risk aggregation and management cost, and leverage capital will dictate the overall solution.

- **Simultaneously rather than sequential authorisation for European branches**

The establishment of a European headquarters may necessitate the transfer of a set of European branch locations away from a UK subsidiary across to this new Euro entity. It appears that the European regulators will facilitate the approval, set-up and transfer of these branches simultaneously with the headquarter application.

Establishing European branches should be a relatively straight-forward process however the transferring the branch activities and clients may pose some legal and tax challenges. The tax implications of branch mergers/changes in European countries could be significant and require detailed analysis and a deep understanding of individual countries' tax considerations

- **Internal models: Temporary tolerance versus grandfathering**

For financial institutions utilising internal risk and financial management models, a significant focus has been on the position of the European regulators acceptance of the internal risk model currently operated by financial institutions.

It appears that the European regulators will accept at least for a nominated period those models which are in use and accepted by the Prudential Regulatory Authority, but there is an emerging view that a formal process to get them approved by the ECB may start almost immediately upon authorisation. This could be an onerous task for some of the major firms.

- **A complex critical path: Integration, authorisation, client migration and infrastructure build**

A major challenge for Brexit programme managers is the hard deadline of 29 March 2019 and the level of uncertainty on final negotiation outcomes which is making management hesitant on kicking off on Brexit spend in earnest. Delivery managers in all impacted firms have been analysing and defining their critical path and many are already worried that they are falling behind the timelines they created for themselves for gaining approval from the regulator, establishing the entity and testing their infrastructure.

At the same time, organisations also need to gain the trust and acceptance of clients to migrate their business and support employees to move themselves and their families. For many organisations, a concern will be that these processes simply may not fit the dwindling 18 months left.

Assuming that a 'hard Brexit' goes ahead in March 2019 the timeline is tight for global banks and investment funds to construct, test and migrate a bank in Ireland. Even for established players, this poses a massive challenge – and it will stretch budgets.

The extent of the work involved means that only the applications of early initiators are even close to the point where they can be submitted.

Adding to this uncertainty is the ongoing political rhetoric, which is impeding decision making within elements of the financial services sector – and this political ambiguity is likely to continue for some time.

We are, however, reaching a tipping point; financial institutions who fail to make steady choices and act on them decisively risk missing the deadline and facing the potentially serious repercussions that would create.

Of course, being granted a banking license is not the end of the critical path - or the beginning of the end - it is the end of the beginning.

Find out more...

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