BREXIT AND NON-EU BANKS

Challenges and Opportunities

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Executive Summary

The UK withdrawal from the European Union, coupled with more stringent regulation at the EU level, constitute substantial challenges for the operation of multinational banking groups in the EMEA region. In this report, we discuss the challenges arising from political and regulatory uncertainty and illustrate possible organisational changes for large non-EU banks. We discuss the implications of the EU IPU proposals and the potential effectiveness of the delegation management model, as an alternative to corporate restructuring. Finally, we provide an overview of the future role of the City of London as an international financial hub.
ACRONYMS

BRRD = Bank Recovery and Resolution Directive
CCD = Capital Requirements Directive
CCR = Capital Requirements Regulation
EBA = European Banking Authority
EC = European Commission
ECB = European Central Bank
EEA = European Economic Area
EFTA = European Free Trade Association
EIOPA = European Insurance and Occupational Pensions Authority
EMEA = Europe, Middle East and Africa
ESM = European Stability Mechanism
ESMA = European Securities and Markets Authority
EU = European Union
FSB = Financial Stability Board
FTA = Free Trade Agreement. CU = Custom Union
G-SIBs = Globally Systemically Important Banks
G-SIIs = Globally Systemically Important Intermediaries
GDPR = General Data Protection Regulation
IPU = Intermediate Parent Undertaking
MiFID = Markets in Financial Instruments Directive
NCA = National Competent Authority
PSD = Payment Services Directive
UCITS = Undertakings for Collective Investment in Transferable Securities
UK = United Kingdom
WTO = World Trade Organisation
INTRODUCTION

Since the result of the referendum on the UK membership of the European Union (EU) in June 2016, financial services firms have put in place planning and strategies to deal with the political uncertainty of Brexit.¹ The result of the referendum forced banks and other financial services providers to consider alternative scenarios and plan for the potential exit from the EU Single Market for financial services, which grants banks ‘passporting rights’ to all EU countries. This planning has advanced and there is now a better understanding of the strategic and operational decisions required to minimise operational disruptions across different future market access scenarios.

As the political discussion continues, many non-EU banks find themselves in an unusual set of circumstances. Most large international financial intermediaries had set up headquarters and operations in the City of London, both to service UK customers and access the UK market infrastructure, but also to obtain access to the EU markets and customers. However, a new regulatory provision at the EU level will require them to establish a legal entity within the EU. The European Commission (EC) 2016 proposals require that non-EU globally systemically important banks (G-SIBs), which have two or more subsidiaries in the EU that qualify as credit institutions or investment firms, must establish an Intermediate Parent Undertaking in the EU (EU IPU).² Non-EU G-SIBs must, therefore, reorganise their European operations and relocate their EU subsidiaries within their group structure, so that one of them becomes the parent company of the other European institution(s) and, thus, qualifies as an EU IPU. Alternatively, a new EU IPU has to be established at the top of the

¹ Brexit is a new term which has come to indicate the process of the UK withdrawal from the European Union. The UK became a member of the then European Communities in January 1973.
² The European Commission (EC) does not determine which banking groups or banks are qualified as G-SIBs but refers to the list published by the Financial Stability Board (FSB).
corporate chain of undertakings in the EU. It is expected that the introduction of the EU IPU requirement will trigger the regulatory consolidation of the European subsidiaries of non-EU GSIBs. This means that the EU IPU, or one of its EU subsidiaries, will have to consolidate the entire EU sub-group (including its non-EU subsidiaries). This requirement is intended to facilitate resolution proceedings. The proposal is also likely to increase the European Central Bank’s supervisory powers (as the consolidating supervisor of the EU IPUs in the euro area). This is because most of the IPUs are likely to be located in the Eurozone, although this would not apply to IPUs located, for example, in Copenhagen, Stockholm or Warsaw.

This proposal is not without critics and there are worries that it will lead to further fragmentation of global banking. Following Brexit, the situation may become even more complex, as the UK ceases to be an EU Member State and no alternative agreement has been negotiated. As a result, credit institutions or financial holding companies located in the UK will not possibly be regarded as EU IPUs. Indeed, even British G-SIBs would become non-EU G-SIBs and, therefore, may be required to set up an EU IPU in one of the EU Member States. This might make it more difficult for firms based in the UK to access the EU market post-Brexit, even if the UK regime were found to be equivalent to that of the EU.

This had led to the current debate on how non-EU banks should re-design their activities in the EMEA region, in order to better address the political and regulatory uncertainty they face. This report will focus on the main challenges posed by Brexit for non-EU large multinational banks. As these financial companies are planning to minimise the business consequences of political and regulatory risk, we will discuss the main options (models) available for business re-organisations. Among several different strategic responses, one model has recently gained popularity, i.e.

the delegation management model, which appears flexible and yet effective in ensuring the maximisation of function specialisations of existing structures and the minimisation of disruption, in terms of human capital. In this context, a key feature of the delegation management model is the ability and feasibility to “delegate back” part of the functions and responsibilities to already established entities. For example, for most non-EU G-SIBs, the UK entity is the main subsidiary for the majority of EMEA operations.

In this report, we will also discuss the challenges posed by Brexit for the City of London and the decision of multinational banks to either relocate their operations within the EU or undertake a structural reorganisation of their operations and adopt a delegation management model, allowing them to delegate their key activities back to London. Our discussion points to the specialness of London as a financial hub at a global level, but specifically here in relation to the EMEA region, both for economic and human capital.

This report represents a first step towards understanding the impact of political risk on multinational banking businesses and their potential strategic response to political uncertainty. Several avenues for further research are highlighted as follows:

I. The investigation of the impact of political uncertainty for multinational banking requires a more complex analysis, which takes into account the interlinkages among the different areas in which the business is organised, given that political uncertainty can be a source of “contagion” for adjacent areas.

II. The delegation management model has, at present, received little attention from academics in economics and finance. This suggests that more theoretical and empirical research is needed to understand the impact on bank governance structures and on headquarter-subsidiary relationships, as principal-agent conflicts and coordination issues are likely to arise.
III. The role of financial hubs and the drivers of their success have generated a rich stream of earlier research, but they have not been consistently investigated in recent years. However, given the unique centrality of these hubs in modern economies, theoretical research could address the issue of i) their resilience to political and economic shocks in the long term and ii) the implication of increased fragmentation across multiple regions (global financial hub vs smaller regional financial hubs).

The rest of the report is organised as follows: Section 1 discusses the challenges facing multinational organisations during a time of increased political and regulatory uncertainty. Section 2 deals with the specific uncertainties brought about by the UK decision to leave the European Union. We will discuss the potential repercussion for the UK financial services industry, particularly in view of the proposed regulatory change which will require global G-SIBs to establish an Intermediate Parent Undertaking in the EU. Section 3 discusses the options available to large multinational banks as they plan to minimise disruption to business. In particular, we will discuss the corporate restructuring option and the delegation management model. Section 4 looks at the growing importance of financial hubs and at the role of London. Finally, Section 5 presents the results of a brief on-line survey designed to gather industry views on the issues analysed in this report. The overall findings indicate that the regulatory and political uncertainty resulting from Brexit will pose challenges for non-EU banks. However, there is also some optimism, since the position of London as a key global financial hub is unlikely to disappear, at least in the short term. Nonetheless, there are challenges deriving not only from other European capitals vying for business, but also from the growth of other financial centres, particularly in Asia.
I. MULTINATIONAL BANKS AT A CROSSROAD: DEALING WITH POLITICAL UNCERTAINTY

Multinational banks, like other multinational firms, have strongly benefited from globalisation, free movement of people, trade, capital and innovation. Over the last two decades, many countries have opened up their banking sectors to foreign-bank entry with the aim of improving the quantity and quality of banking services available to domestic firms and households\(^4\); nevertheless, evidence regarding the role of multinational banks as shock absorbers or transmitters is mixed. For different reasons and in different jurisdictions, this golden era of globalisation seems to have come to an end. This view is supported by several recent political events, such as the US elections, Brexit, and the rise of anti-EU populist movements in Europe. Overall, these new political movements and their anti-globalisation political agenda are likely to challenge the economics, governance, and business models of established multinational banks.

In addition, the regulatory pressure on multinational banks has increased enormously since the 2007-2009 global financial crisis. Regulatory compliance can increase costs and have a negative impact on future growth and profitability of multinational companies, even if it is stability-enhancing.\(^5\) The renewed importance of political and regulatory uncertainty for multinational business is also evidenced by the growing market for political risk insurance, as multinational companies devise ways to protect their business and secure financing from lenders.\(^6\)


In the UK and in the EU, the ever-changing regulatory scenario is currently driven by the political uncertainty underlying the negotiations on the withdrawal agreement of the UK from the EU (Brexit) and the formalisation of the IPU proposals. The status of third-country banks, currently based in London and passporting into the other 27-EU member states, is due to end in March 2019, notwithstanding a possible negotiated transition period. Depending on the type of withdrawal deal and successive agreements between the EU and UK, the current arrangements will have to change in the near future.

When preparing for a post-Brexit world, multinational (non-EU) banks face increasing political risk and are, therefore, in the process of re-designing their business operations in a way that reduces their exposure to this risk and, at the same time, ensures their access to the world’s second largest market, with advanced technologies and an educated labour force.\(^7\)

Political risk can be defined as the possibility that changes in the political environment will produce a positive or negative, direct or indirect, change in the economic outcomes of firms at macro and micro-level.\(^8\) Political environment may refer to: (i) firm-level (i.e. firm-government relations); (ii) industry-level (i.e. trade associations, unions and interest groups); (iii) national level (i.e. elections, policies, norms and regulations in the home and host country); or (iv) international level for multinational business (i.e. supranational relations, international agreements).\(^9\) To some extent, especially for the financial sector, the political

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environments, mentioned above, are all directly or indirectly affected by Brexit.

**Political uncertainty** is an important channel through which the political process affects real economic outcomes. The academic literature has established the impact of political risk on average firm investment in human and physical capital at the aggregate level (asset prices\(^\text{10}\), investment\(^\text{11}\), employment growth and planned capital expenditure, and the cost of corporate debt\(^\text{12}\)). Traditional models consider individual firms as having a stable exposure to aggregate political risks. More recently, however, the literature has emphasised the role of political uncertainty at the firm level\(^\text{13}\), an idiosyncratic component that may, in turn, also affect the macro economy, for instance by distorting resources towards lobbying and the implementation or repeal of new regulations. Recent studies suggest that most of the variation in political risk is at firm-level rather than at the sector-level or affecting the economy as a whole. When facing political risk, firms are more worried about the cross-sectional impact (i.e. increased scrutiny by regulators) than about the general uncertainty of political events. For certain types of political risk, such as elections, firms will postpone their investments and initiatives until the uncertainty is resolved. In this respect, Brexit represents a unique example of political events where uncertainty is not expected to be resolved in the short term, but over a longer time horizon. In this context, even the resolution of uncertainty at national-level will not eliminate the firm-level uncertainty for years to come. As a consequence, firms cannot wait for the political uncertainty to resolve, but must take action to reduce their own

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political risk exposure by restructuring their operations. Brexit also brings into question the role of London as the main international financial centre of the EMEA region.

In addition to Brexit, the rise of anti-EU populist movements in some EU countries is also increasing the political uncertainty facing large multinational companies. Some studies have shown the negative impact of changes in the national political environment on economic outcomes. Interestingly, the literature links the rise of populism to the advanced stage of economic globalisation.

The literature on political risk management is relatively new. Despite the recent renewed attention towards political risk, little research has been devoted to understanding how firms should assess and manage it. Often, managers are aware of the significant impact of a regime change, a shift in government or an increase in political instability on their business, but still tend to ignore, avoid or underestimate its strategic importance. The qualitative and often unexpected nature of this risk and the hard-to-measure impact on businesses and strategies makes it difficult to manage. However, especially for decisions such as foreign direct investment, some studies have provided evidence of political risks being one of the main determinants.

Finally, multinational companies have to consider the broader implications of political uncertainty in a particular world region, given the possibility of risk spillovers.

For example, the Brexit vote resonated also in the US, as it might lead to contagion.

"Because the UK economy, and especially the UK financial system, are highly connected with the rest of Europe and the United States, severe adverse outcomes in the UK and spillovers to Europe could pose a risk to US financial stability."

Richard Berner, Director
Office of Financial Research\textsuperscript{18}

Expert BOX 1
Thorsten Beck, Professor of Finance
(Cass Business School)

How are multinational banks dealing with political and regulatory uncertainty?

The Global Financial Crisis and the Eurozone crisis have put the focus on the role of multinational banks in the global financial system. Many of the banks that failed and had to be bailed out in 2008-2009 were not only large but with operations across the globe. Lehman Brothers (whose insolvency triggered the market panic in September 2008) had subsidiaries in London and many other European countries. The Dutch-Belgian bank Fortis had to be bailed out by both governments shortly afterwards, after having been split along national lines. During the Eurozone crisis, fear of spillover effects loomed large, as many banks across the globe, but especially in the Eurozone, held (supposedly safe) Greek government bonds. The restructuring of Greek government debt in 2011 triggered the Cypriot crisis, as many banks in Cyprus had loaded up on Greek government bonds given their high yields and zero risk weights.

These events have clearly shown the distortions coming from a mis-match between the activities of multinational banks and the geographically limited perimeter of national regulators. Even in times of consolidated supervision, limited information reduces the efficiency of supervision of cross-border banks, whilst the focus of supervisors on national interests distorts their decisions. And these frictions most clearly come to light during times of distress.

There have been two different reactions post-crisis. On the one hand, there has been a stronger regulatory focus on protecting the national financial system. More specifically, during times of crisis, national regulators have the incentives to ring-fence, i.e., encourage banks to keep liquidity in the respective jurisdiction, thus undermining the Single Market in banking and efficiency in
capital allocation. At the height of the Eurozone crisis in 2011-2012, for example, regulators across the region tried to ring-fence local subsidiaries and parent banks in light of denomination risk. For example, the subsidiary of an Italian bank would not be allowed to transfer funds to its parent bank in Italy, while German supervisors were also pushing German banks with subsidiaries in Italy to source funding locally. A similar trend can be observed across the developing world where there is a prominent presence of multinational banks, with regulators aiming to cut local subsidiaries loose from parent banks in times of crisis, demanding that critical staff and systems are local, rather than shared globally.

On the other hand, there has been a trend towards closer supervisory cooperation. The Nordic-Baltic region early on moved towards close cooperation between supervisory, resolution and even fiscal authorities, reflecting close banking sector integration but also a similarity in culture, legal and political systems. In the Eurozone, a supranational supervisor and a single resolution mechanism have been set up to expand the regulatory perimeter to comprise the whole Eurozone, thus also reflecting additional interconnectedness and spillover effects within a currency union. Beyond the Eurozone, there is also closer cooperation across the whole European Union. Cross-border banking groups in the EU - including parent banks located outside the Eurozone - are subject to a regulatory framework that includes: (i) a Single Rulebook of regulations and directives; (ii) a harmonised supervisory framework, including common methodologies and approaches to perform risk assessment and require supervisory measures; and (iii) requirements for cross-border cooperation and coordination, including the establishment of supervisory and resolution colleges and joint decisions in some relevant areas, subject to binding European Banking Authority (EBA) mediation if they do not involve fiscal expenditures.

There are currently discussions under way, at the highest political level, to deepen the banking union further, including through an
establishment of a European Deposit Insurance Scheme and having the European Stability Mechanism (ESM) as a backstop. Ultimately, however, completing the banking union is a necessary but not sufficient condition for creating a Single Market in banking in the Eurozone. There is still too much focus on national champions and too close an interconnectedness between national governments and their respective banking systems. Only by cutting these links will it help the move from 19 national banking systems to one Eurozone banking system, thereby turning the Eurozone into a sustainable currency union.

The same trend towards closer regional cooperation, however, does not necessarily imply a trend towards greater global cooperation. Whilst cooperation within the FSB continues to drive regulatory convergence across the globe, including non-member jurisdictions, closer supervisory cooperation at a global level is often hindered by political barriers. The difficulty of breaking down national borders and underpinning the global financial system with closer regulatory and supervisory cooperation has several roots: firstly, bank resolution might have to involve fiscal policy decisions, which is at a national level. However, there is also the difficulty in separating banking from politics - a centuries-old alliance. And whilst some might see the recent populist-nationalist political wave as partly driving this, the close link between politics and banking (on any level with fiscal policy power) has been a defining characteristic of modern finance for a long time and will be hard to break.
II. THE POLITICAL UNCERTAINTY OF BREXIT

Brexit negotiations have posed multiple challenges for the UK and EU. In this report, we will focus, in particular, on the impact of the changes in the regulatory framework and on those regulations that are most likely to affect the operations of non-EU banks aiming to maintain their operations, both in the UK and the EU.

When dividing their operation by geography, multinational companies may refer to the EMEA (Europe, Middle East and North Africa) region. EMEA is a common geographical division in international business, but it is not precisely defined, with some companies only including the MENA region (Middle East and North Africa), rather than the entire African continent.

Figure 1: The EMEA region

Whilst the current (2018) macroeconomic conditions in EMEA have improved, economic growth in the region remains low and political risk remains high. This requires multinational companies
to revisit their broader regional strategy and devise a clear prioritisation of investments, given constrained global resources and margins being under pressure.

The relevance of such evaluations for the UK and the EU is related to the importance of the non-EU banks in the EMEA region. Foreign banks account for about 50% of the UK banking system and dominate UK investment banking business. They mostly operate via branches located in London (total assets: EUR 3 trillion), currently using the single market passport to provide services to the EU markets and customers. Following Brexit, particularly non-EU banks, but also UK banks, are likely to lose this opportunity and will have to move their EU business to the continent. Most likely, they will have to set up subsidiaries in the EU-27 using their own capital, liquidity, corporate governance and fully-fledged operations. It is estimated that this could lead to an additional EUR 35-45 billion of capital being ‘ring-fenced’. 19

A change in EU regulation regarding the need for global G-SIBs operating in the EU to set up a new holding company, so that EU regulators can have a better regulatory oversight of group affairs, might have implications for both third-country banks operating in the EU via London and for UK banks post-Brexit. These regulatory proposals are reviewed below.

THE EU INTERMEDIATE PARENT UNDERTAKING PROPOSAL

In November 2016, the European Commission (EC) outlined proposals to amend the Capital Requirements Regulation (EU/575/2013) (CRR) and the Capital Requirements Directive (2013/36/EU) (CRD) (together referred to as CRD IV). These

proposals are likely to form part of the next version of these measures (i.e. CRD V).

One proposed “CRD V” measure is a requirement for non-EU banking groups operating in the EU to consolidate their subsidiaries under a single “Intermediate Parent Undertaking” (IPU) in the EU, which will need to be separately authorised and capitalised.

The EC proposals would see a new Article 21b added into CRD to cover IPUs, which would stipulate that:

- if a third country group (i.e. a non-EU group) has two or more institutions (i.e. banks or investment firm subsidiaries) in the EU, it must have an EU-based IPU above them;
- such an IPU must be separately authorised and be subject to EU capital requirements or be an existing bank or investment firm authorised under CRR;
- there must be a single IPU for all subsidiaries that are part of the same group; and
- the threshold for this requirement to apply would be if: (a) the total value of assets in the EU (both subsidiaries and branches) of the non-EU group is at least Euro 30 billion; or (b) the third country group is a non-EU G-SII (i.e. global systemically important institution or bank, defined by the FBS).

These proposals would require non-EU banking groups to hold EU bank and broker-dealer (investment firm) subsidiaries through a single EU-based IPU that would be subject to capital, liquidity, leverage and other prudential standards on a consolidated basis. The ECB (2017) stated that these requirements will allow the consolidating supervisor to evaluate the risks and financial soundness of the entire banking group in the EU and to apply prudential requirements on a consolidated basis.²⁰ Subsidiaries of foreign lenders make up 42 percent of banking subsidiaries in the

bloc, up from 36 percent in 2008, but EU regulators have only “limited access” to timely data on what goes on across these operations, the EC (2016) said. As a consequence, the supervision of subsidiaries that belong to the same third-country group but operate in different member states is fragmented and hence might result in regulatory and supervisory arbitrage.21

As a result of these proposals, non-EU G-SIBs or non-EU banks with assets of more than €30bn, which have at least two subsidiaries in the EU, are required to establish an EU Intermediate Parent Undertaking (IPU). At the time of the proposal, there were 19 global banks for which the new rules could mean a reorganisation of their operational structures. These are: Bank of America, Citi, Credit Suisse, Goldman Sachs, JP Morgan, Morgan Stanley, Mitsubishi UFJ Financial Group, UBS, Bank of New York Mellon, Industrial and Commercial Bank of China, State Street, Sumitomo Mitsui Financial Group, Mizuho Financial Group, Wells Fargo, Bank of China Ltd, Agricultural Bank of China Ltd, China Construction Bank Corp, Nomura Holdings, and Royal Bank of Canada.

At the time of writing, there is considerable uncertainty across the board: the outcome of the Brexit negotiations remains unknown, and the impact of new rules on markets will take time to play out. At the EU level, there is a large volume of implementation work being carried out (including MiFID II, PSD II and GDPR), alongside uncertainties around the future shape of regulation in the UK. Negotiations on these proposals are ongoing and changes may be made (i.e. potentially two IPUs accepted, the threshold for assets increased or the requirement for all G-SIBs to have an IPU removed).

As the deadline of March 2019 approaches, many firms have begun building their presence in EU-27 countries, with Frankfurt,

Paris, Brussels and Dublin receiving most of the business leaving London.

Relocations will not be completed before “Brexit Day” (29 March 2019) but are occurring in small waves and will continue into the possible transition period. The moves, for now, are designed to ensure business continuity and cover the minimum structure and resources needed to continue offering regulated services to clients, as well as meet regulatory expectations. The full extent of the relocations will only become apparent over time and will, crucially, depend upon the final terms of any market access agreement between the UK and the EU. Given the uncertainty on the future terms, large multinational banks are in the process of obtaining authorisations and new banking licences for new entities. Management are working on internal models, infrastructure and technology building, as well as contingency plans.
How are the IPU requirements going to affect the way banks structure their business in the EMEA region?

The new Intermediate Parent Undertaking (IPU) rule, to be introduced in Article 21b of the revised Capital Requirements Directive (CRD), requires third country banking groups (whose ultimate parent is incorporated outside the EU) that have two or more EU-based entities, to establish an intermediate EU parent undertaking. The IPU can be either a holding company subject to the requirements of the Capital Requirements Regulation (CRR) and the CRD, or an EU institution.

Such a new requirement will impact the organisational structure of multinational third-country banking groups operating via subsidiaries and branches, both in the EU and from the EU.

The process originated from the proposed requirement by the European Commission (EC) in November 2016, originally designed to apply only to third-country groups that are identified as non-EU G-SIIs, or that have entities in the EU territory with total assets of at least EUR 30 billion (the assets of both subsidiaries and branches of those third-country groups will be counted). Aiming to enhance the IPU requirement proportionality, the Council suggested allowing for a dual-IPU structure to exist, whereby third-country banks have a regulatory requirement to separate activities, raising the scope threshold from 30 billion to 40 billion EUR in consolidated EU assets (including branch assets), and removing the G-SIB criteria from the scope (exempting G-SIBs whose EU operations otherwise do not meet the IPU thresholds). Earlier requests by the Single Supervisory Mechanism (SSM) and the Single Resolution Board (SRB) to include third country branches under the IPU structure, led to a
compromise agreement allowing national authorities to exercise closer supervision of third country branches. In addition, an implementation period of four years has been agreed (likely to delay the application of the IPU requirements until 2023). The European Parliament’s (EP) approach has been similar to the Council’s, in allowing for a dual-IPU structure for regulatory separation reasons, but it has retained the scope to apply to all banks with 30 billion EUR in consolidated EU assets (including branch assets) and all G-SIBs, irrespective of their operations in the EU. The new IPU requirement will be implemented by early 2019, when the EC/EP/Council Trialogue will result in a common position.

This new requirement is likely to allow the consolidating supervisor in the EU to evaluate the risks and the financial soundness of the entire third-country banking groups operating in the Union, as well as to apply prudential requirements on a consolidated basis. This is essential for financial stability assessment and potential future recovery and resolution, but will entail costs of reallocation, compliance and potential overhaul of the third-country banking groups’ organisational structure.

Indeed, third country banking groups (whose ultimate parent is incorporated outside the EU) that have two or more EU institutions (subsidiaries) are required to establish intermediate EU parent undertakings. The intermediate EU parent undertaking will be subject to the consolidating supervisor in the EU. It will have to meet local requirements, including enhanced prudential standards (capital, leverage and liquidity), EU regulatory reporting and accounting standards, EU governance norms and resolution requirements (including the bail in). This will lead to increasing compliance costs as well as further reporting by the competent authority supervising the new EU IPU.

On one hand, such a requirement will mean further consolidation at the group level from a supervisory perspective, more transparency on banking operations in and from the EU but, at the
same time, there will be the necessity to restructure and develop new organisational models to respond to this regulatory requirement.

Third-country banks falling under this new rule will have to choose which jurisdiction to set up an EU IPU, or which entity to use as the EU parent, which form of incorporation (e.g. a European company or that of the Member State in which the entity is located), whether this will be in or outside the Eurozone and, hence, whether or not to fall under the SSM supervision. Banks also have to consider which activities (e.g. asset management, bond issuance, lending) to undertake and revise accordingly their corporate structure (including capital, liquidity, corporate and risk governance, national accounting standards and tax implications) and to adapt their overall organisational structures inside and outside the EU (e.g. in the EMEA region).

Third-country banks operating via subsidiaries in the EU will also have to examine whether a single IPU could conflict with the third-country structural requirements. This must be assessed on a case-by-case basis.

With Brexit, the uncertainty will increase. The UK will likely become a third-country as far as the EU IPU requirement is concerned, despite the current equivalence between the regulatory regimes of the UK and the EU. As a consequence, a UK subsidiary of a non-EU global banking group may not be considered as an EU IPU for the banking group, possibly from the end of any negotiated transition period. In the absence of an alternative agreement in the Brexit deal with the EU, such a group will have to establish a EU IPU in one of the EU-27 member states and the same will apply to any UK headquartered G-SIB or banking group with two or more subsidiaries in the EU-27. Such a reallocation will be costly and will require a longer transition period.
III. OPTIONS ON THE TABLE FOR NON-EU BANKS: DELEGATION MANAGEMENT MODEL

Non-EU banks and financial firms have been considering how to maintain the equivalent of passporting rights afforded under current regulations (i.e. a single banking licence under Capital Requirement Directive IV (CRD IV)) that allows them to operate in other EU member states, without the need to go through the national competent authority’s (NCA) requirements in getting a licence. Article 17 of CRD IV states that: ‘Member states shall not require authorisation for branches that have already been authorised in other EU Member states’. Once Brexit occurs in March 2019, non-EU banks and financial firms operating in UK will no longer be able to take advantage of passporting, unless the EU and UK form an agreement prior to Brexit. How should non-EU banks manage this political uncertainty?

In this context, multinational banks face a scenario in which their potential reaction to the Brexit and IPU proposals sit between the two options below:

a) Corporate Restructuring: Redomicile in the EU
b) Delegation Management Model: Select a legal entity in the EU as place for passporting and IPU and maintain an entity in London for whom delegate critical activities can benefit from London as financial hub.

In general, corporate restructuring implies a substantial reorganisation of the business, possibly implying:

- Duplication of functions (higher transaction costs);
- Human capital disruptions (in an already fiercely competitive environment for talent);
- Some level of withdrawal from the UK market (and customers), or less credible commitment to it;
- Greater uncertainty related to “readiness” of the selected EU financial hub to offer the same services as London;
- Loss of opportunities whilst waiting for relocation of critical activities to other European financial hubs (higher transaction costs);

As to the **delegation management model**, it can be described as the process whereby certain roles and responsibilities are transferred to another person or entity, to carry out on the transferor’s behalf. In the context of multinational business operations, delegation would be carried out by setting up a presence (via a branch or a subsidiary) in the EU and consecutively entering into an agreement, or an understanding, in respect of the delegation. This would imply keeping the current operational setup unchanged.

Compared to corporate restructuring, the delegation model implies less disruption of the current business organisation structure, most likely leading to:

- Maintaining the specialisation of functions and activities reached at each subsidiary-level (greater efficiency);
- Maintaining full access to the UK market and customers;
- Taking full advantage of the proximity to the largest EMEA (and global) financial hub, i.e. City of London, which includes access to networks, talents, senior managerial skills; and ancillary services;
- Greater flexibility in responding to political and regulatory uncertainty;

The entity, set up in the EU, would delegate or transfer certain roles and responsibilities back to the UK branch or subsidiary, thus enabling the non-EU multinational banks and financial firms adopting this model to continue working from the UK. The EU entity would be part of the EU single market and would be able to take advantage of passporting and, therefore, conduct business within the EU with EU customers. The EU entity would need to
ensure that it considers and follows the regulatory requirements within the chosen European member state that it decides to set up in. Usually NCAs would require *substance* and presence in their local jurisdiction. If these requirements are not satisfied, foreign intermediate holding companies may become subject to local regulation.

However, there is some uncertainty as to what *substance* really amounts to. It is usual practice that NCAs would require that executive directors have local presence, however to what extent this presence needs to be, depends on the NCA requirement and it would need to be analysed on a case by case basis. NCAs usually require employees to be present locally for the independent control functions, i.e. compliance, internal audit and risk management, whilst the other functions can be delegated back to the headquarters or to the legal entity that currently carries out those functions.

In addition, some functions may be outsourced to other group entities or service providers. In any event, there needs to be someone in the EU branch or subsidiary present to be able to answer every question from the NCA at any given time. There will need to be someone to manage all the IT and IT security and risk. Whether these functions need to be present at all times is a question for the particular NCA. The main advantage associated with the Delegation Management model is, crucially, in terms of efficiency, as the delegation hinges on the degree of specialisation across subsidiaries. There is a wide range of activities that can be delegated, such as portfolio management, fund management and investment activities. However, it is essential that a proper monitoring framework for all these activities is in place, as firms remain fully responsible for outsourced tasks. Whilst the delegation model has been widely used in the asset management industry, it is somewhat untested in the context of more traditional banking products and services. Delegation rules are particularly important for UCITS funds, which are officially based and sold in the EU, but can be managed elsewhere. The EU regulator ESMA
wants more power to intervene to avoid companies setting up “letter boxes” entities and transfers risk management to non-EU entities. A stricter regime would entail a large-scale relocation of senior managers from London to EU capitals.

Given the overall political uncertainty regarding the final outcome of a Brexit deal, but also the more general political instability at the EU level (and even more at individual country level, especially in Germany, France and Italy), the current approach is constantly evolving. In a fast-changing regulatory scenario, firms’ key objective is to plan strategically in order to obtain a flexible re-design of business operations, but still to ensure growth opportunities for the multinational business.

In this respect, the delegation management model has the flexibility needed to minimise the loss of human capital expertise that is available in the UK when opting to re-domicile in EU, to reduce the costs related to moving people and functions (i.e. maintaining the current level of efficiency) and to avoid the loss of permanent access to the UK (or the perceived lower commitment to do business in the UK).
The successful implementation of the delegation management model seems to rely on the following factors, which are intertwined with the decision to maintain key functions in the UK and the proximity of a global financial hub, like London.

- **Strong governance/management model**
  Delegation may be associated with a weakening of the governance model and dispersion of responsibilities; therefore, it is essential to delegate the entity with the strongest managerial skills, greater expertise over complex transactions and the ability to create credible incentives across subsidiaries and branches (reducing principal-agent problems).

- **Business volume**
  Delegation, rather than corporate restructuring, may depend on current business volumes in the EU and UK. Whilst
contingency planning may well be underway, the costs of different options will have to be weighed against the potential future benefits. Whilst it is still too early to gauge the full extent of Brexit, or the likelihood of a favourable deal for financial services, the firm’s overall exposure to a particular market needs to be taken into account.

- **Networking**
  Multinational businesses, especially in finance - which is a knowledge-based business - need proximity to a global financial hub, where finance professionals, financial news providers, exchanges, consultants and international law firms operate. Agglomeration of all these actors, provides high quality input and support for the business operating in primary financial centres. Financial centres attract talented people through high salaries who are responsible for high productivity.

- **Closeness to regulators and policy-makers**
  In defining the future environment for financial services of both the UK and EU, regulation and supervision play a key role. Uncertainty over the regulatory process requires proximity to policy decision-making. However, Brexit will not automatically entail divergence from the EU’s standards, as the UK will most likely maintain a high degree of regulatory alignment with the EU in financial services, as part of preserving mutual market access. As EBA is leaving London (as per early 2019, to relocate to Paris), non-EU banks should consider the trade-off between this proximity and the networking benefits outlined above.

- **Close to financial innovation hubs**
  The banking business is currently on the cusp of a digital revolution. Financial innovation creates opportunities which often quickly spread cross-border. In recent years, London has emerged as a global centre of technological innovation in
financial services (Fintech). As suggested by EY (2016)\textsuperscript{22}, the UK ranked first in the world for having the strongest Fintech ecosystem. Further research by the LSE (2018)\textsuperscript{23} also suggests that Fintech business prioritises the UK amongst the top three countries for further expansion, citing London as the key destination for listing equity and capital.

- **Location**

Proximity to a financial hub is especially relevant for complex non-standardised transactions, i.e. mergers and acquisitions, syndicated loan origination or structured finance. Infrastructure, networking and expertise are key in dealing with these types of transactions. These activities are likely to have a major role in the portfolio of activities of large non-EU banks and, thus, the delegation management model should allow for the most skilled units to work on these projects. Location is also key for the attraction of talent, for whom the quality of living is important.

The relevance of the delegation management model is clearly supported by the fact that a number of large European financial groups - thought to have subsidiaries and significant EU-27 branches where they conduct the majority of their EU retail business - have chosen to delegate some of their key operations (e.g. corporate and investment banking, global markets, reinsurance) and closely related functions (risk, treasury, ALM, actuarial, asset portfolio management) in the UK, in order to benefit from London’s infrastructure, its ecosystem of related professional services and supply chains, and its depth of skilled staff.\textsuperscript{24}


\textsuperscript{23}London Stock Exchange Group 2018 - Finance for Fintech.

\textsuperscript{24}PwC, Brexit and the cost to Europe of fragmenting financial services, October 2016.
On the other hand, the UK regulator seems more relaxed about what model banks use, as they move business to the EU after Brexit. Andrew Bailey, the head of the Financial Conduct Authority (FCA), said the UK regulator was “open to a broad range” of arrangements on how to book risk and profit, provided they were properly overseen. However, in a letter addressed to Chief Executive Officers across the City of London, he added:

“If you are expanding your presence elsewhere in Europe, the structures you put in place must enable us to supervise the conduct of your UK business effectively and ensure that you continue to meet our threshold conditions. When designing the structures, you should assess whether the proposed changes are in the best interests of your clients.”

Andrew Bailey
Chief Executive Officer
Financial Conduct Authority
8th August 2018
1. MAIN DRIVERS BEHIND THE ADOPTION OF A DELEGATION MANAGEMENT MODEL IN THE POST-BREXIT ERA

Implementing a delegation management model means transferring certain roles, tasks, functions or duties to another person or entity to carry out such roles, tasks, functions or duties on the transferor’s behalf.

The delegation model is not new in the EU financial sector. It has been commonly used by foreign non-EU groups wishing to operate within the EU (including the UK). This model is implemented differently in each financial group, depending on the group’s needs, the nature and scope of financial services performed by the group and the regulatory requirements of the relevant National Competent Authority (NCA).

In the specific context of Brexit, the delegation model would be carried out by setting up a new EU establishment with limited substance, human capital and operational capacity. This new establishment would delegate certain tasks to its UK headquarters or affiliated/parent UK company. The approaching Brexit deadline has certainly impacted existing delegation model arrangements and accelerated the design and implementation of new delegation models for many (non-EU) financial groups.

The main drivers for such a setup are usually the following:

- Benefitting from all the advantages of the EU passporting framework;
- Continuing to conduct business within the EU and with EU customers;
• No need to move a significant amount of human capital from the UK to the EU;
• Keep relying on existing IT systems, operational and material resources;
• Avoid the costs of having two wholly-independent structures (no need to fully duplicate all functions);
• Preserve a considerable presence in London (which is crucial for all other non-EU operations of the group) and, hence, benefitting from the dominance of London as a financial hub;
• Maintaining access to highly skilled and professional counterparties in London (depositaries, investment banks, settlement institutions, CCPs, external service providers such as legal counsel, consultants, M&A advisors, etc.).

This however raises a number of questions, issues, concerns and hurdles from a regulatory, legal, tax and operational perspective:

• **Regulatory**: how should the conflicts between the new EU entity and the HQ be prevented and managed? How to assess the impact on governance? For more details, see also point 2 below;
• **Legal**: how to adequately formalise such delegation arrangements? Which entity is going to be liable for the proper performance of these services? What law should govern the delegation arrangements?
• **Tax**: how to fix the price of such services? How to ensure these delegated functions are remunerated at arms’ length?
• **Operational**: how to adequately monitor the performance of the services? Which Key Performance Indicators (KPIs) should be used? What if one of the parties (transferee or transferor) is in default?

Each financial institution or group, along with the relevant NCAs, usually finds a proper compromise in order to implement a solid operational model and to tackle these questions and issues.
2. MAIN ANTICIPATED HURDLES BEHIND THE ADOPTION OF A DELEGATION MANAGEMENT MODEL IN THE POST-BREXIT ERA

2.1 A regulatory authority perspective

Although not much has been published on the matter, the ECB and the European Supervisory Authorities (ESAs) (EBA, ESMA and EIOPA) seem to share a common approach on several key issues related to the delegation management model. As the UK will probably become a third country after Brexit (and hence UK firms would not be automatically authorised throughout the EU), the ECB and ESAs are of the view that, any UK or foreign financial institution envisaging the incorporation (and authorisation) of a new EU financial institution, needs to locally implement a sound governance structure. Appropriate staffing arrangements also have to be put in place. It means that policy makers and key personnel must be based in the EU state where such new entity is set up and must dedicate sufficient time, attention and efforts for such new EU-based firm.

As a consequence, any new EU entity will need to benefit from sufficient substance and will not be authorised by the relevant NCA if it is only an “empty shell” or a “letter box entity”, outsourcing or delegating all its key functions and operations back to the UK.

For its part, ESMA seems concerned that UK financial institutions seeking to relocate entities, activities or functions to the EU may be willing to minimise the transfer of the effective performance of those activities or functions in the EU. As a result, ESMA considers that the conditions for authorisation, as well as for outsourcing and delegation arrangements, cannot generate any supervisory arbitrage risks.

For this reason, and relying on the ECB’s view and the opinion of ESMA, the following principles should be followed in order to
foster the authorisation, supervision and enforcement relating to the relocation of entities, activities and functions from the UK:

- **No automatic recognition** of existing authorisations;
- Authorisations granted by any EU NCAs should be rigorous and efficient;
- NCAs should be able to verify the **objective reasons for relocation**;
- Special **attention should be granted to avoid letter-box entities** in the EU;
- **Outsourcing and delegation to third countries is only possible under strict conditions**;
- NCAs should ensure that **substance requirements** are met;
- NCAs should ensure **sound governance** of EU entities;
- NCAs must be in a position to effectively supervise and enforce EU law;
- Co-ordination to ensure effective monitoring by regulatory authorities.

According to the ECB (June 2018), only 20% of the banks operating in the EU through a UK authorisation had applied for an EU banking authorisation in another EU member state. It would be interesting to receive updated statistics on this on-going process, but this shows that, nine months before Brexit, only a limited number of UK-authorised banks had effectively launched the implementation of a post-Brexit model involving a new EU authorised institution. Alternatively, this could also be a clear sign that the level of Brexit readiness of most firms is very low.

### 2.2 A client perspective

Based on the above, the key question is what a firm can do without being considered as an empty shell or letter-box entity. In certain cases, it is not easy to draw the line between an empty shell structure and a valid and appropriate delegation arrangement. Each NCA will also have its own view on this and
could be more or less reluctant to approve (massive) delegation or outsourcing arrangements.

From a client perspective, it seems that a lot of different scenarios and possibilities remain open, subject to ensuring an appropriate and sound risk management and operational model. The financial institutions involved in such a delegation model will need to have an effective governance structure in place to timely, effectively and efficiently identify, monitor and mitigate any potential harm that could arise from modified risk management structure and operational outsourcing or delegation arrangements. They should also be able to demonstrate how proper safeguarding measures have been observed and, in practice, been implemented. The roles and missions of the executive members of the relevant management bodies, of the independent control functions (internal audit, compliance and risk management) and, to a certain extent, of the statutory auditor, are of paramount importance.

In case a firm intends to engage in back-to-back or intragroup operations to transfer risk to another group entity, it should have adequate and robust resources to identify and fully manage their (potential) counterparty risks and any (potential) material risks that they have transferred, in the event of the failure of their counterparty.

Without pretending to be exhaustive, the following key requirements should be considered when envisaging, designing or implementing a new delegation management model. The newly incorporated and authorised EU firm:

- must be capable of managing all material risks potentially affecting it at local level,
- should have control over its balance sheet and all financial exposures;
- must have sufficient staff located at local level to run operations (including in both risk management and front office);
• must be able to use the currency of its local market (and to implement the necessary risk management measures related to currency or exchange risks) and to properly communicate on its local market, including with the local NCA (and hence to master the local language(s));
• should carefully consider potential dual hatting arrangements\(^{25}\), as this will trigger a thorough assessment by the ECB and the relevant NCAs (to ensure that sufficient time is spent carrying out such functions in the supervised banks);
• will have to establish locally independent functions and controls that report to the local board of directors or equivalent supervisory body;
• must ensure that their recovery plans adequately reflect the risk of Brexit and comply with the Bank Recovery and Resolution Directive (BRRD) requirements;
• must review and, where necessary, reinforce its internal models.

The EU firm and its group should also anticipate the CRR II / CRD V proposals, published by the EU Commission in 2016, requiring large non-EU banking groups having at least two entities in the EU to establish an “intermediate parent undertaking” (IPU).

\(^{25}\) Arrangements where an institution gives more than one role to a staff member or conducting officer, on a temporary or permanent basis, and whether this staff member or conducting officer works for several group entities.
IV. COMPARATIVE ADVANTAGE OF LONDON AS A GLOBAL FINANCIAL HUB

Financial centres play a crucial role in a globalised and networked world. Every larger economy has seen the emergency of their own financial centre. Among the key factors behind the development of a financial centre\(^\text{26}\) are:

- A successful economy
- Open and international outlook
- Political/legal stability
- Strong human capital base
- Sound regulatory and supervisory framework
- Well-developed transport and telecommunication infrastructure, robust payment and securities settlement systems.

Financial centres can have: i) a **national focus**, predominantly serving the domestic economy; or ii) a **regional focus**, having more sophisticated financial markets, with an international scope but not a global reach; or iii) a **global focus**, i.e. full-service providers for the global economy.

Among global financial centres, the City of London has the largest reach, even when compared to New York City. Presumably, this is because all the factors above are fulfilled to a larger extent. In terms of business volume, New York is home to the largest bond market in terms of market capitalisation, but the UK is dominant in the issuance of international debt securities. International firms seem to prefer to issue dollar-denominated bonds in London,

whilst New York has a major role in attracting investors wanting to buy US Treasury securities.

The global position enjoyed by London also explains the decision by several non-EU banks to have their market entry point to the EU market in the UK. This decision came into question after the EU referendum result in June 2016. A number of companies have questioned London’s ability to retain its position as a global financial centre.

In 2018, the Global Financial Centres Index\textsuperscript{27} Report (GFCI 24) placed London among the leading global financial centres, second only to New York. The US financial hub has been London’s closest rival over the last decade, however, London dominated the list and has only recently lost the top spot in the league table. New York is expected to be the main beneficiary of the political uncertainty caused by Brexit, even more than other European financial hubs. Zurich, Frankfurt, Amsterdam, Vienna, and Milan moved up the rankings significantly in the last year, but only Zurich and Frankfurt reached the Top10.

\textbf{Table 1: Global Financial Centres Index (Top 10)}

<table>
<thead>
<tr>
<th>CENTRE</th>
<th>2018 RANKING</th>
<th>CHANGE IN RANK</th>
</tr>
</thead>
<tbody>
<tr>
<td>New York</td>
<td>1</td>
<td>+1</td>
</tr>
<tr>
<td>London</td>
<td>2</td>
<td>-1</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>3</td>
<td>--</td>
</tr>
<tr>
<td>Singapore</td>
<td>4</td>
<td>--</td>
</tr>
<tr>
<td>Shanghai</td>
<td>5</td>
<td>+1</td>
</tr>
<tr>
<td>Tokyo</td>
<td>6</td>
<td>-1</td>
</tr>
<tr>
<td>Sydney</td>
<td>7</td>
<td>+2</td>
</tr>
<tr>
<td>Beijing</td>
<td>8</td>
<td>+3</td>
</tr>
<tr>
<td>Zurich</td>
<td>9</td>
<td>+7</td>
</tr>
<tr>
<td>Frankfurt</td>
<td>10</td>
<td>+10</td>
</tr>
</tbody>
</table>


\textsuperscript{27} The Global Financial Centres Index 24\textsuperscript{\textsuperscript{2}} (PDF). Long Finance. September 2018. Available at https://www.longfinance.net/media/documents/GFCI_24_final_Report_7kGxEKS.pdf
Despite some evident success in attracting new business as a result of Brexit uncertainty, other candidates to replace London as a financial hub in the public debate are in even lower positions in the ranking (Paris is 23rd, Brussels is 54th, and Dublin 37th). As for other European hubs, Munich, Hamburg, Copenhagen and Stockholm all fell in the rankings. This index factors in a number of dimensions: business environment, financial sector development, infrastructure, human capital, as well as reputation. Two years after the Brexit referendum, London ranks first for business environment, second for human capital, financial sector development and reputation and third in terms of infrastructure. There are, however, some worrying results illustrated in the 2017 IMD World Talent Ranking that indicate the UK has lost some ground in its ability to attract and retain global talent and it is currently ranked 23rd in the world.\(^{28}\)

Overall, the competitive advantage of London as a financial hub over other European candidates seems to rely on the long-term investment of the City in building a long-standing reputation and high-standards enabling business to thrive. This is also confirmed by the 2016 evidence, reported by the EU Parliament, highlighting the prominent role played by London in the single market for financial services, since it operates as a hub for the whole European Union. Most of the activities in the City of London are not connected to the UK’s membership of the EU, but rather are the result of several factors that make London a “unique ecosystem”. Indeed, half of the world’s financial firms have based their European headquarters in London and more than 1 million people work in the UK financial sector: banking activities, insurance and reinsurance, asset management and market infrastructure. With related professional services (accounting, legal, advisory), the total number amounts to 2.2 million people. The EU Parliament also supports the role of London as a major financial centre, pointing to the dynamic business environment, the predictability of the British legal system, the worldwide use of

\(^{28}\) IMD World Talent Ranking (2017) www.imd.org
English as the language for business and the attractiveness of a cosmopolitan city. London managed to attract a critical mass of expertise in financial and other related professional services and benefitted from the development of the Single Market for financial services in the 1990s and, more recently, from the introduction of the single currency in the Eurozone. Together, all these factors suggest that shifting business elsewhere in the EU could prove quite difficult. The substitution costs are high, and it might take a long time before any EU financial hub can replicate London’s offering in an effective manner. No other financial centre in Europe provides anything like the concentration of skills and infrastructure found in London.

This is also the view of the current Governor of the Bank of England, Mark Carney[^29], who said:

“In some circles in Europe there is a greater predisposition to ring-fence financial activities. That could lead to a very large but effectively local financial centre in Europe, as opposed to a global financial centre, which I believe London will continue to be. There are real benefits for Europe as well as the U.K. in having access to what is a global, resilient, and fair financial sector, which is what London is.”

*Mark Carney - Governor
Bank of England*

One potential scenario could be a general fragmentation of financial services, whereby in the absence of a preferred financial centre - as also suggested by the Global Financial Centre Index - banks and businesses will eventually cluster around different centres in EU. Disaggregating the activities of London as a financial centre across EU would lead to reduced efficiency, loss of synergies and increased costs for European business. This would lead to a less efficient allocation of capital. However, in a

[^29]: Mark Carney speaking to Stephanie Flanders, Bloomberg, 30 July 2018. 
recent survey by the Association of Foreign Banks UK\textsuperscript{30}, the overwhelming majority of banks revealed a strong commitment to remaining in London as a base for their business, as they believe that the role of London as an international financial centre will not be affected in the long-term by the current uncertainty.

There are a number of factors that will enable London to retain its position as a global financial hub post-Brexit. Some of these factors are discussed below.

**SPECIALNESS OF LONDON AS A FINANCIAL HUB**

- **Time Zone**

  London’s time zone means that its business hours overlap those of the Middle East, America and Asia – something which puts the city in good stead when it comes to trading. Euro transactions have been increasingly settled in London, based on the trading time advantage between Asia and the US.

- **London is one of the world’s largest international banking centres.**

  International banks have large exposures to interest rates, commodity prices and currency risks of different countries. Because they hedge these risks, derivatives markets are usually large where international banking activity is high. Together with New York, London is the dominant FX and interest rates trading hub and also clears the vast majority of euro-denominated interest rate swaps.

- **Law and regulation**

The strength of the local court system means that the rule of law will continue to be upheld, including those rules that protect creditor and shareholders’ rights.

- **London as a market for talent**

The UK’s university education offering in economics and finance is currently superior, at least in terms of global reputation, to those of anywhere else in Europe.

- **Capital market integration**

Despite the likelihood of some banks facing operation and roles being moved from the UK to an EU jurisdiction, the high degree of existing capital market integration is likely to mean that a substantial amount of existing EU business will continue in London.

To summarise, the broad view is that London will continue to be a key player in the global financial services industry and capital markets. Nonetheless, some of its operations, capabilities and margins will be affected by the long-term political and regulatory uncertainly underlying the Brexit process.
V. SURVEY RESULTS

To support the issues discussed in this report, and to gather views on the challenges and opportunities posed by Brexit, as perceived by market participants, we designed a short online survey (see Appendix 1) to identify the key issues faced by banks and other financial institutions operating in EMEA. The link to the on-line survey was sent to more than 2,000 contacts during the months of August and September 2018. We targeted industry participants across the financial industry, as well as academic experts.

The questionnaire had three main aims:

- To gather views on the possible future relationship between the UK and the EU and how it would impact on the financial services industry.
- To understand the importance of financial hubs and the key position of London as a financial centre.
- To seek opinions on possible organisational changes under the delegation management model.

In addition, views were sought as to the possible impact of Brexit on the UK’s relationship with third-party countries, such as China.

Although the number of respondents was lower than we anticipated (with a response rate of around 5%), nonetheless, we had 71 respondents from different financial institutions. Please note, that such a high non-response rate is quite common for these types of online surveys. It is important to note that the scope of this survey was to establish a more general industry sentiment on the issues discussed in this report and we do not claim statistical significance. All answers were confidentially collected by the Centre for Banking Research at Cass Business School. The questionnaire method undertaken is a mix of closed and open-ended questions. Participants had a choice of answers for each question, along with an open-ended text option for further discussion, as necessary. The majority of respondents have either a banking or a legal background and work within the financial
services industry. We also had good coverage of the risk function (CRO, CCO, etc.) and board/business delivery. This provided a good insight into the differences of opinion between the functions - in particular with relation to the level of integration between legal risk and operational risk frameworks.

For each of the questions, the results are reported and commented on below. Overall, the answers of the survey point to a growing fragmentation of the financial industry. Respondents were negative as to the likely outcome of the negotiations with the EU, but positive about the enduring position of the City of London as a global financial hub. In addition, while respondents recognised many challenges deriving from uncertainly, they also identified some opportunities, particularly for non-EU banks.

A. The UK-EU relationship post Brexit

At the time of writing, the UK-EU negotiation on the Withdrawal agreement is still on-going. The mood in our sample was rather negative, with almost twenty percent of the respondents believing there will not be a deal.

**Figure 3: Post-Brexit UK-EU Relationship**

![Post-Brexit UK-EU relationship](image)

Note: EEA= European Economic Area. FTA= Free Trade Agreement. CU = Custom Union. WTO = World Trade Organisation.
The EEA option (also known as the Norway option) was a favourite with those wishing to maintain a close relationship with the EU, as it would allow the UK to be a member of the European Free Trade Association (EFTA), thereby wholly maintaining the open trading arrangements of the single market and related economic integration. Whether this option was ever really available to negotiators is unclear.

The second option relates to a Free Trade Agreement (FTA), an option that is also known as Canada Plus, which is an improvement of the trade agreement recently signed between the EU and Canada. This type of agreement would, nonetheless, have some complexities, particularly regarding the provision of financial services. The main reason is that barriers to trade in services would result from the divergence in regulation of service products and markets. The only current example of a custom union agreement is the one in place between the EU and Turkey. There are political difficulties with this option as, in essence, the UK would need to continue to implement the EU’s external trade policy. In the context of the financial services industry, customs unions are limited to trade in goods and do not cover services. In addition, an EU-UK customs union would not do away with the need to manage future regulatory divergence.

The UK is a member of the WTO, as are the EU and all the other EU Member States. The assumption is, therefore, that once the UK leaves the EU, it assumes full responsibility for its own trade policy and continues to be subject to all its WTO law obligations. There are, however, issues that would require renegotiation. It is important to point out that the “No Deal” option is substantially different from the WTO option, although the two are often treated equally. The in-depth analysis of these issues is outside the scope of this analysis, but a good summary is provided by the European Parliament (2018).³¹

A ‘no deal’ means that no agreement will be in place on how the EU and the UK can continue doing business with each other and all rules, agreements and accords would become invalid, waiting to be replaced with new ones. Under this scenario, the difficulties would be compounded by the absence of a transition period. The outcome of our survey may just indicate the difficulties in reaching a deal that is satisfactory to all parties.

**Figure 4: UK FIs access to EU market**

![Chart showing responses to the question: UK FIs to lose right to access EU markets without other arrangements in place]

Most respondents (46%) also believe that UK financial institutions will lose passporting rights to the EU without any other special arrangements being in place post Brexit. As a consequence, a number of large banks and asset management companies are currently moving staff and resources to EU capitals.

Despite the relocations, more optimism concerns the UK’s ability to maintain its current advantages in attracting businesses and financial institutions to invest and operate in the country, as illustrated in Figure 5 below. These results are in line with the view of London’s enduring position as a global financial hub and the fact that the financial ecosystem London has been built over...
several decades and would be difficult to replace - at least in the short term.

**Figure 5: UK to remain an attractive destination for business**

Over 60% of respondents do not believe that Brexit will have a substantially negative impact on the UK financial sector (see Figure 6), while 45% think that EU regulation and supervision restricted development and innovation in the UK financial industry (Figure 7).

**Figure 6: Impact of Brexit on the UK financial sector**
The results reported in Figure 6 may also be influenced by the uncertainty over the UK withdrawal deal with the EU and what it may entail for financial services. The need to comply with different sets of regulations may be a burden for financial instructions. In this context, the EU IPU proposal may increase the negative view of EU regulation and supervision as a hindrance to the UK financial industry.

**Figure 7: The role of EU regulation and supervision**

Respondents also perceive a number of risks arising from Brexit-related uncertainty, ranging from loss of opportunities and loss of key staff to information gaps, regulatory issues and the need to change their current business models (see Figure 8). Two years on from the Brexit referendum, market sentiment is increasingly negative. A recent study by EY (2018) shows that a phased downgrade of the UK is underway. For example, the UK's share of jobs created by the financial services industry in Europe shrank from 37 percent in 2016 to 16 percent in 2017, its lowest level in a decade. At the same time, the competitiveness of both Germany and France increased.\(^{32}\)

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B. LONDON AS A FINANCIAL HUB

The second set of questions aimed at gathering views on the role of the City of London as a global financial hub, post-Brexit. The overall sentiment remains positive, with over 70% of respondents believing that London will remain a favourite location for global banks.

Figure 8: Key threats post-Brexit

Figure 9: London as a financial hub

London remains preferred location

- Yes: 73%
- No: 27%
However, questions have been raised over just how committed big banks are to London and many institutions are in the process of moving some London-based operations into new hubs inside the European Union. We asked respondents what key features of a financial hub are most likely to influence the choice of location. The size of the economy, as well as the size of the financial industry in terms of the number of financial institutions and the overall financial ecosystem of ancillary services, is perceived as being very important. In addition, regulations are also perceived as key in the choice of where to invest and locate business.

*Figure 10: Key factors in choice of location*

![Pie chart showing the key factors in choice of location: Size of the economy (26%), Number of financial institutions (23%), Relevant regulations (18%), Opportunity costs (12%), Operation model (7%), Local competition (5%), Size of the financial industry (9%).]

When asked where, within the EU, they would relocate should they need to, the replies did not indicate a clear overall favourite city. Paris and Frankfurt come up on top; Paris will host the European Banking Authority (EBA) from May 2019 (it is currently in London, but it is in the process of relocating to the EU) and it is already the home of the European Securities and Markets
Authority (ESMA). Frankfurt, on the other hand, is the home of the European Central Bank (ECB). Other European cities, including Brussels, Dublin, Amsterdam and Milan were mentioned. This indicates that Brexit is likely to lead to increased fragmentation of the EU financial services industry.

**Figure 11: New EU location**

![Graph showing new EU IPU location]

<table>
<thead>
<tr>
<th>Location</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brussels</td>
<td>3%</td>
</tr>
<tr>
<td>Frankfurt</td>
<td>9%</td>
</tr>
<tr>
<td>Paris</td>
<td>31%</td>
</tr>
<tr>
<td>Others</td>
<td>57%</td>
</tr>
</tbody>
</table>

**C. DELEGATION MANAGEMENT MODEL**

In the next set of questions, we collected information regarding the strategic organisation of large multinational banks, in view of the challenges posed by Brexit and the changing regulation in the EU, in particular the Intermediate Parent Undertaking (IPU) proposals. Most respondents preferred the option of cross-border expansion via branches, with only 3% indicating subsidiaries. This choice may reflect the fact that, at present, branches should not be included in the IPU regulation, as these are mainly supervised by the bank’s home country. The EBC, though, has indicated that they would potentially include both branches and subsidiaries under IPUs, with the Single Resolution Board in charge of closing down lenders in case of trouble.
When asked about the preferred organisational model for dealing with the current uncertainty, respondents indicated the delegation management model. Almost 20% of respondents believe that their current organisation model will allow them to deal with future challenges, whilst 72% of respondents would consider a change to a delegation management model (see Figure 13). Respondents have indicated a variety of reasons for this preference, including the possibility of remaining close to regulators and policy makers and, therefore, maintaining a good understanding of policy requirements, thereby avoiding information gaps. Other important reasons are to remain close to financial innovation hubs, the location in a financial centre and business volumes (see Figure 13).
**Figure 13: How to deal with political and regulatory uncertainty**

![Figure 13: How to deal with political and regulatory uncertainty](image1)

**Figure 14: Why a delegation management model**

![Figure 14: Why a delegation management model](image2)
D. RELATIONSHIP BETWEEN THE UK AND CHINA POST-BREXIT.

One of the key issues for many non-EU businesses is to try to understand how Brexit will impact their country’s firms. We asked respondents if they thought that the relationship between China and the UK after Brexit will develop in a positive way. Most respondents (80%) thought it would. In particular, they didn’t think Brexit would harm the import/export business of Chinese firms in the UK and in the EU. However, when asked specifically about the impact of Brexit on Chinese banks, views were less positive, with 20% of respondents thinking it would impact business and 34% being unsure of the impact. Respondents thought that Brexit would impact on the operating model of Chinese banks (29%), increased compliance with regulatory requirements (28%); decreased access to markets (18%) and some changes in tax regimes (6%). Only 19% of respondents believed that the overall impact would be limited (see Figure 15).

Figure 15: UK-China post-Brexit relationship

<table>
<thead>
<tr>
<th>Chinese SMEs access to financial services impacted by Brexit</th>
</tr>
</thead>
<tbody>
<tr>
<td>YES</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>UK-China relationship more positive</th>
</tr>
</thead>
<tbody>
<tr>
<td>YES</td>
</tr>
<tr>
<td>NO</td>
</tr>
<tr>
<td>DON’T KNOW</td>
</tr>
</tbody>
</table>
Chinese banks in UK impacted by Brexit

- **YES**: 20%
- **NO**: 46%
- **DON'T KNOW**: 34%

POST-BREXIT IMPACTS ON CHINESE BANKS

- **Limited operation model**: 29%
- **Changes in tax regimes**: 6%
- **Increased regulation**: 28%
- **Loss of passporting to EU**: 18%
CONCLUDING REMARKS

The on-going uncertainty concerning the post-Brexit agreement between the UK and EU regarding financial services has led large banks and other financial firms to consider making contingency plans and streamlining their organisational structure in the EMEA region. In this report, we have discussed the potential sources of risk arising from political uncertainty. In the absence of a comprehensive trade deal in financial services - or even a clear indication of what a future trade deal might entail - financial institutions risk having no replacement for the loss of passporting rights, which currently allows them to offer products and services in all EU countries.

In addition to Brexit, we have looked at another potential source of risk for financial institutions: regulatory uncertainty. In this context, we have provided some background on the EU intermediate parent undertaking (IPU) proposals, a new set of rules forming part of the amended Capital Requirements Directive (CRD) and the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) regulation. Whilst discussion at the EU level is still on-going, the proposed rules will require banks headquartered in third-countries to consolidate their EU activities.

How can banks and other financial institutions respond to these challenges? We have discussed possible corporate restructuring methods and detailed the delegation management model as a flexible approach to dealing with political and regulatory uncertainty. Our assumptions have been developed considering the future role of the City of London as an international financial hub. Whilst there are some worrying indicators that London will lose some of its financial services business to EU competitors, such as Paris and Frankfurt, there is also some optimism deriving from the clear comparative advantages of London which will be difficult to replace - at least in the short term. To test these predictions, we have collected industry views via a short on-line...
survey. The results of the survey confirm the views discussed in the report.

Centre for Banking Research

The Centre for Banking Research at Cass Business School promotes high calibre academic research in the field of banking. We also foster the teaching of banking subjects to a high standard. Drawing on the wide experience of our core and associate members, the Centre offers expert analysis of the economic and business environment that affects the banking and financial sector.

As such, we are able to provide specialist consultancy to the banking and financial services industry, public sector organisations, regulatory authorities and governments. Our core and associate members maintain extensive links to the International Monetary Fund, the European Central Bank, the Bank of England, the Financial Conduct Authority, HMT, Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation.

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Contributor Bios

Rym Ayadi

Rym Ayadi is Honorary Professor at Cass Business School, City, University of London and Member of the Centre for Banking Research (CBR). Rym is also Academic Expert Member of the Banking Stakeholders Group (BSG) of the European Banking Authority (EBA). She is Founding President of the Euro-Mediterranean Economists Association and Founder and Scientific Director of the Euro-Mediterranean Network for Economic Studies (EMNES). She is also Member of the European Shadow Financial Regulatory Committee (ESFRC). She is expert member of several high-level expert groups in the European Commission (Financial Services Users Group (FSUG)), external advisor to the European Parliament (Economic and Financial Committee and Committee on Foreign Affairs), Parliamentary Assembly of the Mediterranean (PAM) and the Union for the Mediterranean (UfM) and invited expert in international organisations (OECD, IMF and others). She is Senior Research Fellow at the Euro-Mediterranean University (EMUNI) and Member of the Forum for Euro-Mediterranean Innovation in Action (FEMIA). Previously, Rym was Director of the International Research Centre on Cooperative Finance and Professor of international business and finance at HEC Montreal; and Senior Fellow and Head of the financial institutions research department at the Centre for European Policy Studies (CEPS).

Thorsten Beck

Thorsten Beck is Professor of Banking and Finance at Cass Business School, City, University of London and Member of the Centre for Banking Research (CBR). Thorsten is one of the world’s leading researchers in banking and finance. According to RePEc (citation count), he is in the top 20 of banking and finance researchers and number 147 (thus in the top 1%) amongst all
economists. Five of his papers are amongst the top 1% of all papers in RePEc. According to Web of Science, his papers have a total of 7,872 citations (excluding self-citations) and he has an H-index of 32. In addition to his publication record, Thorsten has been invited frequently to give keynote speeches on financial sector issues at both research and policy conferences across the world. Over the past 20 years, he has built an extensive network of contacts in leading central banks (e.g., Federal Reserve, ECB, Bank of England, Bundesbank) and international financial institutions (IMF, World Bank, BIS, EBRD, ADB). Thorsten has recently been appointed to the Advisory Scientific Committee (ASC) of the European Systemic Risk Board (ESRB). Before joining Cass, he was the founding chair of the European Banking Centre (2008 to 2013) at Tilburg University.

Marco Boldini

Marco is an Honorary Visiting Fellow at Cass Business School, City, University of London and Member of the Centre for Banking Research (CBR). Marco leads the PWC UK Regulatory Legal Practice and he is the Italian Honorary Consul in Liverpool (UK). Marco advises clients on a wide range of legal topics across all aspects of fund work (UCITS and AIFs) and, more generally, in the financial services industry. His expertise extends across capital raising, Fintech, financial services regulation and assets servicing. Marco is also closely following Brexit and its consequences for the fund and the financial services industry, advising clients on the potential relocation of management services and other structural changes. More recently, Marco has assisted a UK asset manager in analysing, implementing and interpreting regulatory changes required by MiFID II, with particular reference to product governance, inducements, outsourcing and financial research. Marco joined PwC in January 2018 from a leading asset management firm, where he was the European Regulatory Counsel. Prior to that, Marco worked for various international banks and for an international law firm, where he trained and qualified in 2007. Marco is a solicitor and a
barrister, an expert speaker at international roundtables (Brexit and the financial industry) and has been nominated by Legal 500 as one of the rising stars in the legal sector for the year 2017.

Barbara Casu

Barbara Casu is Professor of Banking and Finance at Cass Business School, City, University of London. She is also the Director of the Centre for Banking Research (CBR) and one of the leading experts in topics and analysis related to international banking in the US and Europe. She was also a pioneer on empirical studies on the effect of securitisation on bank risk and performance. Barbara’s research projects are cross-disciplinary and include aspects of financial regulation, structured finance, accounting and corporate governance. She has published extensively in elite academic journals and contributes to current debates in the financial press. Many of her works have a strong focus on EU banking markets and are published in leading international journals as policy-makers’ working paper series (IMF, ECB). The IDEAS (RePEc) ranking places her in in the top 5% of authors (Wu-Index, as of February 2018). Barbara is also widely known for authoring the textbook “Introduction to Banking”, now in its 3rd edition. She is referee and Associate Editor for several international journals and experienced in obtaining and managing international grants from major research institutions (EU Horizon 2020; British Academy/Leverhulme). As Director of CBR since 2011, she has been the reference point for many international scholars visiting the Centre and has developed a wide network, including strong ties with the Bank of England, the IMF and the ECB. She has successfully supervised a number of doctoral students, many of whom now hold senior positions in academia and policy institutions. She is promoter and organiser of the “Emerging Scholars in Banking and Finance” conference, where the most talented PhDs are invited to present their works, now in its 5th edition. Outside academia, Professor Casu has been a consultant/visiting researcher at several organisations, including
the International Monetary Fund (IMF); the SWIFT Institute; the Building Societies Association (BSA). She is an advisory board member for the International Research Centre on Cooperative Finance hosted by HEC Montreal.

Angela Gallo

Dr Angela Gallo joined Cass in 2018 as lecturer in Finance, where she was previously a Marie Sklodowska Curie Fellow. The grant-winning project was on non-bank credit intermediation (shadow banking) and its impact on the real economy. Angela’s research interests are in the areas of banking, risk management and corporate governance. Her research has been published in international peer-reviewed journals and presented at well-reputed finance conferences. Her most recent work investigates the demand for safe assets by institutional investors and the manufacturing of such assets via securitisation of mortgages and ABS outside the regular banking system.
Appendix 1: Questionnaire
Brexit and non-EU banks

Name: Click or tap here to enter text.

Position Title: Click or tap here to enter text.

Company Name: Choose an item. Click or tap here to enter text.

Section 1: Brexit UK - EU relationship and impact on financial services
1. What do you think the post-Brexit UK-EU relationship will consist of?
   Choose an item.
   Provide details: Click or tap here to enter text.

2. Do you think that the UK will still maintain its current advantages in attracting businesses and financial institutions to invest and operate locally following Brexit?
   □ Yes   □ No   □ Don't know
   Provide details: Click or tap here to enter text.

3. Do you think that UK financial institutions will lose rights to access the EU market?
   □ Yes   □ No   □ Don't know
   Provide details: Click or tap here to enter text.

4. Do you think that the development of the UK's financial services sector is restricted by EU regulation?
   □ Yes   □ No   □ Don't know
   Provide details: Click or tap here to enter text.

5. Do you think that Brexit will have a large negative influence on the financial services sector within the UK? If so, to what extent?
   □ Yes   □ No   □ Don't know
   Provide details: Click or tap here to enter text.

Section 2: Brexit impact on bank business models
6. Do you think that banks headquartered in the UK could meet the minimum requirements set out by the EU Commission, that is, to transfer staff to the EU but continue to run key business lines from the UK (Delegation Management Model) instead of setting up new headquarters within the EU?

☐ Yes  ☐ No

Provide details: Click or tap here to enter text.

7. According to the proposed reforms to EU banking rules relating to IPU (Intermediate Parent Undertaking), do you think it is necessary for non-EU banks to set up headquarters in the EU to run their EMEA operations? If so, why?

☐ Yes  ☐ No  ☐ Don’t know

Provide details: Click or tap here to enter text.

1. If you answered yes to question 7, in which city would you advise banks to set up their headquarters?

Choose an item.  
Click or tap here to enter text.

2. What factors do banks need to consider when choosing a city as their headquarters?

Click or tap here to enter text.

3. Would you advise non-EU banks (including UK banks) to set up a branch or subsidiary within the EU, to comply with IPU and IHC rules?

☐ Branch  ☐ Subsidiary  ☐ Don’t know

Section 3: Delegation model option

4. Do you think that London will remain a preferred place for non-EU banks to set up their EMEA headquarters? If so, why?

☐ Yes  ☐ No

Click or tap here to enter text.

5. Many banks are moving towards a delegation management model. What factors are crucial for a successful delegation management model?

Choose an item.  Choose an item.  Choose an item.

Click or tap here to enter text.

6. What are the main threats for the business operations of large international banks due to Brexit-related uncertainty?
7. What is the best organisational model to deal with uncertainty / transition?

Section 4: Relationship between the UK and China post-Brexit

8. Do you think that the relationship between China and the UK after Brexit will develop in a positive way?

☐ Yes ☐ No ☐ Don’t know

Provide details: Click or tap here to enter text.

9. Do you think that Chinese SMEs (Small and Medium Enterprises) importing/exporting to the UK and the EU will be impacted in their access to banking services following Brexit? If so, in which ways?

☐ Yes ☐ No ☐ Don’t know

Provide details: Click or tap here to enter text.

10. With Brexit approaching, do you think there will be implications for the operations of Chinese banks based within the UK?

☐ Yes ☐ No ☐ Don’t know

Provide details: Click or tap here to enter text.

11. If you answered yes to question 10, what factors do Chinese banks need to consider post-Brexit?

Choose an item. Choose an item.

Click or tap here to enter text.

12. Would you be available to be contacted in order to participate in our research?

☐ Yes ☐ No