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Brexit – "Time is ticking"

Implications and challenges of day-1 readiness from a Banking perspective

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Brexit will be catalytic for the Financial Services industry

Long-term effects of Brexit on Financial Services industry have not been acknowledged by all (major) players yet

Capital flows

- UK becoming a third country
- Equivalence decisions potentially not taken in due course
  - ➢ **Transactions with EU non-professional counterparties need to be originated in EU27**

Loss of confidence

- Impacts of Brexit are likely to be reduced shortly before the end of negotiations (transition period)
  - ➢ **EU27 and international partners have lost confidence in reliability of UK**

Dynamic process

- Hard Brexit, soft Brexit or even a reversal of Brexit, they all come at a price for the UK
  - ➢ **EU27 supervisors are using Brexit to further increase requirements for banks**

There will be long-term impacts from Brexit on Financial Services. Capital flows will be redirected from UK to EU27 but also to the U.S. and Asia Pacific. London as a whole will lose but remains a significant Financial Services hub.

! **Lingering uncertainty with regards to the outcome of the Brexit negotiations force all Financial Institutions to plan for the worst case scenario: a hard Brexit and the anticipated loss of the existing passporting rules.**

Three areas of main challenges

Strategic uncertainties determine the Brexit challenge while new requirements and operative complexities amplify the need for short-term tactical solutions

Strategic

- **Uncertainty**
  - About future state of capital markets and capital flows into and out of the EU
  - About outcome of negotiations between UK government and EU Commission
- Necessity to manage Brexit as **contingency program for day-1 readiness**
- **Strategic solutions** will be possible only **after Brexit** has happened

Regulatory

- So called **incoming banks** (newly authorised or authorisation extended) will be **evaluated stricter** than currently operating institutions
- ECB most likely to be responsible for significant investment firms going forward based on EU Commission proposal
- **Brexit** will be **used to clean up issues** previously de-prioritised
- **Background alignment** of ECB and NCAs ongoing
- Decision of Euro Clearing pending

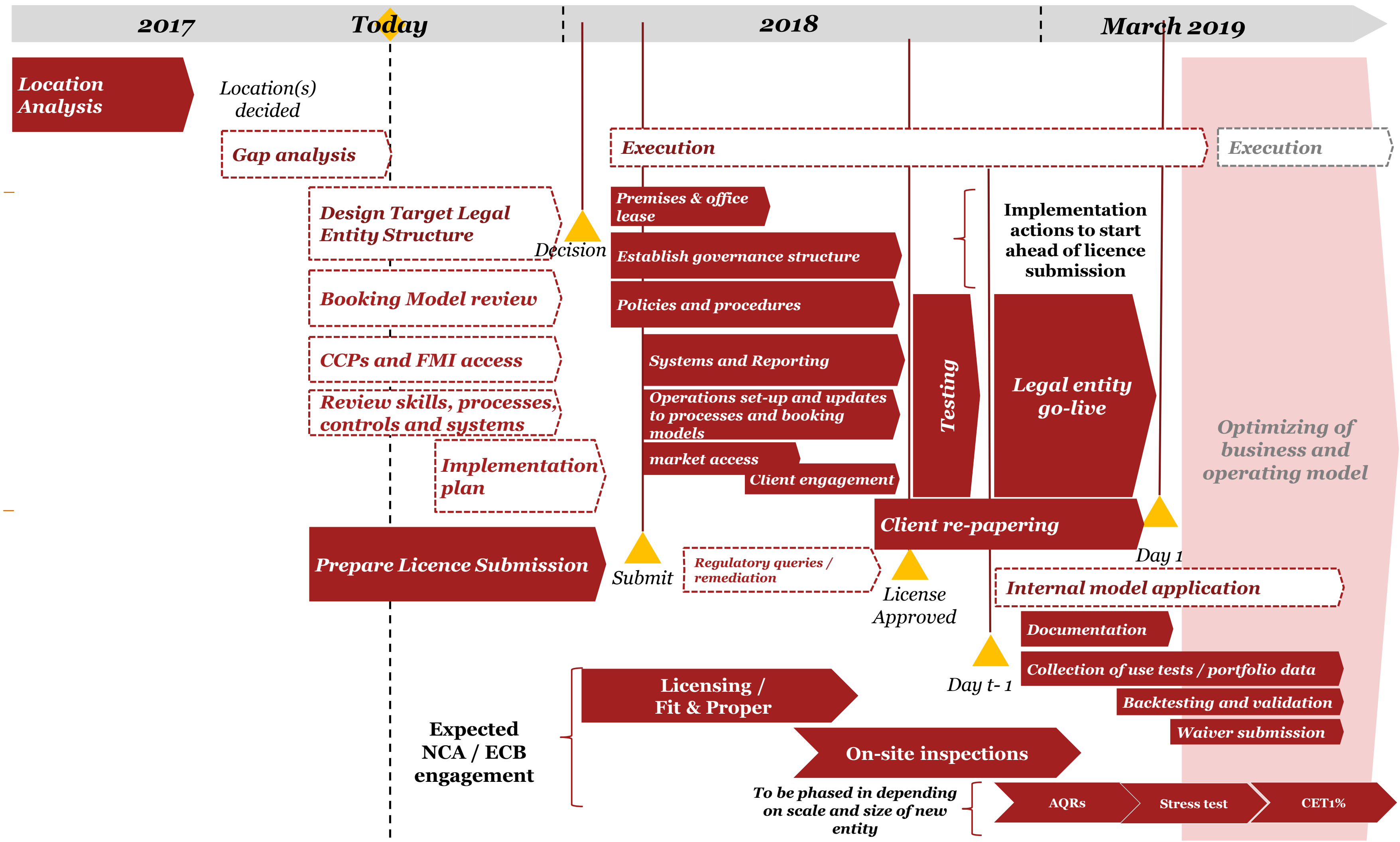
Operative

- **'Empty shells' not acceptable**
- **ECB expected to limit back-to-back risk transfer, remote booking** with EU counterparties and **intragroup outsourcing**
- **Substantive ratio of key function holders and 1st and 2nd line of defence staff on the ground**
- **Day-1 readiness to be achieved operationally** to not disrupt markets
- **Decomposition of trade lifecycle** in the group
- Institutional **politics**

! **"The Brexit plans of the banks are not as advanced as we would like them to be!"**
Sabine Lautenschläger, Börsenzeitung, 17 August 2017

The industry faces a challenging timeline for day-1 readiness

Deliveries come in predictable waves to meet the deadline of March 29th 2019



Location and legal entity strategies are currently finalized

… and 13 out of 20 institutions that communicated their strategy already plan to transfer part of their capital markets and corporate banking activities to Frankfurt

Frankfurt

- Citigroup
- Daiwa Securities
- Deutsche Bank
- Goldman Sachs
- J.P. Morgan Chase
- Lloyds Banking Group
- Mizuho Financial Group
- Morgan Stanley
- Nomura
- Standard Chartered Bank
- Sumitomo Mitsui
- UBS
- VTB

Dublin

- Bank of America
- Barclays
- J.P. Morgan
- Royal Bank of Scotland/NatWest

Paris

- HSBC

Amsterdam

- Mitsubishi UFJ Financial Group
- Royal Bank of Scotland

Luxemburg

- J.P. Morgan
- Northern Trust
- China Everbright

! **The seize of the shift is not yet known due to various uncertainties. A recent estimate from LB Hessen-Thüringen (Helaba) ranges from 5.000 to 10.000 new jobs in Frankfurt by the end of 2019**

Ansturm der Banker, Die Welt, 04 September 2017

ECB position on 'substance requirements' and booking models for incoming banks

Location

- The ECB is completely neutral regarding the location chosen by banks; it does not care to whether banks go to Dublin, Paris, Rome or Frankfurt
- It seeks a "level playing field" of supervision throughout the euro area

Self Sufficiency

- Banks must be capable of managing all material risks potentially affecting them independently and at a local level and should have control over their balance sheet and exposures; they must ensure sufficient market access

Crisis Situation

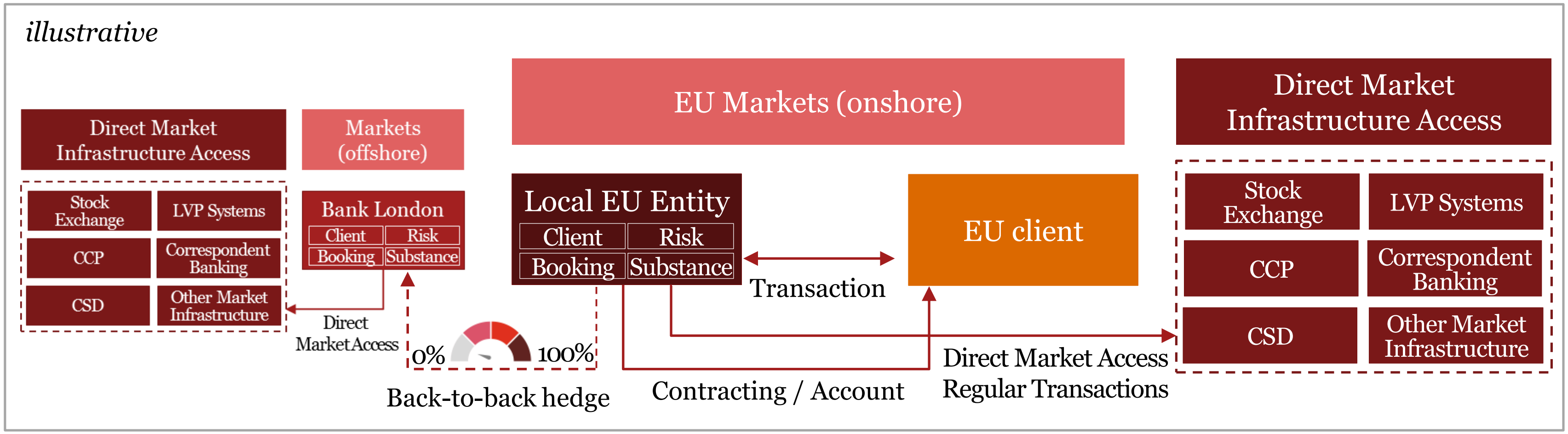
- Focus on resolvability in crisis, where banks can operate independently of parent / hub bank in a third country location with direct market access and lines of liquidity
- This requires local infrastructure, staff and risk management functions

ECB stance is expected to have a significant influence on the design of booking models, capabilities required to be developed in the EU entity, as well as access to FMIs and CCPs.

Whilst incoming banks will be evaluated in line with the stricter interpretation, institutions already operating in the EU are expected to be brought in line by ECB and local regulators over time.

Future model – EU subsidiary according to ECB stance

The ECB is expected to require subsidiaries to have independent risk management capabilities to be able to cope under a 'crisis scenario'



ECB's areas of expectation	***Main expected requirements***
1 Booking / Balance Sheet	Risk exposure not be fully transferred to other entities
2 Front-Office	Sufficient FO staff to manage risks independently
3 Risk, Finance, etc. (2LoD)	Sufficient 2LOD staff to manage and control outsourcing
4 Operations	Sufficient Operations capabilities to control outsourcing and perform own settlement in crisis situation
5 Market Access	Own market access for relevant / significant risk exposures

***Overall main effects*[1)]**

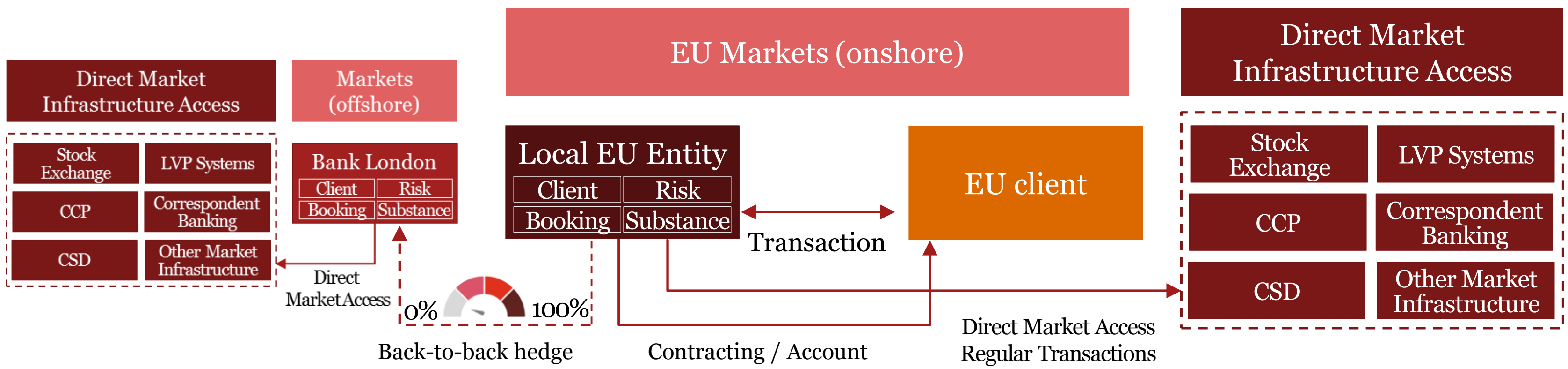
1. *Reduction of B-2-B risk transfer ability to max. 70-80%*
2. *Significant FO, 2LOD and Operations Key Function Holders and staff onshore*
3. *Own Market Access for relevant risk exposures*

1) Related to relevant risk exposures; i.e. small scale risks – e.g. JPY exposure which accounts for 2% of risk exposures overall – will most probably not be looked at

Operational Readiness

Irrespective of the booking model, there is a long list of challenges to be addressed prior day-1, many of them impact all market participants

illustrative



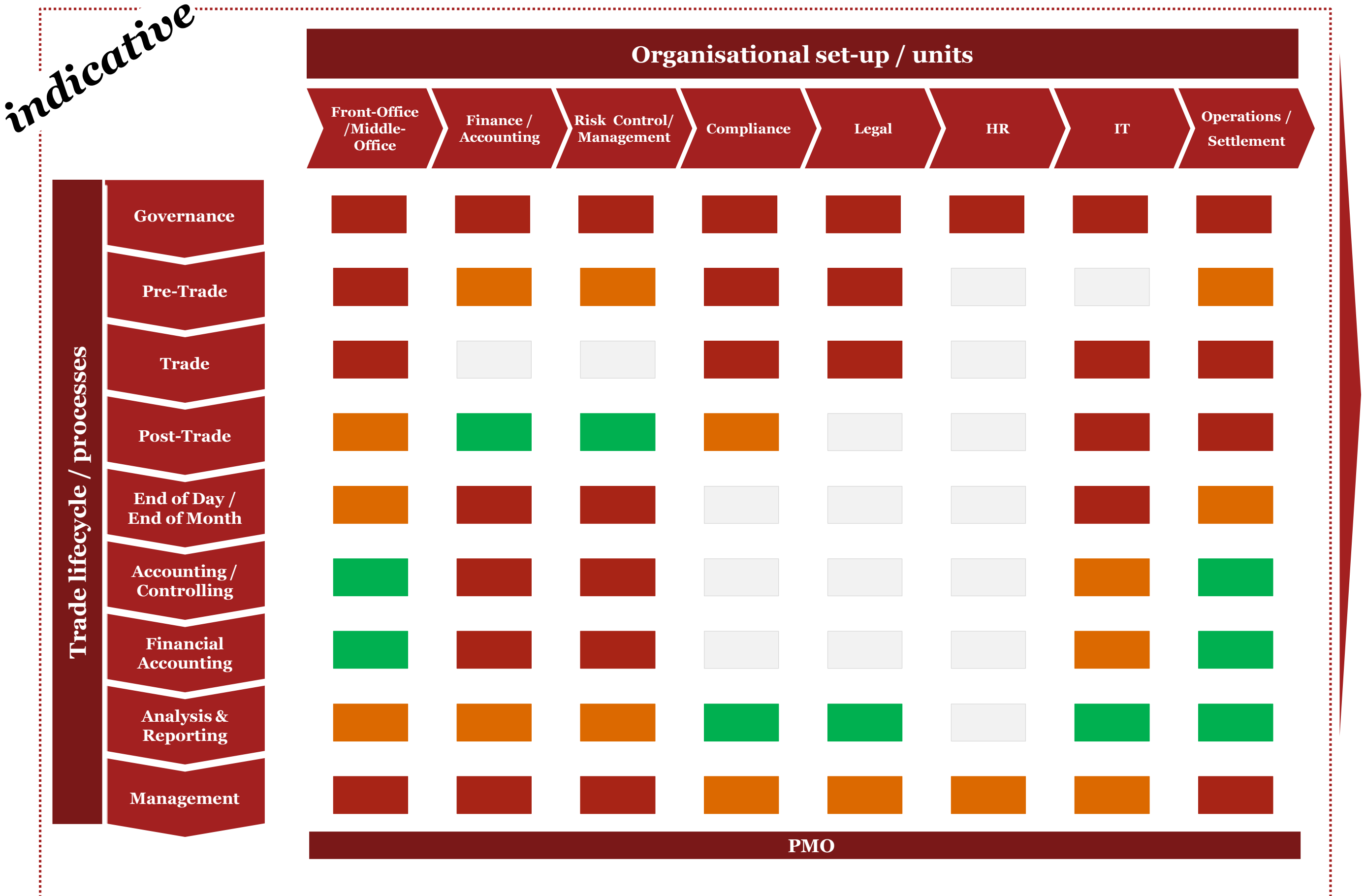
London and other group entities:

1. Support the re-papering of EU clients to EU subsidiary
2. Changes to overall booking model
3. IT systems changes and migration of infrastructure
4. Provide expertise and access to specialised markets outside the EU
5. Manage group-wide risks and overall funding profile of the group

Operational Challenges	1. Novation of existing transactions subject to client agreement 2. Re-papering of EU clients with new ISDAs, GMRAs etc. 3. Breaking up of netting sets (EU / non-EU) with associated separate margin calls, settlements and reporting requirements 4. Market access (new clearing memberships, credit lines and back-up brokers)
Risk Challenges	1. Capital scarcity – business to be expanded and capitalised in phases 2. Breaking up of funding pools to increase liquidity costs / risks 3. Adequacy of governance oversight within the EU entity
Managerial Challenges	1. Scarcity of qualified resources - fit and proper 2. Organisational commitment and alignment

Operational Readiness

… impacts every division to a varying degree and requires costly and complex adjustments to existing Target Operating and Governance Models.



Challenges

- increased complexity
- resources in quantity and quality
- timeline
- associated cost
- coordination
- operational risk

Concerns

- uncertain expectations
- level playing field

Summary

ECB's Position

Post Brexit, banks must

- *be capable of managing all material risks potentially affecting them independently and at a local level*
- *have control over their balance sheet and exposures*
- *be able to operate independently of parent in crisis scenario*
- *establish adequate local infrastructure, staff and risk management functions*

The Market

Fact

- *The market has understood ECB's position, however, there is uncertainty and inconsistency on how to interpret this position.*

Status:

- *In designing a post Brexit organisation, decisions on booking models, remote access arrangements, sourcing and outsourcing, double hatting have massive impact on future operating models, associated operational risk and respective cost.*

Conflict of interest:

- *The more self sufficiency and management capabilities have to be implemented "locally", the more complex and expensive the day-1 readiness will be!*

The Need

Understanding the overall complexity, direct, consistent and clear communication with regards to interpretations/expectations is required

- *to avoid the interpretation of regulatory compliance becoming a competitive differentiator,*
- *to source appropriate management competencies and governance structures required,*
- *to have less theoretical discussion but to focus on implementation of rendering financial services post Brexit.*

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