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Hot Topics

**Banking & Finance**
Eurozone Hub

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# No easy transition: EBA publishes its own strict "supervisory principles on relocations" (SPoRs)

**What do the EBA's SPoRs mean for BREXIT-proofing of business and for other market participants moving to the Eurozone?**

The tone amongst the European Supervisory Authorities (**ESAs**) is becoming increasingly clearer that if "BREXIT means BREXIT" then "third-country means third-country" in a phrase that summarises the European Banking Authority's (**EBA**) recommendations and SPoRs communicated to the EU's supervisors in the European System of Financial Supervision (**ESFS**). On 12 October 2017, the EBA joined the other ESAs and released a legal instrument in the form of an 'Opinion' titled: "issues related to the departure of the United Kingdom from the European Union" (the **EBA General Opinion**)[1].

The EBA General Opinion is supplemented by a "Report" explaining the rationale for certain SPoRs in further detail. The "Annex to the Report" details key questions that competent authorities (NCAs and ECB-SSM) should consider when reviewing a licence application. EU supervisors, as addressees of the Opinion as well as new applicants and existing supervised entities relocating must take account of the EBA's SPoRs, despite the Opinion being drafted as "non-binding", as there will be no automatic grandfathering of existing establishments and there is as yet no indication that the UK will be able to obtain a transition agreement to extend its EU Single Market access/rights beyond its departure from the EU in March 2019 and when entities in the UK will, from an EU regulatory perspective, become third-country entities (**TCEs**).

This Client Alert, which is part of a series[2] covering the SPoRs published by the other ESAs, highlights the practical impacts of the SPoRs in the EBA General Opinion as well as differences to those issued by other ESAs and similar statements from the European Central Bank (**ECB**) acting in its role in the Single Supervisory Mechanism (**SSM**). The ECB-SSM' and the ESAs' statements, FAQs and supervisory "guidance", which are often framed as non-binding, do read like rules and the SPoRs are certainly clear on the intended outcomes. Those publications have been echoed by similar measures taken by national competent authorities (**NCAs**) in the ESFS. This is relevant as the NCAs are the direct addressees of the respective ESA Opinions and are thus tasked with implementing the SPoRs in their supervisory activities.

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[1] Available: http://www.eba.europa.eu/documents/10180/1756362/EBA+Opinion+on+Brexit+Issues+%28EBA-Op-2017-12%29.pdf

[2] See a full list of our Client Alert series on the SPoRs available on our Baker McKenzie homepage: Baker McKenzie Insights

The SPoRs' clear supervisory expectations and principles primarily aim at ensuring supervisory convergence by focusing on the application of:

1. common standards, approaches and rules during the authorisation process as well as internal model approvals[3], booking processes, internal governance[4] and risk management specifically where it concerns outsourcing and risk transfers using back-to-back or intragroup operations;
2. equivalent access for the provision of investment services (whether directly or by establishment) by firms in the EU; and
3. harmonised approaches on participation by firms in deposit guarantee scheme issues and ultimately revisiting adequacy of recovery and resolution plan (**RRP**) frameworks and how these are impacted by the UK's position as a third-country following it leaving the EU.

Whilst these ESA Opinions are addressed to EU supervisors, the SPoRs will be directly relevant to new firms/business units relocating and any intermediate or parent holding companies. And they will also be relevant to those credit institutions and/or Banking Union supervised institutions (**BUSIs**) already operating in the EU and/or the Eurozone and its Banking Union.

In summary, the SPoRs, both of the EBA and those of its sister ESAs, set a clear supervisory tone and expectation for those relocating. They communicate concrete expectations how these entities will need to approach BREXIT-planning as well as on-going compliance obligations. The SPoRs will also apply after the relocation process has been completed. As a result, the SPoRs will impact and shape the supervisory engagement process, including for those entities in the EU that maintain ties back to the UK, including via TCEs, both prior to and following the UK's departure from the EU.

**So what do EBA General Opinion's SPoRs mean in practice and why does it matter?**

The EBA General Opinion's SPoRs are more prescriptive than those set by the sister ESAs. Consequently, this will merit specialist input to ensure that requirements driven by pan-EU as well as global policymakers and supervisors are interoperable in terms of the rules but equally in terms of the business operating environment in respective national jurisdictions. The key practical impacts of the EBA's SPoRs will impact policies, processes, procedures and people involved on "change the business", "run the business" as well as "close the business" workstreams as well as the supervisory engagement process with the NCAs across the EU-27 and, in the Eurozone and its Banking Union, the ECB-SSM and the NCAs participating in the SSM.

[3] Chapter II of the Report component of the EBA General Opinion provides a host of detail on the SPoRs relating to internal model approvals, governance and validation processes. These issues are discussed in greater detail in a standalone Background Briefing available from our Eurozone Hub.

[4] Please see our separate Eurozone Hub coverage on new EBA rules on governance and impacts on authorisation and supervision of key function holders and other senior management staff.

The impacts of the SPoRs on relocating entities can be summarised as follows:

| Summary of EBA General Opinion SPoRs: | Likely practical impact for relocating entities? |
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| ***No automatic recognition of existing authorisations***; | EU law does not provide for a basis of reliance on previous or existing authorisation decisions granted by another EU Member State authority or a third-country. Rather EU law supports the "…best use of existing information where information is exchanged".<br><br>Consequently, as the other ESAs have stated, existing branches and firms will not be able to benefit from any "grandfathering provision" nor will they be given "favourable treatment". Rather each application will be assessed with fresh eyes. |
| ***No lowering of existing standards by supervisors***; | As a result, certain areas, notably those that factor into the 2018/2019 and beyond supervisory workplans and priorities will likely be subject to extra supervisory scrutiny and review. |
| ***Authorisations, registration and variation of permissions granted by EU-27 NCAs should be rigorous and efficient and take into account the final standards specifying information requirements as well details of supporting evidence to be submitted as a part of credit institution[5] applications***; | Relocating entities' applications may need to submit much more detail in the application as well as the supporting evidence than has previously been the case. A greater emphasis is likely to be placed on evidencing specifically why a specific choice or action is justifiable, the control processes involved and how relevant risks are identified, mitigated and managed. Applicants may need to also provide greater detail of evidence as to how a specific decision fits into the firm's general strategy. |
| ***NCAs should be able to verify the objective reasons for relocation***; | |
| ***Special attention should be granted to avoid 'letter-box entities' and 'empty shells' in the EU-27***; | Applicants will need to demonstrate sufficient presence and permanence in terms of persons and processes. As with the other ESA Opinions, this may translate into ensuring that positions that are relocating are staffed with suitably qualified individuals with relevant experience and commitment to being employed and based in the jurisdiction of the relocating entity. Supervisors may also periodically check whether the actual regulated activity that has been applied for is actually being conducted in the EU-27. |
| ***NCAs should ensure that substance requirements are met***; | |
| ***NCAs should assess whether an applicant from the UK has considered that existing branches in the EU*** | This follows earlier SPoRs of the sister ESAs and is quite clear that there is an expectation that any relocating applicant to incorporate as a subsidiary as opposed to a branch of a TCE. |

[5] See: http://www.eba.europa.eu/-/eba-publishes-final-standards-specifying-information-requirements-for-the-authorisation-of-credit-institutions. The "final standards" in the form of the RTS and ITS were submitted by the EBA to the European Commission on 14 July 2017. These final standards are, at the time of the publication of the EBA General Opinion and the date of this Client Alert were yet to be adapted.

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| ***will become a third-country branch of a TCE following BREXIT and its regulatory permissions and ability to operate will change***; | |
| ***Outsourcing and delegation will be subject to greater supervisory scrutiny***; | The EBA General Opinion specifically mentions that the NCA and/or ECB-SSM should have the right to conduct onsite inspections at the outsourcing service provider. As with the SPoRs from the sister ESAs, outsourcing and delegation to third-countries is only possible under strict conditions. |
| ***Credit institutions engaging "…in back-to-back (undefined) or intragroup operations to transfer risk" to another entity should have adequate resources, including regulatory capital, to identify, account for, mitigate and manage risks in the event of a failure***; | This suggests that far more supervisory scrutiny will be given to how firms monitor such exposures and that the concentration risk and large exposures regulatory regime will play a far more important component in the EU and Banking Union use of the Supervisory Review and Evaluation Process (**SREP**)[6] tool. |
| ***The EBA General Opinion like the EIOPA Opinion, proposes "enhanced supervisory cooperation" and information sharing to be imposed, by the relevant NCA or the ECB-SSM***; | This SPoR applies when "...the transfer of market risk relates to volumes of transactions that are significant (undefined) having regard to the size of the local market." In the absence of such enhanced cooperation, the competent authority (i.e. NCA and/or ECB-SSM) can take steps"…to limit or prevent the transfer of significant market risk". |
| ***NCAs should ensure sound governance of EU entities***; | It is expected that this will translate into much closer supervisory scrutiny of both "key function holders" along with internal governance processes and policies. The tone that ESMA sets in these SPoRs follows on from existing guidance of the ESAs on governance as well as, to some degree, the supervisory expectations that are communicated in the ECB-SSM's Guide on Fitness and Propriety which is detailed in our Eurozone Hub's Background Briefing[7]. |
| ***Permissions for existing and new internal model approvals or extensions will receive closer supervisory scrutiny***; | Any relocating entity will need to apply for model approvals prior to using them and take note of existing EBA and/or ECB-SSM supervisory expectations[8] and obligations. |

[6] See our coverage on how SREP is evolving in the Banking Union available here: http://www.bakermckenzie.com/-/media/files/insight/publications/2017/08/al_germany_srep_aug17.pdf?la=en

[7] See: http://www.bakermckenzie.com/-/media/files/insight/publications/2017/07/guide_germany_backgroundbriefingfpguidebankingunion_aug17.pdf?la=en

[8] See our coverage of recent developments and changes to the approvals process: http://www.bakermckenzie.com/-/media/files/insight/publications/al_germany_ecbssmtightemssupervisory_oct17.pdf?la=en

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| ***NCAs should ensure they have sufficient resources to deal with BREXIT-workstreams along with a host of workstreams that have "change the business" impact for supervised firms (MiFID II/MiFIR, PSD2 and GDPR etc.)***; | This SPoR is directed at the supervisors and, as in the Opinions of the other ESAs, requires that sufficient and competent resources be made available to deal with the breadth of non-BREXIT related workstreams. |
| ***ECB-SSM should be responsible for direct supervision those entities that qualify as "Class 1 Investment Firms" as such terms is used within the meaning of the EBA's proposal for a new prudential regime for MiFID Investment Firms****;* | This SPoR is particular to the EBA General Opinion and ties in with changes being proposed to create a new prudential regulatory capital regime specific to the risks of MiFID Investment Firms.<br><br>Please see our Eurozone Hub's coverage[9] on this development. |
| ***BREXIT exposure will matter for "close the business" workstreams***; **and** | NCAs will, in addition to factoring how BREXIT will affect supervised entities' RRP frameworks, participation and contribution to deposit guarantee schemes and protections offered to eligible depositors as well as exposure to financial market infrastructure providers located in the UK, also need to supervise how supervised entities assess and cater for sufficient inventory and issuance plans for instruments used to meet the EU MREL framework[10] and "…in particular their reliance on issues issued under English law."<br><br>Whilst the rationale for the supervisory approach is understandable, the concern really ought to, as with other BREXIT-proofing of financial transaction documentation focus on considering whether the choice of jurisdiction is appropriate where previously this has been the English courts as opposed to attempting to regulate parties' freedom to choose the governing law.<br><br>There are a number of financial instruments admitted to trading across the EU-27 as with financial transaction and operational documentation, where the terms are governed by English law and the offering documentation as well as certain other points by local law. |
| ***NCAs must be in a position to effectively supervise and enforce EU law and share information obtained far*** | NCAs are directed to implement coordination to ensure effective monitoring by the EBA as well as to periodically update the EU Credit Institutions Register[11] and the EBA E-Gate[12] process. |

[9] See: http://www.bakermckenzie.com/en/insight/publications/2017/10/eba-mifid-investment-firms

[10] "Minimum requirement for own funds and eligible liabilities".

[11] This resource, and equivalents of the sister ESAs, are a first and important step to introducing a centralised resource to collect and publish data on entities regulated to conduct financial services business: http://www.eba.europa.eu/risk-analysis-and-data/credit-institutions-register

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| ***more greatly***. | |

The SPoRs, whilst quite vast in what they cover, will have varying degrees of impact across various regulated business types and legal entity structures. What is important to note is that the EBA General Opinion like with those of its sister authorities are drafted as 'jurisdiction agnostic' and 'firm-type agnostic'. The SPoRs thus apply to all relevant types of entities addressed in the Opinions irrespective of their business activity and/or risk profile.

The Annex to the Report to the EBA General Opinion however has some items and explanatory notes that are specific to just credit institutions. These questions should be considered in light of the ECB-SSM's rules that apply within the Banking Union. This also includes an assessment of how the streamlining i.e. elimination of national options and discretions in the CRR/CRD IV Framework[13] will impact relocating entities and their compliance strategy.

**Key takeaways from the Annex to the Report**

The Annex to the Report has a number of general takeaways for supervisors reviewing applications for firms applying as a credit institution as well as more specific questions grouped in 43 headings.

The principles in the general considerations should be fairly familiar to most regulated firms and applicants. The specific items however are highlighted below. In short the SPoRS, plus the considerations in the Annex to the Report, should be read together with the items referenced in our recent coverage[14] on the ECB-SSM's supervisory "guides" on banking licence applications for traditional and "FinTech" credit institutions and certain clarifications on EU banking regulation as well as other on-going coverage from our Eurozone Hub.

The specific considerations from the Annex to the Report include:

- Does the applicant have a LEI? Has the applicant demonstrated sufficient preparedness to meet its regulatory reporting obligations?;
- If the applicant is a legal person, does it have a registered office in the EU Member State? Is the applicant's head office in the same Member State as the registered office? If not where is it? - NB the Explanatory Notes to these questions remind supervisors that Article 13(2) of CRD IV[15] imposes harmonised principles relating to the location of the effective direction of the business and place of the head office. Further, the notes cross refer to Recital 16 of CRD IV and state that "…authorisation should be refused where the factors such as the geographical distribution of activities indicate

[12] EBA E-Gate is an IT tool designed to facilitate the collection, storage and display of different notifications that are reported by several data providers including competent authorities in the ESFS to the EBA. The EBA's ultimate supervisory objective is to include electronic submission of most, if not all, the notifications that are required to be submitted to the EBA.

[13] See some of our Eurozone Hub lawyers' current and previous Thought Leadership contributions available from our Eurozone Hub as well as the Sweet & Maxwell's Journal of International Banking Law and Regulation.

[14] See: http://www.bakermckenzie.com/-/media/files/insight/publications/ar_germany_ecbguideslicenseapplications_sep17.pdf?la=en

[15] Directive 2013/3/EU, as amended and supplemented.

clearly that an applicant has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State on whose territory it carries out or intends to carry out the greater part of its activities";

- Has a "significant event"[16] taken or is one taking place in respect of the applicant or any of its subsidiaries?;
- Are the proposed regulated activities that are being applied relevant and do they align with the proposed business model?;
- Are other regulatory permissions, whether in EU or national legislation, being applied for?;
- Which SREP business model category would the applicant fall into? This will assist in determining whether any additional "special requirements" will need to be set during and following the licence approval process;
- Has the applicant confirmed that before or upon authorisation it will become a member of a deposit guarantee scheme in accordance with Art. 4(3) of Directive 2014/49/EU (DGSD3)?;
- An outline of actual and expected indebtedness and security interests, guarantees, or indemnities granted or expected prior to the commencement of the applicant credit institution plus an analysis of the scope of consolidated supervision;
- Has the applicant provided the following policies and frameworks? These are in addition to those required by national legislation and/or the Banking Union specific rules (in particular those in the ECB-SSM's NPL Guide[17]) and are different to the required "programme of operations" i.e., regulated business plan plus any requirement to explain the internal control framework and take account of the compliance manual[18], compliance monitoring framework, operations manual and/or business continuity plan, RRP or any SREP driven policies (ICAAP, ILAAP or Risk Appetite Framework):
  - risk management framework;

[16] See page 69 of the EBA General Opinion, but this may be briefly summarised as any of the following having or currently occurring in relation to applicant or any of its subsidiaries:

1. declaration of a moratorium of any indebtedness, restructuring or reorganisation process affecting its creditors etc.;
2. administrative penalty or civil or administrative judgment or arbitral award or decision with equivalent effect;
3. any unsatisfied judgment or awards outstanding;
4. any settlements reached in a financial services subject matter and details of any current proceedings; and
5. any criminal conviction or administrative penalty generally and specifically in respect of conducting unauthorised regulated activity, engaging in fraud, acting dishonestly, committing corruption, financial crime or failure to put in place adequate policies and procedures to prevent such events.

[17] See our Client Alert and Background Briefing available: http://www.bakermckenzie.com/en/insight/publications/2017/07/eu-sets-marching-orders

[18] specifically supervisors will, in addition to the above, focus on the following policies and procedures in the compliance manual:

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| whistleblowing policy | complaints handling policy | remuneration policy | product governance policy |
| conflicts of interest policy | policy promoting the diversity of the management body; | market abuse policy | prevention of financial crime policy |

  - liquidity risk management framework;
  - funding concentration and diversification policy;
  - collateral management policy;
  - deposit policy;
  - credit and lending policy;
  - concentration risk policy;
  - provisioning policy;
  - dividend distribution policy;
  - trading book policy?;
- Does the applicant have in place appropriate auditing and internal audit arrangements?; and
- Are there any obstacles which may prevent the effective exercise of supervisory functions of the competent authorities, including where relevant supervision is on a consolidated basis?

The above are minimum considerations. They are also not drafted in a way that interoperates with additional as well as specific requirements set by the NCAs and/or the ECB-SSM.

**Putting the EBA General Opinion into context of the ESA's SPoRs**

The EBA General Opinion is the latest of ESA Opinions. The European Securities and Markets Authority (**ESMA**) General Opinion was released during May 2017 and further supplemented by "Sector Specific Opinions" (**SSOs**). ESMA's SPoRs were the first in a series of regulatory tools to improve supervisory convergence amongst the NCAs as well as amongst the ESAs that make up the ESFS. The European Insurance and Occupational Pensions Authority (**EIOPA**) followed swiftly suit in July 2017.

As with its sister authorities, the EBA General Opinion aims to be far-reaching in its intended territorial application. It is addressed to the NCAs across the EU-27 that with the ESAs make up the ESFS as well as the Eurozone-19's Banking Union authorities, the ECB-SSM and the Single Resolution Board. The EBA General Opinion also applies to the national competent authorities of Norway, Liechtenstein and Iceland in the European Economic Area (**EEA)**.

The EBA General Opinion's release complements, and thus should be read in conjunction with, the SPoRs set by ESMA and EIOPA and more importantly the ESA's Opinions all aim to deliver on the supervisory convergence goals to making the Single Rulebook for financial services more uniform across the EU-27 and the Eurozone-19 and its Banking Union as well as to roll-out the 'level-playing field' to the EEA states.

At close to 70 pages, the EBA General Opinion, whilst sharing a number of common elements with the ESMA and EIOPA Opinions is considerably longer and often elaborates points made by the sister ESAs or the EBA General Opinion. Unlike those of its sister ESAs, the EBA General Opinion's SPoRs impact:
credit institutions and the banking sector;

- MiFID Investment Firms and the investment management sector but not regulated funds and their managers;
- payment institutions and electronic money institutions engaged in payments related business; and
- credit intermediaries and non-credit institutions admitted under the EU's "Mortgage Credit Directive" and active in the mortgage market.

Moreover, conceptually, as with the EIOPA Opinion, the EBA General Opinion's "Recommendations" and SPoRs are focused on businesses relocating from the UK. The ESMA General Opinion focused on any relocation of TCEs to the EU-27. It is important to note that as in the sister ESA's Opinions a "relocation" may also include variation of existing permissions and organisational set-up of firms operating in the UK and the EU-27.

**Outlook and some next steps for firms affected by the SPoRs of the EBA and ESAs**

The SPoRs in the ESA's Opinions have already set a new, more clearly mapped route on how financial services firms will need to structure themselves when relocating to the EU-27 and/or Eurozone-19 as a result of BREXIT or otherwise. The ESA's Opinions all communicate SPoRs with reference to existing as well as pending legislative and regulatory obligations that supervised firms are required to comply with.

The EBA General Opinion and its SPoRs take this much, much further and depending on firm type and structure, might require a number of changes to existing and pending arrangements that will merit earlier consultation and support from external counsel and cross-disciplinary and business unit project teams. As a result, the impact of the SPoRs affected firms will need to:

- review existing and pending BREXIT-proofing and relocation plans, some of which might need to be revisited to make sure they comply with the SPoRs as well as to, in comparison to the ESMA and EIOPA SPoRs, take specific account of the far more complex interplay between pan-EU and/or Banking Union-specific obligations and the requirements of individual jurisdictions whilst tying this back to global developments and firm specific policies, processes and procedures;
- allocate sufficient time and resources in order to take account of potentially more invasive supervisory touchpoints along each of the levels of the ESFS and especially in light of how policies, processes and people are likely to be reviewed. For BREXIT-proofing workstreams, this might mean retaining appropriate legal and regulatory specialists, both within internal and external project teams that can draft, implement and ensure compliance with EU, Eurozone, respective national levels as well as third-country regimes. This dedicated workstream, whilst needing to be interoperable with licence application and relocation workstreams, ought to be run separately so as to have a sufficient degree of independence and an ability to challenge assumptions made by those advising on the relocation; and
- provision for longer supervisory processing timelines and greater detail in relation to supervisors dealing with reviews and approvals and/or

supervisory inspections. For some firms this might also mean taking appropriate advice as to how their business model might be affected by the supervisory priorities of the relevant components of the ESFS, whether there are any quick wins and how to document and embed processes and policies that evidence compliance with the supervisory expectations and the SPoRs.

**Please do get in touch with any of our Eurozone Hub key contacts below if you require specialist support with your licence applications or variation of permissions or if you would like to receive more analysis from our wider Eurozone Group or in relation to the topics discussed above, including what the EBA's General Opinion as well as the SPoRs of the sister ESAs and the ECB-SSM might mean for specific market participant types.**

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