

Brexit: Licensing for UK Branches of EEA Banks

A Guide to PRA Authorisation

January 2018





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Post-Brexit Authorisation: UK Branches of EEA Banks

Introduction

This guide explains what action UK branches of EEA credit institutions (EEA banks) should now be taking to obtain regulatory approval to continue operating post-Brexit, the requirements to be met and the approach taken by the Prudential Regulation Authority (PRA) towards authorisation and supervision.

Both UK and EU financial regulators have reacted to the UK Government's triggering of Article 50 in March 2017 by raising the pressure on firms over their Brexit-readiness. Importantly, regulators have made clear that Brexit planning is a requirement not only for UK firms doing business in the EEA, but also for EEA firms with operations in the UK. During 2017, the PRA, the Financial Conduct Authority (FCA) and the European Central Bank (ECB) have all made public statements. On 7 April 2017, the PRA issued a "Dear CEO / Branch manager" **letter** to all the firms that it regulates, including UK branches of EU/ EEA banks, which required them to set out details of their Brexit contingency plans.

The latest step took place in December 2017 when the Bank of England (of which the PRA forms part), announced that all UK branches of EEA banks must apply for authorisation as branches (or subsidiaries) of international banks in readiness for post-Brexit. At the same time, the PRA published a consultation paper, **CP29/17**, on its approach to the authorisation and supervision of UK branches of foreign banks. This was accompanied by a number of related consultations and announcements from the UK Government and the FCA.

Which firms are affected?

These proposals concern EEA banks which are currently branching into the UK under Single Market "passporting" arrangements.

What's the regulatory position now for UK branches of EEA banks?

Under current EU law, the home state supervisor (HSS) of an EEA bank that operates as a branch in another EEA country is responsible for the prudential supervision of the whole bank (including the branch). This means that the PRA is not responsible for prudential supervision. It is worth noting that under the Capital Requirements Directive 2013/36/EU for EU branches designated as "significant," the PRA may take "precautionary" measures over branches in exceptional situations and has the right be consulted and receive information from the HSS.

In the Eurozone, under the EU's Banking Union and the Single Supervisory Mechanism, all significant credit institutions (circa 120 banks) are directly supervised by the ECB. Supervision of the remaining 5,000 banks is led by national authorities albeit under the overall direction of the ECB.

When does all this happen - is there a deadline?

Branch supervision of EU firms will not change until Brexit day, that is the date the UK withdraws from the EU. This is expected to be on 29 March 2019. Of course, this is subject to any "implementation" (or transitional) period that the UK and EU negotiate and, in the longer term, any new trading arrangements. The UK government has promised that, if necessary, it will bring forward legislation to introduce a temporary permissions regime and will legislate to ensure that contractual obligations can continue to be met.

In the meantime, however, if branches wish to continue in business after Brexit day, the PRA requires them to apply for authorisation as a branch of an international bank by 30 March 2018. This will allow a year for the application to be considered and processed. Post-Brexit, assuming that there is no preferential treatment granted to EEA banks, branches of EEA banks would then be treated in the same way as other international bank branches. See page 5 of this guide for more details on deadlines.

So what is the PRA's approach to authorisation and supervision?

A branch of an international bank is part of a legal entity outside the UK and is dependent on that legal entity, for example, for liquidity and capital. Therefore, the PRA's authorisation framework applies to the whole legal entity rather than just the branch. For those EEA entities setting up a branch in the UK, the PRA authorisation framework will extend from the UK branch to the entity in the EEA.

A key part of the regulatory framework is to have an appropriate degree of supervisory cooperation with the HSS that allows the PRA to understand the risks facing a bank and to input into the HSS's supervision. The more important a branch is to UK financial stability, the greater the degree of supervisory cooperation required. If this cannot be achieved, the PRA would likely only authorise the branch as a subsidiary. In this context, there is also debate in the US on whether to require subsidiarisation of branches of foreign banks and this appears to be the direction of travel in the US.

The PRA's approach will be based, in part, on an assessment of the equivalence of the home state regime in meeting international standards and delivering appropriate outcomes consistent with the PRA's prudential remit, and the degree of cooperation with the HSS. The PRA says it wants a close relationship with other regulators including joint supervisory visits. *Importantly, Sam Woods, CEO of the PRA has stated in a letter to the CEOs dated 20 December 2017 that UK branches of EEA banks may plan on the assumption that these requirements will be met.*

What about non-EEA international banks currently authorised to operate in the UK?

The PRA does not expect its new approach to EEA banks to effect non-EEA international banks. Its policy and expectations are set out in [SS10/14](#) Supervising international banks: the Prudential Regulation Authority's approach to branch supervision." This Supervisory Statement will though be replaced following the current consultation to reflect the world post-Brexit.

What does the PRA require for authorisation?

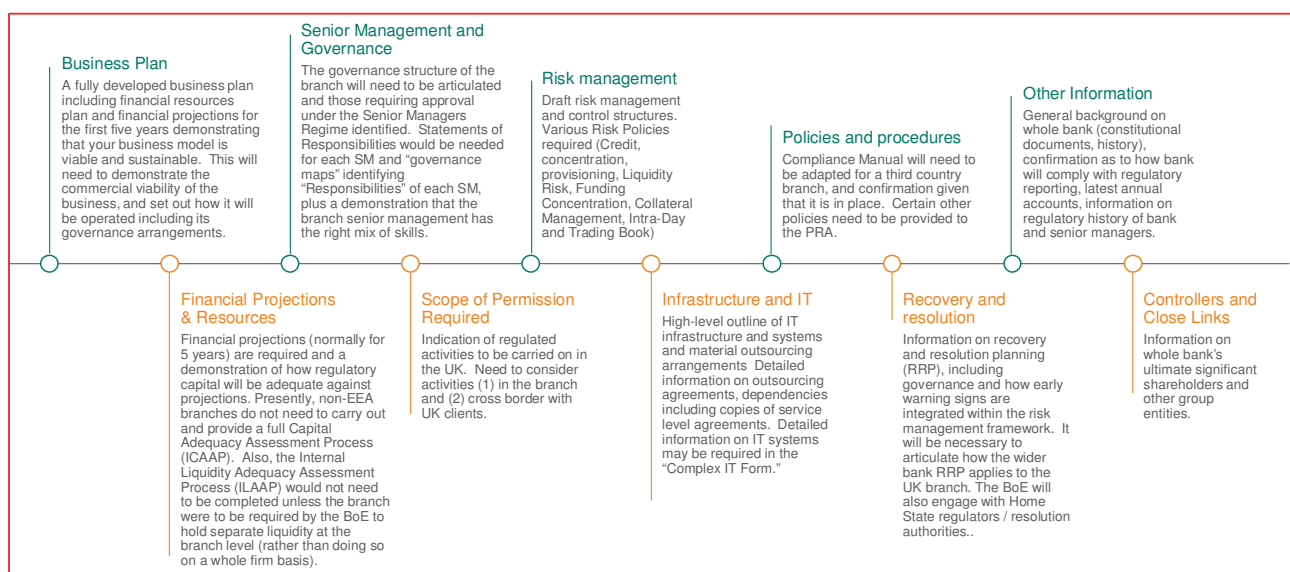
The main requirements are as follows:

- the whole bank meets the PRA's **Threshold Conditions**. These require firms to (1) have an appropriate amount and quality of capital and liquidity, (2) have appropriate resources to measure, monitor and manage risk, (3) to be fit and proper, to conduct their business prudently, and (4) to be capable of being effectively supervised by the PRA. The PRA expects branches to have appropriate risk management to support the "Critical Functions" they undertake (i.e., functions whose disruption or withdrawal could have an adverse material impact on the PRA's regulatory objectives). Critical Functions include, but are not limited to: managing the risk from booking models, operational resilience including systems for payments and, if relevant, algorithmic trading).
- the HSS's **regulatory regime is sufficiently equivalent** to meet international standards and deliver outcomes consistent with the PRA's objectives. Initial, and thereafter, periodic assessments will focus on the regulatory framework, powers, approach to supervision of individual banks and consolidated groups, information sharing, confidentiality, and the competence and independence of supervisors. Knowledge of capital and liquidity requirements will also be important.
- the **degree of supervisory cooperation** with the home state supervisor and the home resolution authority. The degree of supervisory cooperation which the PRA expects is guided by the Basel Committee's Core Principles for Effective Banking Supervision (Sept 2012). It will expect:
 - the HSS to confirm that the whole bank meets the PRA's Threshold Conditions and will want a specific agreement on the split of responsibilities for prudential supervision of the branch; and
 - to engage with the HSS in an open and transparent exchange of information and views, potentially, in a supervisory college format, if appropriate. The HSS will need to support the PRA in meeting its supervisory objectives for the branch where required.

- the PRA must have adequate assurance over **resolution arrangements** for the EEA bank and its UK operations. This will always be a consideration for the PRA, but will be a key concern where branches perform Critical Functions. In particular, the PRA will look at the credibility and feasibility of the whole bank's resolution strategy, including equivalence to the UK and whether it ensures the continuity of the branch's Critical Functions in the UK. Importantly, the PRA's starting point is that UK creditors and depositors should be treated equally with their home state equivalents. In this context, the impact of domestic depositor preference will be a factor, as will be the degree of comfort over the legal and *de facto* protection afforded to foreign depositors in the home state.

Whilst Brexit may mean the UK will be leaving the European Union, the PRA's approach to authorisation of EEA branches and their subsequent supervision will mean that EEA HSS and the UK PRA and the FCA will be working closely together in respect of supervising EEA banks' branches in the UK.

Key Elements of Authorisation Application



What are the Threshold Conditions for authorisation?

An applicant for authorisation under "Part 4A" of the UK's Financial Services and Markets Act, as amended (FSMA) must satisfy the "threshold conditions" set out therein. These are minimum standards for authorisation (and to remain authorised) and are separate and in addition to the PRA's Threshold Conditions. Briefly these FSMA threshold conditions are:

- Location of offices** - For UK incorporated companies, both the head and registered office must be located in the UK. This is not relevant to UK branches of EEA banks, but it places more focus on the second condition below.
- Effective supervision** - The applicant must be capable of being effectively supervised. This emphasises the need for firms to have a substantive presence in the UK that is accessible to UK regulators and enables those regulators to supervise the firm. Moreover, the regulatory authorities will consider whether there are any impediments to supervision of the applicant firm, including the group structure and relevant laws restricting access to information.
- Appropriate resources** - Applicants must satisfy the regulators that they have adequate resources to carry on the relevant regulated activities. Resources include financial resources as well as human resources (including management with the required skills) and infrastructure.
- Suitability** - applicants must be fit and proper to be authorised, having regard to all the circumstances.

- **Business model** - The regulator will examine the applicant's business model in respect of which a "business plan" will be required that should focus on meeting regulatory requirements. In addition to understanding the economic aspects of the business, matters such as the impact of the model on consumers and the impact on the UK financial system will also be considered.

When applying for authorisation a branch will need to know what permissions its needs (e.g. to accept deposits, to carry on investment business etc.). While an application for authorisation is made to the PRA, for conduct matters which include not only the rules governing client relationships (and duties that the firm owes to its clients) but also financial crime, it will consult the FCA which will also request information from the firm and will have to agree to authorisation.

Importantly, any considerations that the UK authorities take in respect of the above in relation to the branch may have carry-through effects to the business of the EEA bank and how it is supervised by both conduct of business and prudential supervisory authorities, including in the context of the Eurozone and its Banking Union. The European Banking Authority's **Guidelines** on supervision of significant branches describe how home and host competent authorities should cooperate to prudentially supervise and coordinate monitoring, including recovery planning, of significant branches requiring intensified supervision. While these will no longer be fully applicable post-Brexit, they will remain a good indication of the approach likely to be taken by EU supervisors.



Business Plan

Key Items Required

Ownership of firm

- Overview of firm and group structure

Business Strategy and Business Model

- Explanation of overall business strategy including strategic goals for the UK business (should be relatively straightforward, given bank's existing UK operations)
- Description of business including:
 - Geographical scope of operations and future expansion plans
 - Details of clients
 - Products and services, delivery channels for each and pricing models
 - Marketing and promotion (current and future arrangements)
 - Funding profile and diversification
 - Market position, competitive advantages, USPs – identifying any market research/analysis

Mapping of Services to Regulatory Permissions

Business Model Viability

- Financial projections (5 years), explanation of initial and long-term viability
- Breakdown of financial projections by product/service line
- Stress scenarios (if key assumptions don't turn out as planned)
- Stress scenarios to include over-success as well as under-success

Financial Resources (high level summary)

Non-Financial Resources

- Description of HR and organogram
- Overview of IT systems (core operating systems, databases, applications)
- Overview of outsourcings intra-group or to 3rd parties (business functions or IT)

Governance Arrangements, Systems and Controls

- Board or equivalent structure, include overseas links
- Committee and management structure charts and reporting lines, identify Senior Manager function holders and committee structures
- Overview of intended structure, resources and reporting lines for Compliance and Internal Audit

Implementation Plan

- Likely to be more limited given that branch is already operating

What happens if the PRA cannot gain sufficient comfort over its ability to supervise wholesale branches?

In light of the UK's withdrawal from the EU, given that many firms will want to continue to carry out cross-border activities, over time there is a risk of greater complexity and opacity in terms of structures, business models and booking arrangements. The PRA is concerned about increased risks to UK financial stability if it cannot adequately assess and mitigate them.

Where the PRA is not satisfied about its ability to supervise, it may apply specific regulatory requirements at branch level on a case-by-case basis to ensure there are sufficient financial and operational resources, and

appropriate governance. These requirements may include: (1) additional senior management functions (2) additional branch liquidity requirements (3) greater assurance on operational resilience and (4) restrictions on scope and/or volume of business. Failing that, the branch would be required to subsidiarise and be supervised on a standalone basis.

Importantly, any considerations that the UK authorities take in respect of the above in relation to the branch, its personnel, its liquidity requirements, its operational resilience and its business model may have carry-through effects to the business of the EEA bank and how it is supervised by both conduct of business and prudential supervisory authorities, including in the context of the Eurozone and its Banking Union.

What about "Systemic Wholesale Branches"?

A systemic wholesale branch is one whose failure could have significant consequences for financial stability in the UK and, as starting point, the branch has in excess of £15 billion in total gross assets. This figure takes account both of assets booked on the balance sheet of the branch and assets traded or originated in the UK, but booked remotely to another jurisdiction. This number is, however, indicative only and account would be taken of the size of the Critical Functions undertaken by the branch and its links to other PRA-regulated entities (e.g. overall complexity and inter-connectedness of the business).

The PRA would also look at its "degree of influence and visibility" over the supervision of the bank as a whole while also seeking to rely on the HSS. Where group structures are more complex (e.g. an EEA bank is accessing the UK as disintermediated branches), the greater the importance attached to this factor.

The PRA would expect regular "structured engagement" with the HSS either via a college or through bilateral meetings. Furthermore, an ability to contribute to supervisory strategy for the firm as a whole, especially where the UK branch is a material part of the group, and to have an insight into the group supervisory strategy, as necessary to achieve the PRA's objectives. There might also be joint supervisory work with the HSS, including joint visits to the branch.

For EEA banks that are subject to direct and/or indirect ECB supervision, it is important to note that the ECB has a number of powers to collect information as well as to conduct on-site supervisory visits.

Key Dates

- CP29/17 consultation closes – 27 February 2018 (subsequent publication of supervisory standards)
- Deadline to submit application for authorisation – 30 March 2018
- Brexit day – 11pm (GMT) on 29 March 2019
- Possible "implementation" period and/or temporary interim permissions – from 29 March 2019?
- End of "implementation" period – December 2020?

Other Key Considerations for the PRA and FCA



Assessing Firm's Systemic Importance

The PRA will assess the firm's importance to UK financial stability – this assessment will determine its approach to supervision. As a rule of thumb, the PRA would assess (i) whether the bank holds >£15 billion total gross assets originating in or traded in the UK (whether traded through its Branch, or cross-border), (ii) whether the bank undertakes "Critical Functions" in the UK, and (iii) the overall complexity and inter-connectedness of the bank's UK business (e.g. whether provides significant operational services or is otherwise interconnected to a systemically important UK bank).



Satisfaction of Threshold Conditions

The PRA will assess whether the bank (as a whole firm) can meet the PRA's Threshold Conditions – including as to amount and quality of capital and liquidity, appropriateness of resources to manage/monitor risks, fitness and propriety of the firm and controllers/senior management, whether the business is conducted prudently and whether the bank is capable of being effectively supervised. The FCA will also consider satisfaction of its Threshold Conditions.



Equivalence of Home State Regime

The PRA will assess Home State prudential arrangements and whether the regime is deemed consistent with international standards. Where gaps/deficiencies identified, PRA will seek to "plug" these through additional UK regulation.

Supervisory Cooperation

PRA will assess degree of supervisory cooperation with Home State regulators having regard to Basel principles on cooperation. There will need to be an agreement as to split of responsibilities for the prudential supervision of the branch, and mechanisms for ongoing engagement whether in a college or bi-laterally. Going forward the PRA would expect to be able to input appropriately into regulatory considerations around the firm's / group strategy.



Resolution and Recovery

PRA will assess equivalence of Home State resolution regime, alignment of the firm / group resolution strategy with the PRA's statutory objectives and credibility of that strategy, including a process for identifying and removing any barriers to resolution. Issues such as whether there is depositor preference for domestic depositors (or the possibility of such a regime being imposed) would be considered.



Booking Arrangements

The PRA will expect to see a clear rationale for booking arrangements, with these being documented and with appropriate risk management including suitable controls for the types of risks that the firm accepts on its balance sheet and the consistency of such arrangements with recovery and resolution.

Where the PRA identifies issues with reliance on the Home State regime, it could seek to mitigate this through – for example – additional branch governance requirements, branch-specific liquidity requirements, greater assurance on operational continuity in resolution, or restrictions on scope or volume of business. Ultimately, the PRA could also require subsidiarisation to address these types of concerns.

Is there a difference in approach between wholesale and retail banking?

The PRA expects new branches of international banks operating in the UK to focus primarily on wholesale banking activities. Its proposed approach to supervising branches that undertake significant retail banking activities is, in substance, the same as the approach set out in SS10/14 for non-EEA branches although it has provided greater detail. In general, the PRA would not wish branches to undertake retail banking activities beyond *de minimis* levels. Specifically across all branches of any one bank:

- not more than £100 million of retail/SME transactional or instant access account balances should be covered by the UK's depositor guarantee scheme, the Financial Services Compensation Scheme (FSCS); or
- more than 5,000 retail and SME customers; and
- exposure to the FSCS to covered deposits should not exceed £500 million.

The PRA will also take into account the diversity of products and the ability of customers to substitute them, together with the EEA bank's market share in niche markets, when looking at both the criticality of a function and whether this falls within its risk appetite.

Will all banks from the EU-27 be treated the same by the UK supervisors?

With respect to doing business in the UK, not all EU banks are equal. Despite the EU's Single Supervisory Mechanism for Eurozone banks, the quality of supervision and the prudential strength of banks varies across the Union. For example, the UK's supervisors consider some EEA banks to have weaker capital adequacy and others have questions over the effectiveness of their anti-money laundering and counter-terrorist financing controls. Post-Brexit, the Bank of England and the PRA will have greater scope to impose their own requirements and may be more discerning over which banks and from which jurisdictions they are prepared to see carry on business in London. In consequence, some EU-27 banks are likely to have little choice but to apply to incorporate and form separately authorised and capitalised subsidiaries that will be

supervised by the PRA on the same basis as any domestic bank. Regulatory and other supervisory conditions and/or restrictions may be imposed on such entities as a condition of authorisation.

What about supervision by the FCA?

The FCA is the conduct regulator for all banks operating in the UK. Its role will remain largely unaffected by Brexit. When any bank applies to the PRA for authorisation, the FCA must be satisfied that the FCA's own threshold conditions are satisfied and its conduct of business rules followed. To recap, an EEA bank will need to meet the threshold conditions in FSMA, those of the PRA and those of the FCA in respect of the UK branch whilst still meeting the threshold conditions, rules and the supervisory expectations of the conduct of business and prudential supervisory authorities, including the ECB in the Eurozone and its Banking Union.

Implications for regulatory outsourcing and treatment of intra-group transactions

Careful thought should be given to outsourcing arrangements whether intra-group or to third party entities. Particular attention may be expected from regulators in respect of operational functions which are judged to be critical for the performance of regulated activities. Banks remain responsible for outsourced functions and must ensure that the quality of their internal control is not materially impaired, nor the ability of the PRA (or FCA) to monitor the firm's compliance with their regulatory obligations. This is an important consideration where a firm seeks authorisation and the PRA looks to see whether it can exercise effective supervision. Where a branch relies on outsourced functions or services (even intra-group) from outside the UK, a bank will need to demonstrate that the arrangements are robust (i.e. identify, manage, monitor and report risks and have internal control mechanisms) and explain its contingency plans.

The EU and EEA supervisors, notably at the European Supervisory Authority level (EBA, ESMA and EIOPA) along with the ECB have communicated clear supervisory expectations on outsourcing including to EEA branches in the UK.

Are there other regulatory consequences of establishing a branch or incorporating a separate subsidiary in the UK?

Yes, there are. Two further important examples are the UK's Senior Managers Regime (SMR) and rules on ring-fencing.

The requirements of the SMR will become more onerous in respect of both PRA and FCA "senior management functions" under which office holders require pre-approval. The SMR is the replacement for the former "Approved Persons Regime". Although it is to be applied in a proportionate manner, it does require practical and cultural changes that should not be underestimated. At its core is heightened individual responsibility for senior staff and improved governance.

An EEA bank that only carries on cross border activity into the UK will become subject to the SMR if it establishes a branch and, as will any existing EEA branch, post-Brexit, it will likely be subject to the rules for third country branches. For PRA prudential matters, this means appointing for the first time a senior manager to perform the Head of Overseas Branch function (SMF19). Beware also that the PRA's focus is on those individuals who, irrespective of their location, are directly responsible for implementing the group's strategy in UK firms. This might catch a senior manager with direct responsibility for UK operations, for instance, based in Frankfurt who would need to be pre-approved to perform the Group Entity Senior Manager function (SMF7). For FCA conduct matters, a third country branch (compared to an EEA branch) needs to appoint a larger number of senior management functions, in addition, to say the Money Laundering Reporting function (SMF17). Where a subsidiary is incorporated this will be subject to the SMR as would any other UK bank, although there are concessions for smaller firms with assets of £250 million or less. The SMR has also introduced a "Certification Regime" for individuals performing "significant harm functions" (that is broadly "Remuneration Code" staff i.e., those subject to restrictions over variable pay - and certain technical and customer facing roles) who are based in the UK and a "Code of Conduct", again for all UK based staff. Importantly, the UK's rules on SMR do not replace or otherwise naturally include any degree of interoperability with the fitness and approval requirements as well as on-going individual accountability rules as they apply at the EU or the national level across the jurisdictions of the EU as well as the supervisory expectations and rules of the Banking Union.

The UK's ring-fencing regime is due to come into force in January 2019. This will mandate the physical separation of retail banking from "riskier" investment banking - a complex and expensive task with ongoing implications regarding the cost of capital. As the regime will only apply to UK incorporated banks with core deposits of at least £25 billion this is unlikely to apply except to the largest foreign branches which choose to incorporate in the UK. On the other hand, potentially, it may give foreign banks an advantage over larger domestic UK banks. Similar ring-fencing reforms to those in the UK have been under consideration in the EU, known as the "Liikanen proposals" but as EU banking sector regulation and the finalisation of the Eurozone's Banking Union has shifted track, the immediate threat of an EU ring-fencing regime has slowed following its withdrawal from the EU Commission's 2018 Work Programme.

CONCLUSION AND NEXT-STEPS

The deadline to submit completed applications for authorisation to the PRA is on 30 March 2018. We would be happy to discuss how we can help you prepare to ensure that your application is complete and submitted on time.

Contacts

London/Financial Services



Mark Simpson

Tel: : +44 0 20 7919 1403

mark.simpson@bakermckenzie.com

Frankfurt/Financial Services



Manuel Lorenz

Tel: : +49 69 2 99 08 606

manuel.lorenz@bakermckenzie.com



www.bakermckenzie.com

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