Matheson Brexit Impact Series: Banking Sector Supervison

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While the COVID-19 outbreak has caused delays to post-Brexit EU-UK trade negotiations, the issue of UK access to the EU single market in financial services has not gone away. The December deadline for conclusion of a trade deal always seemed ambitious and now seems surely impossible as governments focus on the pandemic crisis.

On the UK side, attention had originally been focused on the idea of gaining 'permanent equivalence' for the UK financial services industry. This was, in our view, based on some commentators having perhaps unrealistic expectations about how far the, by now quite settled, concept and application of equivalence could and would be stretched and adapted to provide a more palatable and less disruptive outcome for UK-based institutions. Equivalence is a process by which a third-country's financial services industry, in specific sectors and for specific purposes, is deemed supervised to a standard broadly equal to that of the EU. It is not a concept that applies across all sectors and for all purposes and could never have provided the UK industry with comprehensive access equal to that available under single market membership.

Further, equivalence under EU financial services legislation can be granted and withdrawn, so that it requires continuing alignment by the relevant third country with EU norms (as we see currently in the case of Switzerland, where large swathes of its financial services law are simply adopted from EU legislation). So whilst it may have been hoped that equivalence, if granted to the UK, would have been permanent and would not have required such continuing alignment, this idea was roundly rebuffed by Michel Barnier in February and, from the EU side at least, is 'off the table'.

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y days following the Brexit vote, there were fears that UK banks might seek to obtain icences by opening small subsidiaries (or, less likely, branches) with limited EU nd substance, but with large parts of the 'real' activity being outsourced back to the UK. Both the European Banking Authority ("**EBA**") and the European Securities and Markets Authority ("**ESMA**") on the one hand, and the European Central Bank ("**ECB**")'s Single Supervisory Mechanism ("**SSM**") on the other, have, through their opinions and pronouncements regarding 'shell banks' and booking models, made it clear that this will not be tolerated (see 2017 and 2018 EBA opinions on Brexit and the ECB guidance on booking models). The ECB SSM has taken a strict approach not only with regard to the activities of EU subsidiaries and branches of UK institutions, but also with regard to the activities of UK branches of EU institutions post-Brexit. It has outlined its regulatory expectation (although without making the legal basis for this explicit) that UK branches of EU / EEA credit institutions should service UK, and not EU / EEA, business (see ECB FAQs on Brexit).

In Ireland, while the Central Bank of Ireland ("**CBI**")'s approach to substance requirements when considering new or expanded business activities by credit institutions and other financial sector entities in Ireland may initially have raised eyebrows in some quarters in London, particularly when compared to some early assurances from other EU member states that they would accommodate a different approach, the CBI proved to be prescient in anticipating where the EBA, ESMA and the ECB would arrive at on this point - and many are now relieved that they do not have to further adapt their Irish plans and structures or to include greater substance than they were originally led to believe would be necessary. The vast majority of UK groups that require an EU authorisation to continue providing services after December 2020 have already obtained that authorisation or restructured their activities as required in order to do so. But a key risk to those newly established operations in the coming years will be supervisory scrutiny of their activities, and in particular their reliance on their UK group services entities or affiliates, to determine whether these arrangements meet with EU authorities' substance expectations. Whether there is equivalence or not for the UK industry in any post-Brexit trade deal, this regulatory risk to newly established operations will remain. Groups should now consider internal and external verification exercises in advance of any regulatory inspection to ensure that the CBI's expectations are being met.

For those (relatively few) UK financial entities with EU clients that have not sought EU authorisations, the legal landscape is complex and needs to be analysed on a state-by-state basis. Concepts of 'safe harbour' may exist in certain sectors and in certain member states. Many have sought to bring their EU activities within the concepts of 'reverse solicitation' with 'characteristic performance' in the UK. These are complex legal concepts and in our experience do not present easy options in practice. Detailed legal and factual analysis of existing books of business and future business models is necessary before any UK financial entity can rely with confidence on these concepts, especially having regard to CBI communications on the issue in the banking sector.

The size, scale and importance of the UK market for financial services will not be lost on the EU negotiators as they attempt to reach a position on market access, but it would appear overly optimistic to assume that the EU will be willing to re-write the rule book to accommodate UK providers. In addition, the UK's stated intention to engage in regulatory arbitrage will make the EU reluctant to encourage dependence on London going forward. During a representation to the European Union on 11 March 2020, Professor Joachim Wuermeling of the Deutsche Bundesbank claimed that the solution was clear: the EU had to become a stronger financial centre, less dependent on London. This would require an independent capital supply and increased direct

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he EU to global markets; EU policy has never aimed at this in the past due to reliance . The EU's Banking Union project (see our update here) will undoubtedly be revisited ng years not only in view of Brexit, but also in the light of the COVID-19 pandemic. The Capital Markets Union ("**CMU**") project has been identified as having even greater importance as a result of Brexit, and the economic impacts of the pandemic may also serve to increase focus on the upcoming set of CMU policy recommendations due to be published in May 2020, together with the Commission's commitment to producing an action plan on CMU this year. Our firm will continue to keep our clients updated on these important initiatives.

To conclude, the progress and the outcomes of the current EU-UK negotiations on the future relationship are still uncertain, and the questions around UK access to the EU single market in financial services remain. To echo the recent advice from the CBI Governor, Gabriel Makhlouf, the transition period should continue to be used to prepare for change - including by regulators and the financial services industry.

For further information, please contact Patrick Molloy, Donal O'Donovan, David O'Mahony, Michael Hastings, Liam Flynn, Joe Beashel, Louise Dobbyn, Lorna Smith or your usual Matheson contact.

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