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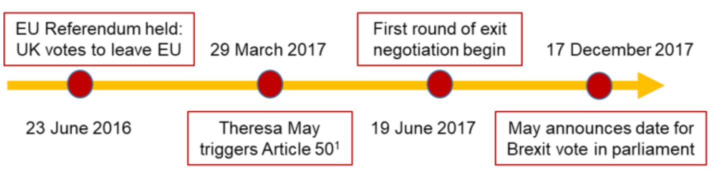
Brexit: Implications for the financial services industry

The process of Britain leaving the European Union (EU), popularly known as 'Brexit', has been in the news around the world for quite some time now. Political and financial analysts are closely watching as events unfold in this dramatic, suspense-filled and seemingly never-ending political saga.

Brexit will clearly have myriad political and social ramifications, which tabloids and newspapers have been covering in great detail. This edition of *Vinyamak* seeks to summarise the impact of Brexit on the financial services industry.

The Brexit journey so far



On 19 June 2017, the UK, led by Theresa May, and the EU started the exit negotiation according to Article 50[1]. Both the parties agreed on several key issues over the next 18 months. The official withdrawal agreement (WA), which is also referred to as 'the deal', was released on 25 November 2018. The deal was set for vote in the UK's lower House of Commons on 15 January 2019, and Theresa May lost the vote. At the time of writing this article, Theresa May is set to go back to the EU with a promise to present a revised deal to the UK Parliament by 13 February 2019.

What are the possible outcomes?

There are three possible outcomes at this juncture—hard Brexit, soft Brexit or no Brexit. However, the outcomes and the possible impact of each of these have changed over time.

Hard Brexit

The rejection of the WA and the strong stance taken by the EU that it will not re-negotiate the WA means that the UK will have to leave the single market, the customs union and free trade area without a deal on 29 March 2019—a situation neither the UK nor the EU wants. This also means that there will not be the 21 month transition period that a soft Brexit promises and the UK will become a third country immediately.

Soft Brexit

The UK has time till 29 March to convince the EU to re-negotiate the WA and come to a middle ground. However, any re-negotiation will take time and the 29 March 2019 deadline is very near. The UK can request an extension of Article 50, which will have to be approved by each of the 27 EU countries. However, the UK Parliament has voted against extending the deadline.

No Brexit

The UK Parliament can also unilaterally revoke Article 50, since it was a public advice and is not necessarily binding. However, no MP will want to be seen as going against the people's mandate. The other way is to give people the option to decide on the UK's fate through a second referendum. This time, the voters may have the option to choose between May's current deal, 'No deal Brexit' and 'No Brexit'.

What will be the impact on financial service industry?

Although the finance industry in the UK is diversified, the risk posed by Brexit is expected to vary widely across different institutions. Financial institutions (FIs) in the UK and other EU jurisdictions rely on passporting[2] rights and right of establishment to operate across borders. The big issue will be to evaluate which businesses in the UK depend on passporting,[2] and the way forward.

[1] Article 50 of the Lisbon Treaty specifies how an EU country might voluntarily leave the European Union.

[2] Passporting is exercise of the right by a firm registered in the European Economic Area (EEA) to do business in any other EEA country without needing further authorisation in each country.

Impact on banking and capital markets

For banks in the EU and the UK, the path ahead is fraught with challenges. Some of the key challenges include:

- In the case of a hard Brexit, the automatic EU passport for banking services will be lost. This will force UK banks to apply for new licences in multiple jurisdictions.
- UK banks, which are currently providing custody services, will find it difficult to provide these services if the UK leaves the EU.
- Brexit, which revokes access rights to a substantial extent, will result in an adverse material change. This will lead to rating downgrades for specific issuers, and thereby increase financing costs for the affected issuers.
- Post-Brexit, UK banks will no longer be EU institutions and will not be able to meet their EU Central counterparts' eligibility criteria. As a result, such banks may be subject to additional qualification-related requirements, or in the worst scenario, not be permitted to operate as clearing members.
- Banks hosting and processing UK data in the EU may need to repatriate this data, and vice versa. This could force companies to consider large investments in IT. In the case of a hard Brexit, the UK will be free to legislate in this area. However, the EU would need to be reassured that the British standard of protection is adequate and will meet EU standards. Failure to do so is likely to prove catastrophic for all FIs who regularly transfer data between the EU and the UK.
- Banks will need to ponder on how they will be affected by the potential volatility of the GBP over the short, medium and long term. Speaking on the subject, the Bank of England's Governor Mark Carney said, "There will be events that will move the sterling up and events that will move the sterling down; that is likely to continue for a little while".
- FIs will need to be able to fund themselves for maturity of future contracts due to the changed scenario and should be able to mitigate or service liabilities arising due to Brexit.

Impact on insurance sector

London is the hub of the global insurance market, but might lose its coveted denotation, since uncertainty will lead businesses to review their presence in the city. The key impact for the insurance industry:

- Insurers that have written contracts before Brexit will not be able to pay claims or accept premiums after the UK leaves the EU.
- Brexit will force the UK to lose its passporting rights to freely underwrite policies and insure risks across Europe.
- After Brexit, the UK will no longer have to comply with the stringent regulations of Solvency II. This will help it create its own set of rules and regulations. Moreover, insurers are likely to incur large short-term costs to ensure that their policies, documents, literature and promotions are compliant with new UK legislation.

The impact of Brexit on the UK's economy will be severe and felt across multiple channels. There is a growing concern regarding potential new talent, who will be wary about seeking jobs in the UK, and also a fear that the existing talent pool in the UK from EU countries may not find favourable markets to work in. Even hard Brexiteers feel that there is likely to be short-term consequences that the UK will have to fight through. A report suggests that Brexit is already costing the UK, GBP500 million[3] every week and this is set to rise. According to UBS economists, "The UK's gross domestic product (GDP) is already 2.1 percent lower in level terms than where it would have been without Brexit".

[3] ***The Guardian***: Brexit costing Britain £500m a week and rising https://www.theguardian.com/politics/2018/sep/29/britain-bill-brexit-hits-500-million-pounds-a-week

Conclusion

As a part of their contingency planning, different organisations have reacted to Brexit differently. While some have completely migrated their operations, others have set up additional operations in other major European cities such as Frankfurt, Paris, Amsterdam and Dublin to ensure guaranteed access to the EU market, irrespective of the outcome of Brexit. Smaller organisations have taken this as an opportunity to move to low-cost locations. Some investment companies have taken a low touch approach by moving their salespersons to the EU while keeping their trading desks in the UK. UK based companies who are setting new shops in the EU have also started novating[4] existing contracts for their priority EU clients to avoid any regulatory risk due to implementation of hard Brexit.

However, the picture is not completely grim, since there are ongoing talks between countries and institutions to provide relief to ensure there is a smooth transition. The European Securities and Markets Authority (ESMA) has already proposed a limited exemption to facilitate novation from the clearing obligations UK enterprises are likely to face in the event of a no-deal Brexit. However, how these measures will unfold, only time can tell.

Regulatory news

External Commercial Borrowings (ECB) Policy: New ECB framework

The RBI has issued revised guidelines for External Commercial Borrowings (ECBs) and Rupee-denominated bonds to enhance ease of doing business. This network is instrument-neutral and is likely to strengthen the existing AML or CFT framework. The key points elaborated on in the guidelines include the following:

- Merging of tracks
- Eligible borrowers
- Recognised lender
- Minimum average maturity period (MAMP)
- Late submission fee (LSF) for delay in reporting

The revised guidelines will come into force with immediate effect. The detailed notification can be accessed here.

Basel III Capital Regulations: Review of transitional arrangements

The RBI has amended the transitional arrangements of the Capital Conservation Buffer Framework on Basel III Capital Regulations. According to the notification, the following are the key aspects:

1. Implementation of the last tranche of 0.625% of Capital Conservation Buffer (CCB) is deferred from 31 March 2019 to 31 March 2020.
2. Consequently, the minimum capital conservation ratios of the CCB framework, effective from 31 March 2018, will also be effective from 31 March 2019 till the CCB attains 2.5% on 31 March 2020.
3. The pre-specified trigger for loss absorption through conversion or write-down of Additional Tier 1 instruments will remain 5.5% of risk-weighted assets (RWAs) and will increase to 6.125% of RWAs on 31 March 2020.

The detailed notification can be accessed here.

Micro, small and medium enterprise (MSME) sector: Restructuring of advances

The RBI has permitted one-time restructuring of existing loans to MSMEs, classified as 'standard' without a downgrade in classification of assets. This is to facilitate restructuring of stressed MSME accounts. It will be subject to conditions, which include banks' and non-banking financial companies' (NBFCs) aggregate exposure to the

[4] Novation is the act of either replacing a party in contract with another or replacing one contractual obligation with another, requiring the consent of all parties involved

borrower not exceeding INR250 million as on 1 January 2019, asset classification of a borrower's account, GST registration of a borrowing entity, date of implementation of restructuring and the additional provision of 5% over provisions already held.

After the restructuring, classification of Non-Performing Assets will be according to extant IRAC norms. Banks and NBFCs should therefore make appropriate disclosures on restructured accounts in their financial statements.

The detailed notification can be accessed here.

Tokenisation: Card transactions

The RBI has decided to permit authorised card payment networks to render card tokenisation services to any token requestor. The permit extends to all use cases or channels with token storage mechanisms. Customers availing this service will not be charged.

Authorised card payment networks will need to conduct periodic system and security audits of all entities involved in rendering card tokenisation services. The notification also delineates the conditions:

- Tokenisation—de-tokenisation service
- Certification of systems of card issuers or acquirers, token requestors and their app, etc.
- Registration by customer
- Secure storage of tokens
- Customer service and dispute resolution
- Safety and security of transactions

The detailed notification can be accessed here.

Other regulatory news

Reporting for AI and ML applications and systems offered and used by market intermediaries

The SEBI has published a framework for regulatory reporting for the Artificial Intelligence (AI)- or machine learning (ML)-based product offerings of market participants and intermediaries. This is to avoid misrepresentation due to the advertised financial benefits, resulting from these technologies being associated with these products. According to the notification, regulatory requirements include:

- Need for all registered stockbrokers or depository participants offering or using applications or systems, AI- or ML- based applications to participate in the reporting process
- AI or ML reporting form to be submitted by stockbrokers or depository participants on a quarterly basis
- Need for stock exchanges and depositories to file reports, based on AI or ML applications reported by stockbrokers or depository participants in reporting format prescribed by SEBI on a quarterly basis

The regulation will be effective from the quarter ending March 2019. The detailed notification can be accessed here.

Portfolio concentration norms for Equity Exchange Traded Funds (ETFs) and Index Funds

The following norms, published by SEBI and applicable to all ETFs or Index Funds tracking equity indices, address the risks associated with portfolio concentration in ETFs and Index Funds. According to the circular, the key points include:

- The index should have a minimum of 10 stocks.
- No single stock should have more than 35% weight in the index and more than 25% weight in the index for sectoral or thematic index, and for other than sectoral or thematic indices, respectively.
- The cumulative weightage of the top three constituents of the index cannot be more than 65%.

- Any individual constituent of the index should have had trading frequency of 80% and an average impact cost of 1% or less over the previous six months.

Issuers of all existing Equity ETFs or Index Funds are required to comply with the new norms within a period of three months from the notification date. The detailed notification can be accessed here.

Additional disclosures by stock Exchanges for commodity derivatives

SEBI has published additional disclosures to be made by all recognised Stock Exchanges trading in commodity derivatives to facilitate transparency to the public. In this regard, the stock exchanges, while disclosing the open interest (OI) and turnover at the commodity and market level, will categorise the participants into six categories—Farmers or FPOs, value chain participants (VCPs), proprietary traders, domestic financial institutional investors, foreign participants and others.

Stock exchanges will also make commodity-wise disclosures for top participants, members and market-wise position limits on a daily basis. They will also maintain complete historical data of these disclosures on their website.

Initially, the stock exchanges will make disclosures on a weekly basis by 1 October 2019. From 1 April 2020 onwards, disclosures will be made on a daily basis on T+1 day. The notification can be accessed here.

Alignment of trading lot and delivery lot size

The stock exchanges keep different 'trading lot sizes' and 'delivery lot sizes' of some of the derivatives. The practice of different lot sizes often proves to be disadvantageous to participants. SEBI has decided to have a uniform trading and delivery lot size for commodity derivatives contracts for all the exchanges. There may be exceptions on a case-to-case basis where stock exchanges will need to furnish reasons for keeping different lot sizes and have adequate mechanism to ensure that participants are not in a disadvantageous position and delivery of the commodity is in no way affected.

The circular will come into force with immediate effect and can be accessed here.

Global regulatory news

ESAs publish joint report on regulatory sandboxes and innovation hubs

The report provides a comparative analysis of established innovation facilitators in the EU. The ESAs also frame best practices for designing and operation of the facilitators.

According to the notification, the best practices are intended to uphold and maintain uniformity across a single market in designing and operation of innovation facilitators. This will not only promote transparency in regulatory and supervisory policy outcomes arising from interactions, but also facilitate cooperation between national authorities, including consumer and data protection bodies.

The European Commission's March 2018 Fin-Tech Action Plan directs ESAs to analyse innovation facilitators and identify best practices. The detailed notification can be accessed here.

Private sector working group publishes 'Guiding principles for fall back provisions in new contracts for euro-denominated cash products'

The working group on Euro risk-free rates is an industry-led group established by the ECB, the Financial Services and Markets Authority, the European Securities and Markets Authority, and the European Commission. The main objectives of this group is to identify and provide advice on alternative risk-free rates and transition paths.

The paper provides an overview of legal frameworks and market practices applicable for cash products such as mortgages, loans and bonds, and focuses on fall-back clauses.

The detailed notification can be accessed here.

European Banking Authority (EBA) publishes final guidance regarding exposures associated with high risk

The European Banking Authority (EBA) has published its final guidelines on various exposures associated with high risk under Capital Requirements Regulation (CRR). These guidelines will not only ease comparability of current practices to identify exposures associated with high risk, but also facilitate the transition to future regulatory revisions.

The guidelines comprise two sections. The first clarifies the functions of venture capital firms and equity. The second section furnishes details of types of exposures that are to be considered as high risk. This section also focuses on stakeholders with an identification scheme to identify exposures associated with high risk.

The forthcoming implementation of the revised Basel standards will only apply as of 2022. The detailed notification can be accessed here.

Endorsement of the finalised market risk capital framework and Basel Committee work programme by Governors and Heads of Supervision

The Group of Central Bank Governors and Heads of Supervision (GHOS) have endorsed a set of revisions to the market risk framework.

According to the notification, the revised market risk framework enhanced its design and calibration by introducing a standardised approach for banks with small or non-complex trading portfolios; clarifying the scope of exposures subjected to market risk capital requirements, and enhancing the risk sensitivity of the approach by revising treatment of foreign exchange risk, index instruments and options. The revised framework was calibrated by revising the standardised approach risk weights applicable to general interest rate risk, foreign exchange risk and selected credit spread risk exposures and revamping the assessment process. Additionally, the framework guidelines revise requirements for identification of risk factors that are eligible for internal modelling and the capital requirement applicable to risk factors that are deemed non-modellable.

The revised market risk framework will take effect from 1 January 2022. The detailed notification can be accessed here.

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