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Brexit: Beyond Day 1

How will banks reconfigure their capital markets business?

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CENTRE *for* **REGULATORY STRATEGY**

Executive summary

Since the UK voted to leave the EU on 23 June 2016, Brexit has dominated headlines, as well as the agendas of policy-makers, regulators and Boards. In the course of November 2018, EU and UK negotiators agreed the draft Withdrawal Agreement, together with the outline of a political declaration on the future relationship between the UK and EU. However, a number of political and legal hurdles lie ahead before the Withdrawal Agreement can enter into law in both the UK and the EU. Much of the debate in the financial services industry is focused on how firms are planning for Brexit "Day 1" on 30 March 2019 in the event there is no Withdrawal Agreement or transition.

While what happens by Day 1 is clearly very important, it is only the first chapter of the story. In this briefing, we look beyond Brexit Day 1 at how regulatory developments might affect how global banks[1] reconfigure their capital markets business in the medium-term, focusing on the provision of investment services and activities. The purpose of this briefing is not to make predictions about the future balance of capital markets activity between the UK and the EU. Instead, it sets out some of the early warning indicators of possible shifts in activity that banks and their Boards should watch. In executing Brexit plans and doing everything else necessary to prepare for European Central Bank (ECB) supervision (e.g. the Asset Quality Review (AQR)), banks need to be ready to adjust their medium-term strategies in response to shifts in the balance of market liquidity and clearing, whether driven by regulation, market forces or client preferences. The table below provides an overview of the key sections contained in this briefing.

	Section	Key points
	Rest of World (RoW)[2] and UK banks' post-Brexit structure will be inefficient relative to the status quo – page 3	• There is no doubt that the UK, specifically London, is currently the EU's dominant capital markets hub, having both a regional and global reach. • Despite the date of the UK's departure from the EU being just several months away, much uncertainty remains about the impact of Brexit on capital markets activity in the UK, both in the short- and medium-term. • The majority of RoW and UK banks are building out their EU presence, focusing on what they need to do to continue operations immediately post-Brexit and thereafter satisfy supervisory expectations over a one to three year "glidepath". • Brexit inevitably leads to inefficiencies e.g. in terms of capital, liquidity, and operating, business and booking models, while the overall revenue pool is unlikely to increase. The combination of increased costs together with static revenues at a time when the return on many banks' European business is currently lower than that available in other parts of the world is not an appealing one.
	How large a footprint do banks need in the UK vs the EU? – page 4	• As banks reconfigure their investment services and activities post-Brexit, they will consider what form their presence in the EU and the UK should take in light of their medium-term strategy. • UK banks will continue to focus predominantly on their UK business, but will also require an EU subsidiary for market access. • RoW banks will likely review their UK and EU activities as their businesses and operations become less efficient and due to the challenging economics of supporting an EMEA dual-headquartered model. • EU banks may choose to review their UK presence, influenced in some cases by home supervisory pressure, or if market liquidity or a substantial inter-dealer market forms in the EU.
	Market access to the EU – page 5	• The UK gaining the relevant equivalences when it becomes a third country should, in principle, be straightforward. However, a number of challenges mean banks are unable to rely on this in their Brexit preparations. In particular, whether there will be a transition period, future revisions to some third country regimes, and the fact that the current third country regimes are limited and cover only certain activities. • The outline of the political declaration seeks to address some concerns around timing, stating that the EU and UK should endeavour to conclude equivalence assessments before the end of June 2020. However, what follows from the political declaration is uncertain and the commitment to conclude assessments does not mean that equivalence will necessarily be granted. The declaration also does not address the scope limitations of EU third country regimes, as the UK Government's July 2018 proposals on "enhanced equivalence" sought to do.
	Market liquidity – which way will the pendulum swing? – page 6	• A number of regulatory factors could affect market liquidity in the UK relative to the EU post-Brexit. For certain products or activities, there may come a "tipping point" when sufficient liquidity has moved to the EU and prompts further trading and clearing activity to move. However, it is not a zero-sum game. Some developments could reduce liquidity in both the UK and the EU in favour of other third country markets e.g. the US.
	The future regulatory and supervisory environment in the UK relative to the EU – page 7	• The UK is likely to remain open and global in its outlook, seeking to maintain international influence. • There are signs that the EU will become more closed and intrusive towards third country firms' cross-border activity. • While regulatory divergence will not be an ambition of the UK regulators, divergence is likely to start to emerge and this will have implications for international competitiveness and for the global banking model.

RoW and UK banks' post-Brexit structure will be inefficient relative to the status quo

Much uncertainty surrounds banks' Brexit implementation plans, such as on the agreement of a transition period and finalisation of EU contingency planning (which will determine the extent of the "cliff edge" risks banks face); market access under EU third country regimes; client preferences; and the future risk profile of banks' EU and UK entities. Therefore, RoW and UK[3] banks are preparing for a no-deal scenario and building out their presence in the EU. As part of licence application processes and ongoing supervisory dialogue with National Competent Authorities (NCAs) in the EU and/or the ECB, RoW, UK and EU banks are agreeing what will move to the EU on Brexit Day 1. They are also on the point of agreeing "glidepaths" on how to build up this presence over a one to three year period to get to "Day 2".

The majority of RoW and UK banks are focusing on what they need to do to continue operations post-Brexit. They are close to the point of no return, looking to relocate staff and close out or transfer client contracts to EU entities. For a number of reasons, RoW and UK banks' post-Brexit structure will be inefficient relative to the status quo.

	Current arrangements	Post-Brexit structure	Emerging inefficiencies
Legal entity structure	UK banks make use of EU Single Market legislation to passport services and activities across the EU, either via branches or on a cross-border basis. **Number of firms passporting under EU Single Market legislation[4]** Inbound to UK: 8,008 Outbound from UK: 5,476	In order to maintain the ability to service EU clients and passport, banks are establishing or expanding subsidiaries in the EU and revising their branch networks. "We see an increase in the number of banks taking decisions on their Brexit plans and starting to relocate to the euro area." **– Daniele Nouy, ECB, March 2018**	Subsidiaries must meet prudential and business requirements on a stand-alone basis, with sufficient staff across all functions and fragmenting capital, liquidity and collateral within the group. Foreign banks setting up or building out subsidiaries in the EU "could lead to an additional €35-45 bn of capital being 'ring-fenced'". **– Deutsche Bank, July 2018[5]**
Booking models	Many banks operate "triangular" booking models, with global booking model hubs in the UK, US and Asia. "More international activity is booked in the UK than any other country" – **HM Government, July 2018[6]**	On Day 1, most market risk will continue to be managed in the UK. By Day 2, the ECB and NCAs expect much of this to move to the EU. "For SSM entities, the expectation is that EU products and transactions with EU clients are booked onshore." **– ECB, August 2018[7]**	Fragmentation of market risk management, and duplication of the governance, infrastructure and financial resources which underpin it. The future looks increasingly "square", with an extra booking hub added in the EU
Trading and investment services	More than half of all UK securities sales and trading revenue is generated from EU clients[8] and a significant number of firms and venues are based in the UK. **UK vs EU trading venues and investment firm authorisations[9]** (UK / EU / EEA) RMs 11% MTFs 52% OTFs 79% IFs 36% SIs 41%	Investment services to EU clients will be from EU entities, except where banks can make use of national exemptions or equivalence if granted. Some legacy derivative contracts are being novated. Venues are establishing in the EU. "A number of trading venues... are currently seeking authorisations in the EU27 to continue to access their financial markets" – **Steven Maijoor, European Securities and Markets Authority (ESMA), October 2018**	Fragmentation of booking hubs and restructuring plans mean that there is unlikely to be a single EU capital markets hub, although a number of trading venues are relocating to Paris and Amsterdam. "In general, there are indications of a stronger regional diversification of financial activities in Europe after Brexit." **– Helaba, September 2018[10]**
Clearing	UK central counterparties (CCPs) clear large volumes of euro-denominated derivatives, providing cost efficiencies for firms in terms of netting and portfolio compression. "The ECB estimates EU-based firms clear 90% of their interest rate swaps in the UK. Overall, EU-based firms have OTC derivative contracts with a notional value of £69 trillion at UK CCPs" **– Bank of England, October 2018[11]**	Banks are building connectivity to EU CCPs, though they will continue to try to clear on UK CCPs. Due to supervisory expectations, banks may increasingly shift trading and clearing of more EU products to the EU. "In the absence of transitional arrangements, EU27 banks could find themselves in breach of regulation for maintaining positions in UK CCPs" **– Association for Financial Markets in Europe (AFME), January 2018[12]**	Fragmentation in clearing, loss of netting benefits and duplication of financial market infrastructure membership/default fund contributions may emerge. EU CCPs do not have the same coverage as UK CCPs. Cost increases arising from changes to third country clearing rules "could lead to downstream effects such as fractured liquidity and increased systemic risk." **– Christopher Giancarlo, Commodity Futures Trading Commission, March 2018**

How large a footprint do banks need in the UK vs the EU?

As banks look to reconfigure their investment services and activities post-Brexit, they should consider what form their presence in the UK and EU should take, given the inefficiencies as set out in the previous section. A further consideration is the comparatively lower returns that are currently available in Europe versus the US and Asia, which are leading to a reduction in new investment in Europe.[13] In addition, and regardless of Brexit, the trend of outsourcing functional capability to lower-cost locations will continue.

Brexit programmes will need to take into account the next wave of regulations, before optimisation can take place. UK and RoW banks will need to consider regulation and supervisory expectations on recovery and resolution, as well as the upcoming intermediate parent undertaking (IPU) requirements under the Capital Requirements Directive V (CRD V). Under the original proposals, third country banking groups with two or more "institutions" (i.e. credit institutions or investment firms) established in the EU must have a single EU IPU if they breach specified thresholds in terms of aggregate assets, or if they are global systemically important banks (G-SIBs). Whilst the rules are still subject to negotiation, they will undoubtedly require some banks to restructure. Bringing entities under an IPU could have undesirable capital, leverage and liquidity consequences which could drive further restructuring.

EU bank	RoW bank	UK bank
• EU banks may choose to review their UK presence, influenced in some cases by home supervisory pressure, or if market liquidity or a substantial inter-dealer market forms in the EU.	• RoW banks must have a subsidiary in the EU and, in the medium-term, may favour a branch over a subsidiary in the UK. They are most likely to review their UK presence if market liquidity and a substantial inter-dealer market form in the EU. • Winding down existing UK subsidiaries would be complex. A key question would be whether the UK branch is part of the RoW or EU entity. EU and UK supervisors may have concerns with the level of market risk being booked in the UK branch of an EU entity. • The extent to which a RoW bank can limit its presence in the EU depends on market access rules, outsourcing rules, and supervisory expectations.	• UK banks will continue to focus on their UK business, but will also need an EU subsidiary for market access. • Concerns regarding current lower returns in Europe and capital constraints will disincentivise additional investment. • The extent to which a UK bank can limit its presence in the EU depends on market access rules, outsourcing rules, and supervisory expectations.

	In UK	In EU
Does the bank need a locally incorporated subsidiary for investment services and activities?	• No – although some branches may face supervisory pressure to subsidiarise. The Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) look at a number of factors to determine whether a bank is required to operate as a subsidiary. For example, the PRA assesses (i) the amount of retail deposits; (ii) systemic importance; or (iii) whether the bank meets minimum expectations to be supervisable. On (ii), the PRA looks more closely where the bank is branching into the UK via an intermediate subsidiary. Regarding (iii), the PRA looks at threshold conditions, supervisory cooperation, resolution arrangements, and the outcomes-based equivalence of the home state supervisor's regulatory regime.[14] In addition, the FCA Overseas Persons Exclusion rules permit cross-border provision of certain investment services and activities into the UK (subject to conditions).	• Yes – in order to passport under EU Single Market legislation. However, some third country access may be possible without a subsidiary. For example, via a branch in the Member State (MS) where the branch is located, or on a cross-border basis under (i) MS national rules; (ii) to professional clients as part of the Markets in Financial Instruments Regulation (MiFIR) third country regime for investment services (although no third country has yet been granted equivalence); or (iii) under Markets in Financial Instruments Directive II (MiFID II) and MiFIR reverse solicitation rules.
Is outsourcing permitted from the subsidiary?	• Yes – subject to meeting PRA and FCA rules and expectations, which derive to a certain extent from EU legislation, such as CRD IV, MiFID II, the Alternative Investment Fund Managers Directive and the Undertakings for Collective Investment in Transferable Securities Directive.	• Yes – subject to meeting NCA, ECB and European Banking Authority (EBA) supervisory expectations (e.g. the EBA consulted on outsourcing guidelines in June 2018) and EU rules (e.g. under MiFID II).
Do IPU requirements apply?	• No.	• Yes – if G-SIB or above threshold (subject to CRD V negotiations).

Market access to the EU

A key unknown for UK banks (and also RoW banks regarding revisions to EU regimes) is on equivalence assessments. Some EU legislation permits third country firms to provide certain services or activities into the EU when specific requirements are met, such as where the third country regulatory regime is deemed "equivalent" to the EU's. The outline of the political declaration on the future relationship between the UK and the EU stated that equivalence assessments should be commenced as soon as possible after Brexit, during the transition period, with both sides endeavouring to conclude the assessments before the end of June 2020. Regardless of whether the Withdrawal Agreement enters into law, the UK gaining the relevant equivalences when it becomes a third country post-Brexit ought to be straightforward (as regimes will be the same at the outset). However, there are a number of challenges that mean banks are unable to rely on this.

Revisions underway

- The prospect of Brexit has prompted the EU institutions to look again at their third country rules and already a number of revisions to equivalence regimes are in train.

Key areas of market access to the EU	Potential revisions to third country regimes
Trading venues – trading of derivatives and equities that are subject to the MiFIR trading obligations is only permitted on equivalent third country trading venues (which excludes systematic internalisers (SIs)).	Steven Maijoor, ESMA Chair, said he would "welcome an initiative by the Commission on third country trading venues" as MiFID II does not provide harmonisation for some areas of remote access e.g. the placing of trading screens. Whether, and how, this proposal might be taken forward is not clear.
Investment services and activities – passporting to EU professional clients is permitted subject to a MiFIR equivalence assessment and other conditions (such as firm registration with ESMA).	No country has yet been granted equivalence under the MiFIR third country regime for investment services and the regime is already being revised as part of a package looking at the Prudential Regime for Investment Firms (PRIF). It is not yet clear how the regime will evolve, but indications are that equivalence assessments will become more granular and the regime will become more restrictive to third countries. For example, the European Parliament voted in the ECON Committee in September 2018 to remove dealing on own account and underwriting and/or placing of financial instruments on a firm commitment basis from the scope of activities that could be passported to professional clients.
CCPs – only recognised third country CCPs under the European Market Infrastructure Regulation (EMIR) are permitted to provide clearing services to EU clearing members and trading venues, and instruments subject to the clearing obligation can only be cleared on recognised third country CCPs.	The EU is currently revising its rules on the recognition of third country CCPs under EMIR 2.2. Relocation of euro-clearing to the Eurozone could be required under certain circumstances, although any such decision would face strong opposition from other third countries as well, such as the US.

Uncertainty

- While the third country regime for CCPs and trading venues is live, the third country regime for investment services is currently untested. If granted, it would provide some flexibility at the margins, but would also overwrite the ability to use exemptions on providing investment services under certain national rules.
- Furthermore, equivalence decisions are ultimately political and can be withdrawn e.g. Switzerland was only granted equivalence for its equity trading venues for one year.

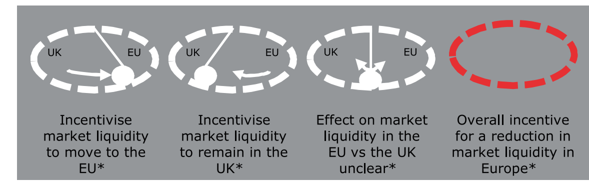
Timing

- There are significant concerns that the UK will leave the EU without relevant equivalences in place, either on Day 1 or following a transition period, if one is agreed. For example, the outline of the political declaration sets out the intention that equivalence assessments should be complete by the end of June 2020, but not that the assessments should deem the other's regime as equivalent. Lack of equivalence would lead to "cliff edge" risks, particularly regarding legacy derivative contracts and CCP recognition.
- Both the UK and the EU have undertaken contingency planning in the event of no-deal. Regarding legacy derivative contracts, ESMA has sought to alleviate some of the concerns by proposing some limited and time-bound relief in draft Regulatory Technical Standards to facilitate novation of certain legacy derivative contracts without triggering the clearing obligation in the event of a no-deal. However, this would not address all of industry's concerns.
- On CCP recognition, Valdis Dombrovskis, European Commission Vice President, has stated that temporary access to UK CCPs should be permitted in the event of a no-deal scenario. It seems likely that an interim recognition of UK CCPs under EMIR will be granted until assessments under EMIR 2.2 take place.
- Despite the outline of the political declaration, it is not certain when equivalence assessments in relation to the MiFIR third country regime for investment services will start. For example, they could be delayed until the PRIF legislation is finalised.[15]

Existing regimes provide only limited access

- The current third country regimes are limited and cover only certain activities. They therefore do not provide the basis for a bank to provide all the services its EU clients may want.
- The outline of the political declaration does not address these concerns, as the UK Government's July 2018 proposals on "enhanced equivalence" sought to do.

Market liquidity: which way will the pendulum swing?



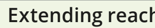
The depth and scale of EU capital markets are small relative to the size of the EU economy and the UK currently has the EU's largest and deepest capital markets. Brexit, as well as a number of other regulatory developments, such as tightening monetary policy, will further affect market liquidity in Europe. Below, we capture some of the factors where Brexit is likely to affect the balance of market liquidity as between the UK and the EU. For certain products or activities, there may come a "tipping point" where sufficient liquidity has moved to the EU that it will pull further trading and clearing activity with it. However, it is not a zero-sum game. Some developments could reduce liquidity in both the UK and EU.

	Description	Products affected	Timing considerations**
Booking models	The ECB expects certain market risk to be managed in the EU, which in turn may require more traders to be located in the EU. The extent to which they continue to access UK markets may be affected by the MiFIR trading obligation and third country access rules.	• EU products and transactions with EU clients	"Glidepaths", as agreed with the ECB, as well as other NCAs, will see banks shifting market risk management in EU products and transactions with EU clients to the EU over the course of one to three years.
No single capital markets hub	Different EU countries are competing for UK business, fragmenting liquidity across the EU. This may prevent the emergence of a single EU capital markets hub. Instead, banks will leverage their branch networks to conduct business where the client is located. Liquidity could also migrate to capital markets hubs outside the UK and the EU.	• All products traded on secondary capital markets	Trading venues, banks and investment firms are establishing or building their presence across the EU over the course of one to three years.
Clearing	Migration of some clearing activity to the EU may cause additional trading and clearing activity to move, due to netting benefits and portfolio compression. If UK CCPs are not recognised, there will be an incentive for market liquidity to move to the EU, or other third country jurisdictions with equivalence.	• EU-denominated derivatives and repos	UK CCPs are expected to be recognised under EMIR on a temporary basis. More stringent equivalence assessments under EMIR 2.2 could start from 2020-2021.
Prudential rules	Prudential rules to be implemented over the next few years will increase trading costs for certain activities, and incentivise banks towards holding certain assets. The UK may adhere to BCBS rules more closely than the EU, potentially disincentivising the growth of capital markets activity post-Brexit.	• Trading book products, particularly illiquid products • Certain classes of derivatives • Repo activities	The Net Stable Funding Ratio (NSFR) and the leverage ratio are expected to be finalised in early 2019 and apply in mid-2021. Fundamental Review of the Trading Book (FRTB) reporting rules will not apply until 2021 under the Standardised Approach and 2023 under the Internal Models Approach at the earliest.
Portfolio management delegation	If cooperation arrangements between ESMA and the FCA are not agreed, portfolio management delegation arrangements must be revised. Funds investing predominantly in EU assets will also come under increased scrutiny to justify delegation outside the EU. This may bring more portfolio management into the EU. The extent to which they continue to access UK markets may be affected by the MiFIR trading obligation and third country access rules.	• Predominantly equity and bond markets	ESMA and the FCA are both ready to start negotiating cooperation arrangements with the aim of having these in place by Brexit Day 1.
Capital Markets Union (CMU)	The Capital Markets Union (CMU) Action Plan was issued in 2015. New EU legislation on specific products is intended to deepen EU capital markets, as well as increase funding to the real economy. However, potential lack of industry take-up for certain initiatives and delays in finalising certain rules could hamper this.	• Certain pension investments • Sustainable investments • Covered bonds • SME equities	The CMU includes a number of "in-train" legislative measures, including on the Pan-European Pension Product, sustainable investments, covered bonds and small and medium-sized enterprise equities. If not finalised before elections in 2019, then progress will be delayed to 2020/2021.
Investment services and venues	If the UK does not receive relevant equivalences for investment services and trading venues, and there is a disruption to continued market access, there will be an incentive for market liquidity to move to the EU, or other third country jurisdictions with equivalence.	• MiFID II financial instruments	When, and if, the UK receives equivalence on investment services and trading venues depends on a number of factors, such as PRIF finalisation, whether there is a transition period, and future negotiations on the EU-UK relationship.

* May depend on the outcome of equivalence assessments
** Best estimates

The future regulatory and supervisory environment in the UK relative to the EU

It is important that banks bear in mind how regulation and supervision are likely to evolve in the UK and EU post-Brexit as they consider their medium-term strategy. The UK is likely to remain open and global in its outlook, seeking to maintain international influence. Current signs point to the EU becoming more closed and intrusive towards third country firms' cross-border activity. While regulatory divergence will not be an ambition of the UK regulators, divergence is likely to start to emerge with implications for international competitiveness and for the global banking model.

	EU	UK
Open vs closed?	**On the outside, looking in** Without the UK, there will be a shift in the balance of power within the Council of the EU post-Brexit. While Germany's voting share will remain decisive, France is likely to emerge as the dominant player due to its alliance with the "Club Med" block of countries. The voting share of the new "Hanseatic League", made up of eight North European countries supportive of open and globally competitive EU capital markets, is relatively small. However, attempts to close the EU to cross-border activity could backfire as banks will focus on profitability above all to determine their EU footprint. The EU "has the ambition to build up its own financial capabilities… a large set of its own financial operations should effectively take place inside the EU and not be outsourced to third countries." **Robert Ophèle, Autorité des Marchés Financiers (AMF) Chair, March 2018**	**A global approach** The UK tends to be one of the more open regimes in the EU, with its Overseas Persons Exclusion regime permitting significant cross-border access to the UK from third country firms. If the UK maintains its relatively open approach, RoW and EU firms may reduce their physical footprint in the UK. On the other hand, third country firms choosing where to locate may find the UK's open approach and well developed financial ecosystem more attractive relative to the EU, supporting UK market liquidity. "…the intention of Brexit is not to turn inwards but to broaden openness over time; the strategy is to step back in order to jump forward." **Mark Carney, Governor of the Bank of England, July 2018**
 Influence	**Extending reach** The EU is revising its supervisory powers over third country entities in the context of Brexit. While still subject to negotiations, the proposals are expected to give the ECB and ESMA increased powers over third country CCPs, and ESMA increased powers over third country investment firms, trading venues and CSDs. US pushback may temper the EU's ambition. "As we face the departure of the largest EU financial centre, we need to make certain adjustments to our rules to ensure [the safety and stability of the financial system]", **Valdis Dombrovskis, European Commission, June 2017**	**Maintaining international influence** Post-Brexit, the evolution of UK regulation will remain closely tied to international rules and the need to ensure equivalence with major hubs, such as the EU. Maintaining international influence in rule-making will be essential for the UK. However, losing influence within Europe, or any EU agreement that effectively makes the UK a "rule-taker", could reduce UK influence internationally. "…we have always played an active role in developing the global standards that we have today. And we are continuing to play that role…" **Nausicaa Delfas, FCA Executive Director of International, July 2018**
Competitiveness and divergence	**Rivalry within the EU** The ambition of increased EU capital markets' integration may be hampered by internal competition within the EU, as countries seek to attract business from the UK. This could also prevent the emergence of a single capital markets hub to rival London. "Financial centres in the EU27 should be free to compete based on the particular strengths they can offer relocating firms, like speed and efficiency, but in all cases the EU rulebook should be consistently applied", **Steven Maijoor, ESMA Chair, March 2018**	**Regulatory divergence** While revising regulation will not be the immediate priority of the UK regulators post-Brexit, regulatory regimes will likely evolve over time in both the UK and the EU as the pipeline of outstanding regulation is agreed and implemented. How they evolve will have implications for the competitiveness of the UK relative to the EU and other global financial centres. "It is imperative that we don't slip into a model of fragmented regulation, with competing philosophies and regulatory agendas", **Megan Butler, FCA Executive Director of Supervision, October 2018**

Examples of potential areas of regulatory divergence between the EU and the UK

MiFID II payment for research rules	MiFID II transparency rules	Bonus cap rules	FRTB & NSFR	FTT
MiFID II payment for research rules: the European Commission, AMF and FCA are all reviewing the impact of the rules – could they arrive at different conclusions?	**MiFID II transparency rules:** as the regime evolves, the EU and FCA will have to consider the appropriate calibration of the rules for their individual markets.	**Bonus cap rules:** these were strongly opposed by the UK in CRD IV negotiations. The UK could seek to revise remuneration rules in a way it considers would better tackle incentives for risk-taking.	**FRTB & NSFR:** capital and liquidity requirements will be implemented in the EU post-Brexit. The UK may decide to adhere to the BCBS standards more closely than the EU.	**FTT:** could there be a revised Financial Transaction Tax imposed at the EU-level? The UK opposed the original proposals.

Conclusion

While what happens by Brexit Day 1 is clearly very important, it is only the first chapter of the story of banks' capital markets business. Relative to today, the new structure for many banks' capital markets business will be inefficient. For example, any additional subsidiary will have to meet capital and liquidity requirements on a solo basis (and, once the IPU takes effect, there will also be a sub-group to be consolidated and capitalised), the operating model will be less efficient, and any fragmentation of clearing markets will lead to a reduction in netting benefits. This will increase costs, while the overall revenue pool is unlikely to increase. This also comes at a time when the return on many banks' European business is currently lower than that available in other parts of the world.

This is neither an optimal, nor a sustainable, situation. Banks will increasingly be considering where to locate their European investment services and activities. Which way will the pendulum swing: towards the UK, or the EU, or away from both?

Towards the UK
In this scenario, the UK remains very much the dominant capital markets hub within Europe and a major hub for global business. The EU would grant the UK equivalence in relation to key capital markets and clearing activities, enabling access from the UK to EU customers and counterparties. In many respects this would be a "win win" outcome. London would remain the pre-eminent capital markets centre in Europe and EU investors would continue to benefit from its deep and liquid markets.

Towards the EU
In this scenario, the EU tightens up equivalence, and makes further efforts to pull activity and liquidity onshore, including through restrictions on the delegation of portfolio management activities to third countries. There are already signs of this happening. For example, the PRIF legislation is likely to make the MiFIR third country regime more restrictive. If successful, this approach could well see significant liquidity pools develop in the EU and more clearing of derivatives move to EU CCPs. And, on the assumption that the UK remains open to global business and to banks using their UK branches to undertake capital markets activities, we could over a longer horizon see a gradual extraction of capital from the UK subsidiaries of RoW banks.

Away from both
Alternatively, the inefficiencies involved in maintaining a dual-headquartered model in Europe may cause banks to reduce their UK and EU activities, particularly for global business that can be conducted outside Europe and where the profitability of certain activities is marginal or the activity is not core to the business. Despite potential changes to EU third country regimes, designed to build third country firm presence within the EU, building capital markets through regulatory fiat is quite a tall order, as the slow progress with the EU's CMU initiative has shown. In this scenario, activity and liquidity move away from Europe generally, particularly towards hubs in the US and Asia.

In this paper, we have not sought to make predictions as to which of these outcomes will come to pass (and there are many and more subtle variations in between them). Instead, its purpose is to highlight to banks and their Boards some of the early warning signs that will indicate which way the pendulum will swing.

Banks' post-Day 1 analysis will need to be undertaken in an "agile" manner to factor in the continuing political and regulatory uncertainty that is likely to persist for some time and to respond to shifts in the balance of market liquidity and clearing, whether driven by regulation, market forces or client preferences. Banks should seek to regain as many of the lost efficiencies as possible, such as combining or enlarging EU entities. These efforts will of course need to focus on optimising business and operating models, capital allocation and collateral management.

Endnotes

1. Throughout the briefing, the term "bank" refers to a banking group, that might contain both credit institutions and investment firms.
2. By the term "RoW bank" we are referring to any bank that is headquartered outside of the European Economic Area (EEA) or UK.
3. EU banks will also be affected to the extent they currently use their UK branch as the main hub for their trading activities.
4. Letter from Andrew Bailey to Andrew Tyrie, August 2016.
5. Brexit Impact on Investment Banking in Europe, Deutsche Bank, July 2018, authored by Orcun Kaya, Jan Schildbach and Kinner Lakhani.
6. The future relationship between the UK and the EU, HM Government, July 2018.
7. Supervisory expectations on booking models, ECB, August 2018.
8. Implementing Brexit, Practical challenges for wholesale banking in adapting to the new environment, AFME, April 2017.
9. ESMA register (data as of November 2018): Regulated Markets (RMs); Multilateral Trading Facilities (MTFs); Organised Trading Facilities (OTFs); Investment Firms (IFs); and Systematic Internalisers (SIs).
10. Financial Centre of Frankfurt: Brexit Banks are packing their Bags, Helaba Research, September 2018.
11. Financial Policy Committee Statement from its policy meeting, 3 October 2018, Bank of England.
12. Key cliff edge risks in wholesale financial services, AFME, January 2018.
13. Global Financial Stability Report, International Monetary Fund, April 2017.
14. International banks: the Prudential Regulation Authority's approach to branch authorisation and supervision, Supervisory Statement, PRA, March 2018.
15. The PRIF legislation may enter into force in Q1 2019. If it does not, there will be a significant delay due to European Parliament elections and appointment changes at the European Commission in 2019 and negotiations could be re-opened.

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