ECB updated FAQs on procedure for relocation of banks to euro area in context of Brexit

On 11 January 2018, the European Central Bank (ECB) updated its FAQs on the procedure for the relocation of banks to the eurozone area in the context of Brexit. The purpose of the FAQs is to collate questions about the ECB's role in supervising eurozone banks and, in particular, they set out the ECB's expectations concerning authorisations and licensing applications, internal governance and risk management, internal booking models and on-going supervision. The original FAQs were published on 12 April 2017 and are aimed at banks considering relocating their banking activities to an EU Member State (EU27) as part of their Brexit strategy planning. These FAQs should be read in conjunction with both ESMA's General Principles to support supervisory convergence in the context of the UK withdrawing from the EU[1] and the EBA's Opinion on issues relating to the departure of the UK from the EU, which are directed at National Competent Authorities (NCAs) with the aim of ensuring a consistent approach across the EU27.

Banks currently located in Member States that are part of the eurozone are currently either: (i) directly supervised by the ECB if they are a "significant institution"; or (ii) subject to indirect oversight by the ECB and day-to-day direct supervision by their NCA if they are a "less significant institution". In either case, the ECB's role is defined under the Single Supervisory Mechanism (SSM), which forms the core of the current European banking union. Given that the UK is not currently a participant in the eurozone and, in turn, the SSM, UK-headquartered banks and UK branches of third country banks are not subject to direct supervision or oversight by the ECB. However, the FAQs will be relevant to, for example, a UK-headquartered bank that services EU clients either from the UK or via an EU branch that is currently in the midst of its Brexit planning project. While the FAQs note that the ECB is neutral regarding where in the EU27 such an institution may seek to relocate its business in anticipation of Brexit, the EBA Opinion requires clear explanations of objective factors for the choice of location to be included in the application. Significant institutions are subject to a single set of ECB standards, meaning there will be no differentiation based on location. However, this does not exclude differences in national regulatory requirements that will apply to significant and less significant institutions. With regard to less significant institutions, due to the fact that they will be overseen by the ECB but will be supervised by the NCA of the Member State selected, there is scope for further divergence in approach between NCAs.

The FAQs are divided into six sections:

1. Background on banking supervision in the eurozone: this section explains the ECB's role in the SSM (a nod to the fact that institutions predominantly affected by Brexit are unlikely to be as familiar with ECB supervision as their continental counterparts) and provides the context for how the ECB will work with NCAs and applicant institutions.

2. Authorisation and licences: the ECB actively encourages institutions to approach the ECB and/or NCAs to have planning discussions as early as possible once they have defined the fundamental elements of their Brexit plan and have initially narrowed down their options. This is permissible even before an application is complete or a new legal entity to be authorised is incorporated. It is clear that the ECB is looking to be an active participant in these decisions. In addition, the FAQs emphasise that an application will take, on average, six months and that uncertainty as to the timing of the loss of existing passporting rights or the implementation of any transitional arrangements will not serve as a valid reason should applications not be made in sufficient time to allow for the full authorisation process to take place. In addition, and in line with the ESMA and the EBA opinions (referenced above), the ECB seeks to make clear that "shopping around" for a more favourable NCA or Member State will not be successful given that all licencing applications will be processed in accordance with a common procedure. Our anecdotal experience is that the ECB's confidence is not always replicated "on the ground", where some NCAs seem to have been more competitive and flexible than others.

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[1] Note that ESMA has also published opinions to support supervisory convergence in the areas of investment firms, secondary markets and investment management, each in the context of the United Kingdom withdrawing from the European Union.

3. Internal governance and risk management: institutions seeking to relocate part of their business into the EU27 must ensure that sufficient staff and resources are located in the EU supervised entity (or branch) in order to run operations, including both risk management and front office staff. In other words, an EU supervised entity/branch must be more than a letterbox entity. The FAQs also expressly state that branches in third countries (such as the UK after Brexit) will not be able to service EU clients; rather, the purpose of these branches is to service third country (i.e. UK) clients and not EU clients. Therefore the general principle is that whilst personnel in third country branches can assist risk management and front office staff of the EU supervised entity, the ECB expects banks established in the EU27 to have sufficient capabilities in place to manage all material risks locally (as opposed to outsourcing this back to a third country entity).

In addition, the updated FAQs include more detail regarding back to back booking models and whether they will be acceptable going forwards. Specifically, the ECB and NCAs will assess whether banks implement (or plan to implement) appropriate locally-based governance and risk management frameworks, and employ staff to identify and manage risk originating locally.

Particular attention will be paid to whether the bank's local governance framework and staffing infrastructure, as well as risk management capabilities, are appropriate and commensurate with its trading activities, hedging strategies and ability to hedge risk with a diversified set of counterparties, the planned level of access to financial market infrastructure, the level and internal arrangement of intragroup transactions and exposures, and counterparty concentrations and other large exposures.

Supervisory expectations vis-à-vis booking models will be applied proportionately according to the materiality and complexity of each individual institution's activities. The result of this is that large banks, with a high level of interconnectedness and complex capital market operations, will be subject to higher supervisory expectations and assessments. The EBA opinion emphasises that the EU27 entity/branch must have enough capital in excess of the pillar 1 minimum requirement to be able to cover any material risks stemming from back to back booking models (pillar 2 SREP requirement).

In terms of outsourcing more generally, the FAQs clarify that whilst outsourcing remains generally permissible (within the parameters mentioned above), the operational independence of the EU supervised entity must not be fettered and local management must retain responsibility for, and have full access to information on, the outsourcing arrangements.

We see these statements as something of a climb down from early anti-back to back and anti-outsourcing positions. As both back to back booking and outsourcing are permissible under applicable EU law, this new position in the FAQs is more sophisticated and advanced, and legally correct. A firm can use back to back models and outsource services, but it must manage the risks of doing so, and be able to cope if the booking or outsourced service was unavailable for any reason.

4. Recovery planning: institutions are reminded that they will need to develop BRRD-compliant EU recovery plans if they are either newly authorised in the EU or have significantly expanded their activities. Equally, institutions with a material exposure to the UK are encouraged to update their recovery plans to: (a) consider how Brexit will impact (i) their ability to exercise recovery options, (ii) their strategic analysis, and (iii) recovery indicators; and (b) outline appropriate preparatory measures to mitigate any identified risks, including planned changes to the group structure.

5. Internal models: existing permissions for internal models from a third country NCA (such as the UK regulators after Brexit) will not be grandfathered across. Under the CRR, the (continued) use of internal models by: (i) a newly established bank in the EU27; and (ii) an existing bank, in the event that it intends to effect changes to the underlying portfolios (e.g. the addition of portfolios to be covered by the internal model) requires the bank to submit a new application for permission.

However, there will be a limited period in which either new EU27 banks expanding or migrating from the UK will be allowed to use internal models that have not yet been approved by the ECB, provided certain conditions are met. First, the internal models must have been approved by the UK regulators, and the scope and content of this approval at the consolidated level must match the portfolios that will exist in the new/expanded entity. Second, banks must have applied for internal model approval in the EU27. Third the ECB may, in line with the principle of proportionate supervision, frontload certain checks and take action as appropriate if deficiencies are found. This limited period will cease as soon as the applicant bank's model application has been approved or rejected.

6. On-going supervision: notably, the ECB acknowledges but does not provide any further guidance on the current proposals for CRD V, in particular the proposals to require certain third country banking groups to establish an intermediate parent undertaking in the EU. A separate ECB Opinion was published on this issue in November 2017, in which the ECB supported these proposals and suggested they be taken further by capturing third country banking groups with branches as well as subsidiaries in the EU, and by requiring such branches to be re-established as branches of an EU-based bank.

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