Brexit pinch points

Case studies for financial services

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Building a better working world

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Introduction

Financial services firms have been at the vanguard of understanding, and preparing for, the implications of Brexit. The sector is highly regulated, with a significant level of cross-border service provision under EU standards. Financial services firms will be conscious that whilst the outcome from the December talks was positive, nothing is agreed until everything is agreed and, as a result they are going to have to continue pushing on with their short-term contingency plans in case the UK leaves the EU with no new trade arrangements in place.

Faced with many challenges, firms are preparing and implementing plans that will "self-solve" many of the issues foreseen, but there are a number of "pinch points" for Financial Services that may pose problems when the UK leaves the EU.

In this short paper, we take a look at four areas of financial services that are consistently raised as the most challenging for firms to deal with:

- Cross-border long term derivative contracts
- Insurance and reinsurance
- Delegated authorities
- Data protection

This list is certainly not exhaustive but it demonstrates that many difficulties can be solved with the appropriate amount of time and care. Careful planning will be needed to ensure that these issues and others like them do not compromise the integrity and efficiency of UK financial services. In some areas, politicians, officials and regulators may need to consider broader solutions that can be put in place.

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Cross-border derivatives contracts

Background

A no-deal scenario creates significant uncertainty over all financial contracts. In the event of a hard Brexit scenario, the current regulatory framework supporting cross-border financial contracts between UK-based banks and businesses and their EU counterparts will cease to exist. The resulting legal uncertainty surrounding these contracts, which include lending agreements, insurance policies and derivative contracts could impede funding, investment decisions and effective risk management.

The focus of this case study is on derivatives contracts with a maturity beyond 29 March 2019; how they will be impacted by a cliff-edge Brexit scenario, how firms are responding and the possible solutions available to regulators and policymakers.

The notional size of derivative contracts involving UK and EU institutions is significant

Recent estimates from the Bank of England suggest that UK banks hold around £20t of gross notional derivatives with a cross-border EU element. ECB estimates EU financial institutions hold a similar £20t amount with a UK element. These estimates relate to uncleared derivatives contracts and do not include the £70t of gross notional derivatives to be cleared through clearing houses and central counterparties.[1]

Currently, we estimate that around half of these contracts have a maturity beyond March 2019 and would be "active" at the point of Brexit. The majority (more than 80%) of contracts relate to interest rate (IR) products such as IR swaps, IR Options and forward rate agreements (FRAs). The remaining contracts relate to foreign exchange, commodities, credit and equities.[2]

Given their important role in risk management, derivatives are commonly used across all major industries such as oil & gas, aviation, automotive, retail, and financial services (insurance, pension funds, asset managers, banking, etc.). Whilst most derivative contracts will involve a financial institution, some contracts will be between corporates themselves e.g., a global oil and gas firm could agree a bespoke derivative contract with a major airline to help them manage risks associated with movements in the price of oil.

In a worst case no-deal scenario firms would need to amend and/or transfer derivative contracts

Whilst the contracts themselves would not be void post-Brexit, common life-cycle events such as a client exercising an option, rolling over an open position or novation could be deemed as a regulated activity and therefore illegal without the appropriate permissions for the entity the contract is with.[3]

In the absence of a UK and EU27 wide solution, firms will be forced to "self-solve" primarily by either using a "Part VII" business transfer scheme to migrate contracts currently facing UK established entities to face EU established entities or by transferring (re-papering) existing individual transactions with clients.[4]

What are firms doing? Firms have begun to size the problem and evaluate mitigants

As part of their Brexit contingency plans, firms have begun to evaluate the potential impact of a no-deal scenario on their derivatives contracts and options to mitigate these risks:

- Identification of the population of contracts likely to be affected (e.g., with an existing maturity, or likely to be rolled over, beyond March 2019).
- Evaluation of whether the relevant conditions for a "Part VII" transfer have been met.
- Identification of the clients and associated contracts which would need to be re-papered (e.g., in response to a specific client request, bespoke nature of the contract, etc.).
- Evaluation of potential changes to certain aspects of the International Swaps and Derivatives Association (ISDA) Master Agreements including, but not limited to, inclusion of additional termination rights, arbitration clauses and jurisdiction clauses. However, ISDA suggest that such amendments are not immediately required.

[1] Financial regulation and supervision following Brexit – *oral evidence to the EU Financial Affairs Sub-Committee by Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England; Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority*, 01 November 2017

[2] EY analysis of Bank of International Settlements data as at 30 June 2017

[3] *Brexit: An Update and Implications for Derivatives, ISDA and Linklaters, 20 Nov 2017*

[4] ISDA *Brexit Briefings FAQs*, 1 October 2017 (https://www.isda.org//2017/10/01/brexit-faqs)

Solutions at an individual firm level can be expensive, time consuming and incomplete

ISDA recently highlighted that whilst use of "(the) Part VII Scheme to transfer contracts from a UK to an EU entity provides a level of certainty of outcome and convenience (versus individual contract re-papering), it does require a lengthy procedure involving two court hearings and that a number of conditions are satisfied including that the business being transferred includes an authorised deposit-taking business."[5] Furthermore, the timeline for a Part VII transfer is around a year, which could increase if a significant number are submitted simultaneously, meaning some contracts may be left exposed post-Brexit.

Individual contract re-papering can be an expensive and highly manual exercise. For example, existing repapering solutions involving legal managed services typically cost c. £500–£700 per contract with a throughput level of c. 2,000–3,000 contracts repapered per month for a 100-person team.

Given the volume of contracts to be addressed (we estimate 1.5 million ISDA contracts will be impacted when the UK leaves the EU), it is unlikely that all contracts, across all firms and all clients will have been transferred. Further, long-term contracts are often difficult to unwind and hard to renegotiate. Firms will therefore need to be prioritising their largest and most significant client contracts, with others having a more industrial solution.

Given that Brexit is not the only driver of contractual terms, banks will need to turn to technology led solutions

Regulation such as Markets in Financial Instruments Directive II (MiFID II) ,Margin Requirements for Uncleared Derivatives (MRUD) and Bank recovery and resolution directive (BRRD) are all driving firms to re-evaluate their contractual terms and consider a technology enabled approach to move to "smart digital contracts." Banks will therefore be looking to leverage new technologies such as AI to reduce the cost of repapering exercises. Whilst technology-led solutions will better enable banks to "self-solve" for a number a requirements, the sheer number of contracts and limited timeframe suggest that a policymaker and/or regulator led solution at the UK and EU level is required.

Regulatory and political considerations

The financial services industry has never had to face self-solve transfers and re-bookings of this size and scale because policymakers makers and regulators have recognised the issue and found solutions at the national level. As a recent Association for Financial Markets in Europe (AFME) and UK Finance paper highlighted: "Uncertainty of this kind relating to the treatment of an existing stock of contracts during a period of transition between two legal regimes is not without precedent. The introduction of the Euro currency and new EU regulation on OTC derivatives, central counterparties and trade repositories each required such continuity measures. Common legislative provisions were implemented on these occasions to address the treatment of existing contracts."[6]

In order to mitigate the uncertainty around existing contracts and avoid inefficient "self-solve" solutions, there are three main actions available at UK, EU-wide and EU 27 Member State level:

1. A UK to EU-wide agreement to confirm the legal right to continue contracting in this way as part of the withdrawal bill; the easiest and most desirable solution for which there is precedent
2. A UK to EU-wide transitional agreement to continue contracting in this way for a defined period; this would give firms time to transfer and/or restructure contracts and reduce the risk of conducting any unauthorised activity post-Brexit
3. The UK and individual EU Member States address the issue under their own national regimes (e.g., grandfathering contracts); whilst less desirable than a UK to EU-wide agreement, this option would still be more effective than firms attempting to "self-solve"

Conclusion

Given the recent progress in Brexit talks, the precedent of EU-wide solutions to past contractual issues and the expense and inefficiency associated with a "self-solve" solution, firms have reason to be cautiously optimistic about a UK to EU-wide solution to the cross-border derivatives cliff-edge.

However, as with any negotiation process, the end result is far from guaranteed. In the short term, firms will still benefit from sizing their potential contractual problem as part of mitigating the risks associated with a cliff-edge scenario. More broadly, firms may also wish to use Brexit as further impetus for evaluating and implementing technology-led solutions as part of a move to digitised or "SMART" contracts. Firms can use the possibility of having to "self-solve" as a means of generating efficiencies beyond the issues posed by cross-border derivatives cliff-edge.

[4] ISDA, *Brexit Briefings FAQs,* 1 October 2017 (https://www.isda.org//2017/10/01/brexit-faqs)

[5] AFME and UK Finance, *Impact of Brexit on cross-border financial services contracts*, September 2017

[6] AFME and UK Finance, *Impact of Brexit on cross-border financial services contracts,* September 2017

Delegated authorities

Background

London is the centre of the European asset management industry. It is estimated that UK-based managers manage assets worth £7.8t, being 36.3% of the Europe-wide asset management industry managing £21.5t.[7] Such assets are managed through a variety of structures, including a range of different collective investment structures. London-based managers also manage assets through segregated accounts for individual clients. The possibility of a no-deal Brexit has brought into doubt the manner in which all these assets may continue to be managed from London.

A concern in the financial services industry is the ability to continue to use delegated authorities. While we do not expect this to stop post Brexit, European Securities and Markets Authority (ESMA) and the EU Commission have concerns that significant volumes of EU assets under the control and legal system of a third country could expose the EU to unnecessary risk — particularly market integrity. If that is the case then it may become difficult for UK-based asset managers to directly service EU-based clients without establishing EU fund structures, along with EU-based management companies and distribution entities that can benefit from the EU-wide financial services passport. However, it has been generally assumed that having created such entities, organisations would continue to be able to support these entities from London using delegated authorities. This is where an EU-based fund is sold to an EU investor (or where an EU-based portfolio manager holds the direct relationship with the EU client), but where the portfolio management or other services are delegated to a separate portfolio manager based elsewhere (often, but not always, in the UK). There is a growing possibility that a no-deal Brexit would undermine this historic and widespread structure.

Regulatory and political considerations

Subject to ensuring regulatory cooperation, we would not expect a hard Brexit to immediately impact the viability of the model under current regulation. But recent ESMA Opinions suggest the following:

- ESMA will be policing the substance of EU-based management companies and other regulated entities particularly carefully.
- There may be political pressure from key Eurozone jurisdictions to ensure that European entities maintain as much substance as possible.
- Jurisdictions with well-developed fund product ranges such as Luxembourg and Ireland may be under greater scrutiny when allowing organizations to delegate portfolio management to staff in the UK.

This may be a precursor to legislative changes that could make delegation outside of the EU more difficult.

It is worth noting that early EU Commission-led drafts of the Alternative Investment Fund Managers Directive (AIFMD), for example, required delegations to be approved by (rather than merely notified to) EU regulators and that delegations of portfolio or risk management could only be granted to other authorised AIFMs: this would have prohibited the delegation model in the AIFMD space. Other areas of EU regulation have also seen similar pressure to retain regulated activity and oversight within the Single Market. With the UK no longer part of EU legislative processes, it is possible that these sorts of provisions are more likely to find their way into EU regulation. Clearly in a no-deal scenario where relationships with a key third country may become increasingly strained, this risk becomes greater.

In one particular area a hard Brexit could have an immediate impact upon delegation models: under both Undertakings for Collective Investment in Transferable Securities (UCITS) and AIFMD, portfolio management can only be delegated to an entity in a third country where there are cooperation arrangements between the relevant EU and third-country regulators. In the event of a hard Brexit, cooperation between UK and EU regulators under the current EU Treaties could fall away. Regulators should consider the extent to which such cooperation can be ensured regardless of the political settlement.

A key goal for UK negotiators wishing to protect London's asset management industry will be to ensure that the agreements reached with the EU in relation to FS include reassurance that EU-based organisations will continue to have the freedom to delegate portfolio management and other functions to UK-based organisations. Furthermore, UK supervisors could look to maintain close supervisory cooperation with ESMA to alleviate firms' concerns, whilst retaining industry confidence that UK courts will enforce EU regulatory decisions if required.

Whilst even a hard Brexit may not directly the legislative status of the delegation model, it is critical that industry participants in the UK and current third countries monitor developments to ensure that the model is not inadvertently undermined by changing regulatory practices or undue political pressure.

[7] European Fund and Asset Management Association, *Asset Management in Europe: Facts and figures*, May 2017

The ESMA Opinion

Whilst there may be a number of differing political positions being discussed, the prevailing view is that the delegated model will continue to be permitted, both immediately upon a hard Brexit but also in the foreseeable future following Brexit. However, various statements from politicians and regulators have raised concern. In particular, ESMA released a series of Opinions in July focusing on: "Sector-specific principles on relocations from the UK to the EU27."[8] These did not propose a legislative change prohibiting delegation, but (taking the Opinion on Investment Management as an example) set out in significant detail how EU regulators should pay very careful attention to various elements of delegated models. Key suggestions include:

- That EU regulators investigate proposed delegations carefully and in particular, "ensure that they carry out a case-by-case analysis taking into account the materiality of the delegated activity", and that "in no way should this assessment procedure be interpreted as a mere notification procedure."
- This therefore implies that EU regulators should focus on delegation of key activities such as portfolio management and using their ability to authorise EU-regulated entities as an opportunity to approve delegation models. This is notwithstanding the fact that the primary EU legislation does not necessarily require authorised firms to seek approval of delegations but merely notify the applicable regulators delegations.
- Provide special attention to "investment advisers." This is notable as typically in the UK, we would not ordinarily consider an investment adviser to be a delegate. Many closed-ended fund managers (such as private equity, infrastructure, real estate and debt managers) have UK-based advisory entities that advise alternative investment fund managers located elsewhere. It will be increasingly important to ensure that such AIFMs can demonstrate their own portfolio management abilities.

Although many would argue that nothing in the Opinions changes current best practices, it is clear that the intention is to increase scrutiny of delegated authority models. At the margins it may increasingly lead to European regulators rejecting (or pushing against) operating models that rely heavily on delegation. We have not yet seen evidence of delegation being prohibited, but anecdotal evidence suggests that it is leading to somewhat increased demands for substance within European entities, increasing the costs to managers, and ultimately, European investors.

Case study: the UCITS Framework

As a case study, we can examine one of the more successful pieces of EU regulation: the creation of the UCITS brand of mutual funds for distribution to retail investors. It is currently possible for an EU-based UCITS to appoint an EU-based management company to take overall responsibility for the management of the UCITS and ensure that it is managed in compliance with the applicable rules. Such an EU-based UCITS can then be marketed, across the whole of the EU, using the passport. But the management company is not required to perform all of the relevant management activities
and it often takes on a supervisory, risk and compliance role, whilst portfolio management and trading activity (often the more high-value activity) is delegated to portfolio management teams based in the UK (or indeed elsewhere in the world, such as New York or Hong Kong). This has proved a cost-effective way to deliver high-quality regulated investment products to European retail investors, whilst benefitting from investment expertise globally.

Luxembourg and Dublin have become key centres for UCITS products distributed across the EU and have developed a deep range of fund structures service providers focussed on product governance, risk and compliance. Most UK-based asset managers have established UCITS ranges in Dublin or Ireland for European distribution – but must of the portfolio management for those assets is undertaken in the UK. Those asset managers that did not have EU-based UCITS ranges are in the process of establishing them on the assumption that following Brexit UK-based UCITS will no longer be distributable to EU-based retail investors. All of this planning assumes that delegation back to the UK will continue to be possible following Brexit.

Time will tell whether this is the start of a direction of travel that may intensify through and after the Brexit process.

[8] ESMA, *ESMA Opinion: Sector-specific principles on relocations from the UK to the EU27*, July 2017

Delegated authorities

Related concerns

We would also note that at present those non-EU entities acting under delegation from an EU entity are themselves providing a cross-border service of portfolio management into the EU. Historically, most London-based entities will have benefitted from a financial services passport to do this and those already outside of the EU will have benefitted from national exemptions for overseas persons and/or could have stated that they were only performing services for grouped entities or as a consequence of a so called "reverse solicitation" (where the European entity proactively seeks out their services).

This position may become more complex however following the implementation of MiFID II, which is due to enter into force on 3 January 2018. MiFID II seeks to impose a harmonised regime in relation to the third-country entities that may eventually prohibit key fund jurisdictions such as Ireland or Luxembourg from allowing non-EU organisations to provide cross-border portfolio management services into their jurisdictions, without such organisations seeking a registration with ESMA. It remains to be seen how this and other MiFID II-related changes would work in practice and how it may impact upon the delegation model.

Conclusion

At present, there is little that can be done about the potential threat to the delegated asset management model and it remains our working assumption that, one way or another, it will continue to be permitted. Most post-Brexit strategies assume that it will continue to be available.

There has, however, been a growing recognition that EU entities established to ensure an EU presence post-Brexit will require increasing substance. This is already clearly the case for banks and more complex organisations. But it could become an increasing challenge for small asset and fund management entities seeking to access the EU. As we saw with the implementation of AIFMD, many will simply focus their capital-raising activities outside of the EU.

For those many organisations that will need to rely upon the delegated model, it will be important to monitor developments carefully and to ensure that their EU business are always adequately resourced and that delegation arrangements are carefully reviewed to ensure that they remain robust and compliant before increasingly inquisitive European regulators.

Insurance and reinsurance

Background

London is a key risk transfer market for European corporates, underwriting more than £8b of insurance risk from the EU27. The UK is the global centre of expertise and capital for wholesale insurance and reinsurance, providing a unique ecosystem of risk management and risk transfer capability for organisations across the world.

Many of the risks underwritten in the UK are both large and complex, and cannot be easily absorbed by other insurance centres. The underlying business being insured includes some of the world's largest projects, and finding appropriate insurance cover is commercially critical for the initial investment case and ongoing operation of these projects. Much of this activity is centred on Lloyd's and the London insurance market, but there is associated activity spread across the UK.

Moreover, there is a wider ecosystem of supporting expertise that is unique to the UK insurance market — including claims adjusters, lawyers, accountants and risk engineers.

More than £5b of insurance premium is estimated to be underwritten in the London insurance market via a so-called "inbound passport."[9] This includes insurance risk, both domestic and international, that a non-UK European Economic Area (EEA)-headquartered insurer is underwriting from a London office maintained under the EEA's Freedom of Establishment. Inbound firms also play an extensive role in the UK's domestic insurance market, both corporate and retail. Post-Brexit, as these firms hold an inbound branch passport, they will therefore have to apply to the Prudential Regulation Authority (PRA) for authorisation in order to continue trading in the UK. This is a non-trivial process, requiring an application to become either a third country or the authorisation of a new UK subsidiary. Similarly, UK insurers writing EEA risks either directly from the UK under the Freedom to Provide Services or from branches under the Freedom of Establishment have to find alternative modes of access to the EEA, and may face difficulties even in servicing existing policies, post-Brexit.

[9] International Underwriters Association London Company Market statistics report 2017

Case study: European manufacturer

A global manufacturing company is headquartered in the EU and has production sites in the majority of the EU27 countries. Many of these are in locations where labour costs are cheaper. Some production sites are wholly owned and others are within a third-party supply chain.

The geographical spread means that a small number of production sites in the EU are in potential earthquake catastrophe zones, and others are in areas with heightened political risk. In addition, some activity involves hazardous material and some goods produced are of a high value.

The company requires a complex insurance programme covering property and liability and including specialist risks such as pollution, trade credit indemnity and business interruption. Whilst some of this coverage can be provided from the company's home state, the scale of the risk and expertise required means that the insurance is underwritten via a multinational insurance programme in the UK.

A range of insurers participate on this programme — including those based in the Lloyd's market and those operating via inbound passports from the EU to the UK.

Key considerations

Key considerations for the company if the UK leaves the EU with no deal include:

- How to access the financial capacity to underwrite the variety of risks, some of which are very significant. Whilst UK-headquartered insurers are setting up EU27 subsidiaries to facilitate this, the existing UK insurance ecosystem may be fragmented and it could be difficult to access large scale insurance capacity.
- How it will practically separate the EU risk from its wider multinational insurance programme, and the manual activity required by its broker and insurers to "repaper" local insurance policies.
- How, or if, it would need to reduce or simplify current activities because of a lack of adequate risk transfer capabilities.
- Whether there is an impact on service and claims payment of existing insurance policies held by the company post-Brexit; the authorisation requirements, and potential "grandfathering" rights, for the insurers of these policies are still unclear.
- The impact on future innovation, if new products or capabilities cannot be insured without full access to the specialist expertise of the UK insurance market.

Case study: EU27 airline

An EU27 airline requires a wide range of insurance coverage. The majority of this is mandatory in order to operate. The airline requires separate insurance policies covering specific risks, structured into a single insurance programme that is renewed annually. These include:

- Air freight
- Hijack, kidnap and extortion
- Hull, for the aircraft itself
- Hull-and-war-related risks
- Passenger and public liability
- Terrorism

The UK insurance market is the one of the only global locations with the specialist aviation insurance knowledge and financial capacity to provide full coverage of these risks. A specialist aviation insurance broker, likely based in London, structures the placement that is provided by multiple insurers – often sharing a proportion of the risk on the same policy. A lead underwriter – likely operating within the Lloyd's market – would price each policy and manage the payment of claims. All other underwriters "follow" this lead, and are likely to include EEA-headquartered insurers operating in the UK via an inbound passport from their home state. These insurers provide financial capacity for the risks within the insurance placement, to complement the deep aviation expertise that may sit with other firms.

Key considerations

As well as those outlined above for the European manufacturer, the EU27 airline would also need to consider the following in a no-deal scenario:

- How it will access the expertise needed to assess and price the insurance risk, as Freedom of Movement may not exist in its current form. Many of these specialist skills are in the UK.
- Whether it will be possible to fully insure the airline post-Brexit, and the potential impact of this scenario on its operations.
- How to prepare for this by seeking specific insurance broking, underwriting and servicing expertise from other markets.

Regulatory and political considerations

The insurance industry is moving forward with contingency plans in case of a "no deal" scenario for Brexit. In many cases, firms are close to being able to stand up the new operating models at the core of these plans.

In order to provide minimise unnecessary complexity and cost for the industry, we expect the following would be welcomed.

- Publication of the authorisation process for existing UK branches of EEA-headquartered firms to become third country branches after Brexit.
- Guidance on the status of existing contracts post-Brexit, including whether specific authorisation will be required in the UK and EU27 to service and pay claims on these policies.
- Early agreement of a transition period that specifically includes intermediation and underwriting of insurance.
- Confirmation of regulatory equivalence under the Solvency II regulations.
- A comprehensive free trade agreement that includes financial services.

Conclusion

Complex insurance transactions are dependent on specialist experience from both brokers and underwriters. Much of the current planning for Brexit has focused upon continued access to underwriting capital for EU risks, minimising to some extent the impact of a no-deal Brexit. However, fragmentation of the expertise necessary to structure the coverages, as well as the wide range of professional services groups that support the industry, may still be a significant challenge for insurance firms.

The future of data protection

Background

The General Data Protection Regulation (GDPR) is set to impact all financial services firms regardless of their size, and boards will need to be preparing for it alongside their Brexit planning. Brexit is likely to mean that a pervasive and difficult regulation to implement will have more moving parts to tackle. As a result transformation will need to take into account future changes to both law and circumstance when the UK eventually leaves the European Union.

Key issues

- **The impacts are widespread:** the UK's financial services model is intrinsically linked with its European counterparts. The blurring of data boundaries with the advent of the Internet of Things (IoT), data processing and financial outsourcing models mean that almost all UK firms of any size are likely to be impacted in some way.
- **The GDPR is difficult to avoid:** the Regulation will be immediately effective in UK law until the UK formally leaves the Union. UK firms with establishments in the EU must remain compliant with the Regulation post-Brexit. Financial institutions outside the EU post-Brexit who offer goods or services to data subjects in the EU or those that monitor their behaviour will also be subject to the Regulation due to its extraterritorial effect.
- **The EU will continue to set the agenda:** UK firms are likely to face a data protection and cybersecurity law landscape heavily influenced by EU laws for the foreseeable future – rules that the UK may not participate in setting. Furthermore the UK's data privacy authority, the Information Commissioner's Office, will no longer be a supervisory authority in a Member State, and its voice will be muted.
- **Adequacy is not guaranteed:** the Government has stressed that it wants to maintain the unhindered flow of data between the UK and the EU after Brexit and has stated an aim to obtain an adequacy decision from the European Data Protection Board to facilitate this. This would allow continued flow of data between the EU and the UK. Whilst the UK starts from an unprecedented point of alignment with the EU, an adequacy decision is not certain or guaranteed. This could mean alternative legal bases for data transfers between the UK and EU are required.
- **Firms need to remain compliant:** as Brexit unfolds there likely be no excusing financial institutions from GDPR compliance, firms will be subject to both EU and UK data protection laws. Whilst aligned, even the slightest nuances could cause untold complexity; it is likely that further misalignment could cause issues for firms.
- **Governance structures may become more complex:** companies without a presence in the EU but within scope of the GDPR will in most circumstances need to appoint a representative in the EU. This will require another layer in governance structures and target operating models.

What are firms doing?

Companies which rely on complex cross-border data transfers, with European and global data centres, and outsourcing of data processing to subprocessors will be significantly affected by Brexit. Due diligence will be necessary to ensure processing activities involving any of the above remain compliant with legislation.

Many financial institutions are having a hard enough time in their progress to becoming compliant with the GDPR as it stands, without taking into account amendments that Brexit might require. The majority are prioritising GDPR compliance by May 2018 over additional requirements that come into play in 2019. Furthermore, firms will need to be considering the wider industry impacts, such as:

- An extra layer of regulation to contend with.
- Uncertainty in the ability to transfer data across borders.
- The potential need to appoint an EU representative.

That said, we have identified three key issues that financial services firms will need to consider when it comes to GDPR and Brexit no-deal preparedness.

1. Principal location of business – main establishment

In accordance with the GDPR, the lead supervisory authority of a data controller or processor that conducts processing activities in multiple Member States (or a single establishment with processing activities that affect data subjects in multiple Member States), is determined by the jurisdiction of their "main establishment." This may have some bearing on where financial institutions choose to host data processing activities going forward. There is some precedent for jurisdiction shopping. Some US companies for example moved servers out of the US after the invalidation of the Safe Harbour rules.

2. Governance

Where EU data protection law applies to a controller or to a processor established outside the EU, that institution is obliged to appoint a representative in the EU, as a point of contact for EU data subjects and data protection authorities (unless the processing is occasional, small-scale and does not involve processing special categories of personal data).[9] The designation of the representative is without any prejudice to legal actions that can be taken against a respective controller or processor.

There will be a duplication of responsibilities between institutions and representatives. This overlap may extend to:

- Maintaining the records of processing activities.
- Cooperating and reporting data breaches to data protection authorities.
- Notifying data breaches to relevant data subjects.

Given the extra layer of governance, institutions will need to ensure its target operating model, and roles and responsibilities are clearly demarcated and understood.

3. Cross-border data flows

Cross-border data flows can take place within the EEA under the GDPR. When the UK leaves the EEA post-Brexit, it will be deemed a third country. In the absence of the UK receiving an adequacy decision from the European Data Protection Board, controllers or processors transferring data to the EU must ensure adequate safeguards are in place. These include:

- Binding corporate rules that allow the transfer of data between the establishments of a company located inside and outside the EU.
- Standard contractual clauses that data controllers can adopt as the basis for data transfers.
- Approved codes of conduct, or approved certification mechanisms.

These mechanisms will be extremely costly and onerous for businesses to implement, not to mention the associated timing concerns. For example, Binding Corporate Rules require approval by EU regulators and the UK Government's August 2017 paper *The exchange and protection of personal data: a future partnership* indicated that on average they could cost around £250,000 to set up.

Whilst the Data Protection Bill will apply the EU's GDPR standards, preparing Britain for Brexit, there is no guarantee that the UK will receive an adequacy decision. Receiving such a decision may also take some time. The last major data deal between the EU and a third country was with New Zealand and that took four years to complete. Without effective contingency planning financial institutions will be facing a steep no-deal.

Regulatory and political considerations

As outlined above, there are a number of data protection and GDPR considerations the FS industry will be looking to "self-solve." However, in order to provide some clarity, regulators and negotiators in both the EU and the UK could consider the following:

1. UK regulatory authorities to consider issuing an adequacy decision (or equivalent) on data for inbound EU firms.
2. UK authorities to finalise the Data Protection Bill and issue explanation on what the eventual UK data protection and storage framework will be.
3. Negotiators to reach an early agreement outside the Article 50 framework on cross-border data flows and protection.
4. Regulators to provide guidance to corporates on their intended future-state cross-border data frameworks.

Conclusion

Firms are taking a number of actions in order to respond to some of the issues outlined in this paper. For regulators, acting on the above considerations could provide clarity for firms in both the EU and UK on the issues which they cannot "self-solve", potentially reducing some of the impacts of Brexit on data protection across the industry.

[9]Outlined in Article 9 of the GDPR as personal data revealing racial or ethnic origin, political opinions, religious or philosophical beliefs, or trade union membership, and the processing of genetic data, biometric data for the purpose of uniquely identifying a natural person, data concerning health or data concerning a natural person's sex life or sexual orientation.

Conclusion

As we approach Brexit, contingency plans will be finalised. As the industry races to deliver them, many of the issues raised in this document will continue to be front of mind for firms and their supervisors. The scarcest commodity will be time, as evidenced overleaf. The practical and technical burdens of repapering contracts, moving highly expert people (and their families) to new locations around the continent, and considering the impact of regulatory divergence during a period of uncertainty, are significant.

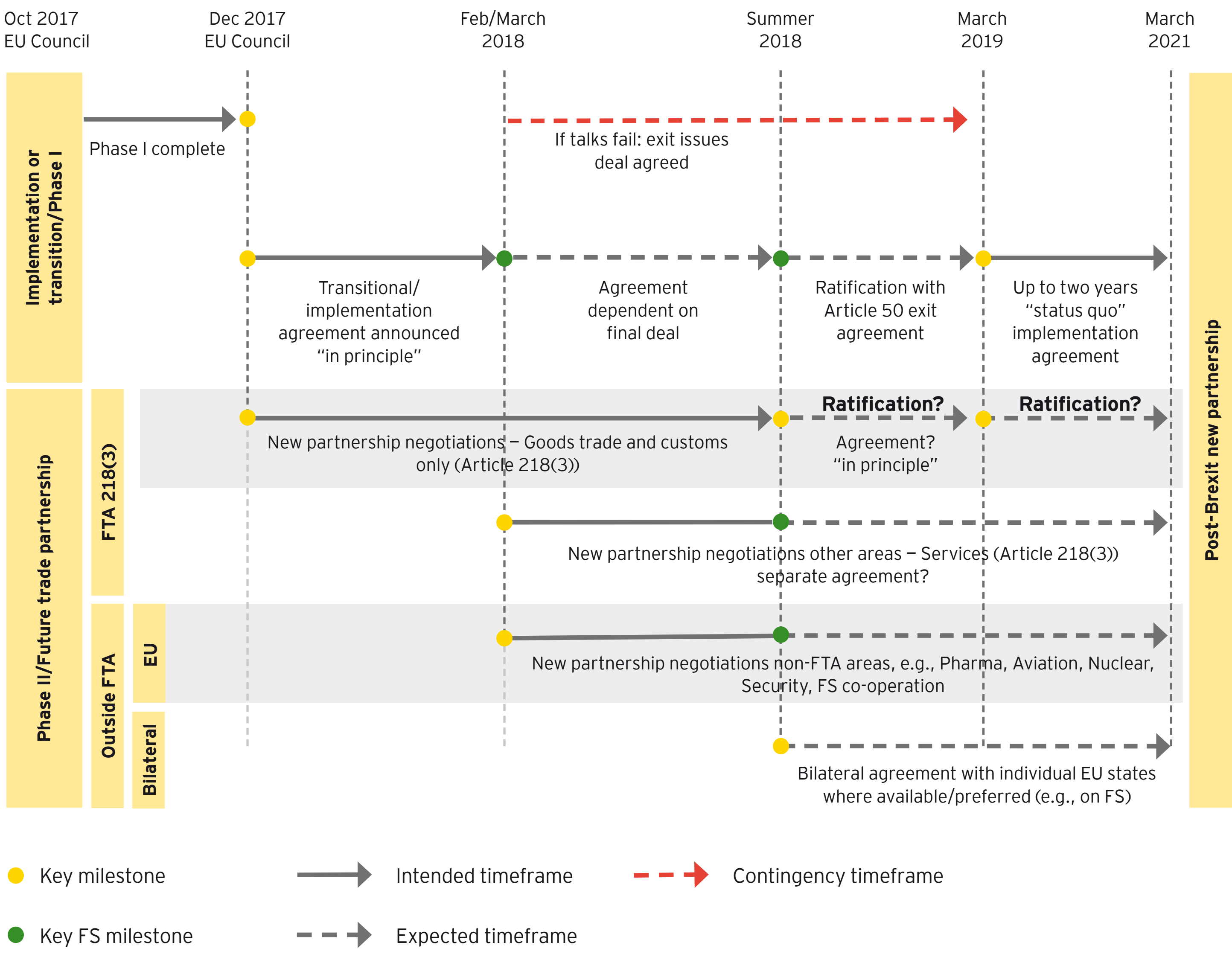
Brexit is not happening in isolation. Firms will be reacting to wider events in the real economy and will need to remain agile to respond to this.

Whatever the outcome of the negotiations and the eventual relationship model between the EU and the UK, there is a clear volition amongst regulators to maintain financial stability. With this in mind there are four specific considerations on which further clarity would be particularly helpful:

1. Grandfathering agreement for regulations and adequacy decisions or equivalence of data protection.
2. Contract continuity and continued allowance of risk transfer between the UK and EU (subject to certain conditions).
3. Clarity and legal overview of the eventual model as soon as feasibly possible.
4. Limited change to legislation whilst the future trading relationships are being negotiated.

Firms will need to continue implementing on their contingency plans at speed, and indeed where they can fix issues themselves, we believe they are doing so. But governments, regulators and supervisors also need to be aware to issues that firms cannot "self-solve" within the limited timescales foreseen. As with many areas of Brexit, flexible and pragmatic solutions, providing temporary tolerances to existing and changing business, will be required as the EU and UK part ways.

Deal or no deal: possible Brexit timeline



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