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CAPCO POV ON FINANCIAL SERVICES UPDATE FROM THE CHANCELLOR OF THE EXCHEQUER

MAINTAINING SOUND CAPITAL MARKETS

INTRODUCTION

Under the terms of the EU-UK Withdrawal Agreement, the Government will continue to implement EU legislation coming into force during the transition period that ends on December 31, 2020. The EU is currently implementing a range of regulatory changes, aspects of which will come into force both before and after the conclusion of the transition period.

On June 23 the UK Government issued a statement from the Chancellor of the Exchequer Rishi Sunak, which outlined its plans regarding some of the EU regulations which will not be fully implemented prior to the end of the transition period. Sunak's statement also set out the UK Government's position on the management of regulatory supervision post Brexit.

It is critical for the UK to remain a leading global financial centres, and the statement made reference to continued financial stability, market integrity and consumer protection. Just as importantly, it made a strong statement regarding the UK's desire to continue to work with the EU to find a solution for regulatory equivalence, while acknowledging that "the EU is naturally already making decisions on amending its current rules without regard for the UK's interests". The statement continues: "We will therefore also tailor our approach to implementation to ensure that it better suits the UK market outside the EU".

As the UK moves into the next phase of the Financial Services Future Regulatory Framework Review, a very positive statement was made around the inclusion of financial services stakeholders being involved. We would like to see the UK Government go further by engaging with trade associations (such as AFME, BBA, FIA, ISDA, ISLA and ICMA) when defining new regulations or pursuing amendments to previously implemented regulations.

It is encouraging to see a commitment that firms will be given sufficient time to prepare for the implementation of new regulations. This would dramatically mitigate the impact of some key current challenges arising from ambiguity in regulatory requirements, which has seen a lengthy back and forth between policymakers and industry participants and the imposition of often unrealistic implementation timelines upon the industry.

It will be interesting to see what the PRA and the FCA set out in terms of further details of the proposed regimes, as is expected in due course.

Sunak's statement covers several updates to regulations which in our view will not lift or reduce the implementation burden faced by firms, unless they operate purely in the UK. Below we outline key points to consider regarding SFTR and CSDR, along with the other regulations mentioned in the statement.

SFTR

The UK will not be looking to incorporate into UK law the reporting obligations within the EU's Securities Financing Transactions Regulation (SFTR) for non-financial counterparties (NFCs), which is will apply in the EU from January 2021.

"Given that systemically important non-financial counterparty (NFC) trading activity will be captured sufficiently through the other reporting obligations that are due to apply to financial counterparties, it is appropriate for the UK not to impose this further obligation on UK firms," said Sunak

Our initial analysis suggests the high-level business benefits for the industry are as follows:

- **UTI Sharing & Generation:** Some of the more complex reporting standards – including the generation and sharing of unique trade identifiers (UTIs) - has proved to be very challenging for sell side and buy side firms alike. Considering UK NFCs are now considered out of scope from a SFTR reporting perspective, the financial counterparties (FCs) facing UK NFCs will not have an obligation to share the UTI.

- **Delegated Reporting:** Firms offering delegated reporting to NFCs will not now need to facilitate reporting for NFCs in the UK. We see this as a major positive, as it removes one of the key challenges of reporting collateral and the re-use of information on behalf of UK NFCs.

- **Pairing & Matching Breaks:** Since UK NFCs are now non-reportable, this changes the procedure for reporting on a single-sided basis, and therefore reduces the volume risk associated with Pairing and Matching breaks.

- From the perspective of small EU firms that are conducting securities financing transactions, the change may make the UK more attractive as a trading location, as reporting costs should not be significant due to their relatively small trade volumes.

CSDR

CSDR's Settlement Discipline Regime (SDR) seeks to improve settlement efficiency and is expected to go live in February 2021. Its key components are:

- **Buy-Ins:** Mandatory Buy-In rules when the seller fails to deliver securities to the buyer within a defined extension period – and the most complex and controversial aspect of SDR;

- **Penalties:** Standardised penalty regime across the EU to be applied in case of settlement fails or late matching;

- **Allocations & Confirmations:** Obligations aimed at the timely exchange of allocations and confirmations to prevent any settlement delays.

Further to the Chancellor's announcement, the UK will not be implementing SDR. However, UK-based firms will still have to adhere to SDR requirements for all European transactions that are settled with European central securities depositories. **Further clarification is required from the UK Parliament and trading associations on this point.**

Potential impacts arising from the implementation of SDR include

- **Scope of SDR:** The scope of SDR is defined by place of settlement and an instrument's eligibility for trading and/or clearing by an EU venue. Clarity will be required for in-scope instruments on out of scope venues. As such, the announcement implies that:

    - Securities admitted to trading solely on an UK venue and cleared through UK CCPs, regardless of whether settled in a UK CSD or EU CSD/ICSD, will be out of scope;

    - Further confirmation is required with regards to the treatment of securities admitted to trading on both an UK and EU venue - however in such cases, the place of settlement is likely to be the scope determinant.

- **Key Scope Drivers:** When designing solutions for CSDR, firms will need to focus on the security eligibility criteria rather than simply the place of settlement to accurately establish in and out of scope settlement instructions. This should not be a new requirement, however, but remains an important consideration when analysing the implications of Sunak's statement.

- **Euroclear:** It is worth noting that Euroclear UK and Ireland (EUI) settles both UK and Irish securities. It is expected that most will look to settle these over CREST in the future to avoid the increased costs. The same rule as above applies to distinguish between the in-scope Irish securities vs. out of scope UK securities. Irish corporate securities are set to migrate from EUI by March 2021, with a temporary equivalence granted to EUI to over the period between Dec 2020 and March 2021. The additional complication and/or impact for dual listed Irish/UK stock is that there will be a preference to short the UK stock, which may result in price divergence between the two listings.

- **CREST Go Live:** Based on an email update from CREST on 25 June 2020, the planned release to introduce two new transactional fields - needed to comply with the recordkeeping reporting requirements of CSDR, namely CSDR Transaction Type and Place of Trade - will go live as planned on 27 July 2020.

CSDR (CONTINUED)

- **Other considerations:** It is worth focusing on how a possible lack of equivalence might effect cross-border securities trading and settlement; subject to the eligibility criteria, settlement in CREST may become a more attractive option without a threat of late settlement penalties or mandatory buy-ins. On the other hand, settlement chains spanning different regimes may result in broken buy-in chains, further impeding overall settlement efficiency. **Other considerations and further feedback are pending from the UK Parliament and trade associations.**

In summary

- **Does CSDR/SDR work stop completely?** It is expected that the majority of UK-based financial institutions and investment managers will be trading and settling transactions across the EU. UK trading entities, along with all third country trading entities, are therefore likely to be brought into scope of CSDR, as it applies at EU settlement level and requires trading parties to put enforceable contractual arrangements in place - effectively importing the mandatory buy-in regime.
- **What firms can completely stop CSDR/SDR work:** Only UK specific brokers or sub-custodians with a CREST-only offering can now ignore or de-scope SDR.
- **Bespoke approach:** A tailored methodology may be applicable depending on the size of the impacted financial institution, its current business model, client offering, incumbent reporting model and where it current finds itself regarding the CSDR transformation technology lifecycle.
- **Trading considerations:** This announcement is likely to affect trading patterns and behaviours at Investment Firms around strategic business modelling. For instance, short-selling securities in UK markets could now be somewhat favorable post announcement.

UPDATES TO PRUDENTIAL RULES - THE BANKING PACKAGE (CRD V, CRR II, BRRD II, IFR & IFD)

The UK's new Financial Services Bill will legislate for the implementation of a new prudential regime for investment firms and to update the regulation of credit institutions, including the implementation of Basel III standards. This new regime will be called Investment Firms Prudential Regime (IFPR).

- Government will introduce the IFPR and updated rules for credit institutions in line with the intended outcomes for the EU's Investment Firm Review / Directive (IFR & IFD) and Capital Requirements Regulation II (CRR II).

- Any EU legislation to be transposed before the end of the transition period (31st December 2020) must be transposed into UK law. This will include Bank Recovery Resolution Directive II (BRRD II) and Capital Requirements Directive V (CRD V) with go-live dates of 28th December 2020. Treasury have said they do not intend to require FCA-regulated investment firms to comply with the requirements laid out in CRD V until the new IFPR applies. A consultation on the transposition of CRD V will take place in July.

- BRRD II will largely apply but Article 1(17) that revises MREL (minimum amount of debt / equity a firm must maintain to absorb losses and provide recapitalisation in the event of resolution) requirements will not need to be followed as these come into effect after the transition period.

- UK already has in place a MREL framework in line with international standards. BRRD II states by 2024 firms must comply with the MREL end state. UK reserves the right to decide if they will implement this as it is after the transition period.

Impacts & Implications

- The Banking Package (CRD V, CRR II, BRRD II, SRMR II) final rules were released in June 2019. Therefore, firms would have already gone through their regulatory rule interpretation, article applicability, gap analysis and started to devise their runbooks. Best practice would have been to track the UK's departure from the EU because any FCA regulated firms could be impacted by the historic event. Although some parts of CRRII will apply before the end of the Transition Period, a number of provisions will apply in the EU from June 2021. As this is after the end of the Transition Period, these elements will not automatically apply in the UK. The June policy paper does state that UK is supportive of the intended outcome, so no major changes are expected.

- At the end of 2019 we saw final rules for IFR / IFD published. The go-live for the regulation was June 2021. IFR has firms classify their entities into different categories. The classification will drive how a firm calculates its capital requirements. Much like The Banking Package, firms will have already started working on IFR / IFD. The HM Treasury are now saying that any firms who are FCA regulated would follow the new UK specific IFPR instead of the EU IFR / IFD. The positive thing here is HM Treasury state they are looking to adopt the outcomes of CRR II and IFR/D, however project teams will now need to add IFPR to their scope to validate this.

UPDATES TO PRUDENTIAL RULES - THE BANKING PACKAGE (CRD V, CRR II, BRRD II, IFR & IFD) (CONTINUED)

- MREL changes are most likely to result in Capital savings for UK based banks. Smaller banks are likely to benefit more from reduced MREL requirements as G-SIBs also need to meet their FSB TLAC requirements.

- Most of the Basel 3.1 revisions are not included in CRRII and CRDV and have not yet been legislated for in the EU or the UK, given the delayed implementation deadline to 1 January 2023. However, HM Treasury remains committed to the full, timely and consistent implementation of the Basel 3.1 standards.

In summary

- **How should firms react to the Banking Package updates?** Clients should continue with their efforts on CRRII and also watch out for the July consultation which will give further direction on CRD V and to what extent the UK IFPR will differ from the EU IFR/IFD. Clients should also revisit their capital plan and ensure it is optimised as per the UK MREL framework.

- **Basel 3 implementation approach:** Clients should continue their in-flight Basel 3/3.1 projects even though they would be implemented post Brexit

EU BENCHMARK REGULATION (EUBR)

Whilst EUBR became effective on 1 January 2018, both existing EU and third country benchmark administrators were given time to apply for authorisation any time before 1 January 2020. In 2019, this application for authorisation deadline was moved to 1 January 2022. Many industry pundits and trade associations viewed this two-year extension as “kicking the can down the road”, since the regulation was stringent in some areas, especially in respect of Third Country Benchmarks. Third country administrators were scrambling to achieve authorisation for their benchmarks prior to the original deadline, as in general the rules set out in the regulation were not deemed favourable when it came to sharing their benchmarks across the EU (including the UK, in its former guise as an EU member state).

EU BENCHMARK REGULATION (EUBR) (CONTINUED)

Proposed change by UK Parliament

The Chancellor's recent statement of the 23 June may have been viewed by regulatory bodies such as the FCA as a welcome respite for Third Country Administrators in the UK. There are expected legislative amendments to the Benchmarks Regulation to ensure continued market access to Third Country benchmarks until the end of 2025, but HM Treasury has indicated that it will publish a policy statement in July 2020 to confirm the content of this change. There is an expectation that this announcement will make the UK a more lucrative market for Third Country Administrators compared to the countries within the EU, due to the fact that the authorisation timeline for benchmarks in the latter example is 1 January 2022, nearly 4 years earlier than the UK. Furthermore it has been indicated that the FCA will have enhanced regulatory enforcement powers on this respective regulation.

MARKET ABUSE REGULATION

MAR strengthens the previous UK market abuse framework by extending its scope to new markets, new platforms and new behaviours. It contains prohibitions of insider dealing, unlawful disclosure of inside information and market manipulation, and provisions to prevent and detect these:

- MAR Article 19 requires persons discharging managerial responsibilities within issuers (PDMRs), and persons closely associated with them (PCAs), to notify the FCA and the issuer of relevant personal transactions they undertake in the issuer's shares, debt instruments, derivatives or other linked financial instruments if the total amount of transactions per calendar year has reached €5,000. The issuer in turn must make that information public within three business days.

- PDMRs and PCAs are only required to notify under Article 19 when they deal in shares or debt instruments of the issuer.

- Similarly, PDMRs within Emission Allowances and Other Related Products (EMAPs) involved in the relevant auctions, and PCAs, must notify the FCA and the EAMPs or the parties involved in the relevant auctions of certain transactions in emission allowances, auction products based on them or derivatives related to them once the total amount of €5,000 has been reached in a calendar year. The notification must be made promptly and no later than 3 business days after the transaction date

- PDMRs are also prohibited from conducting certain personal transactions during a closed period.

MARKET ABUSE REGULATION (CONTINUED)

Proposed change by UK Parliament

Amendments are proposed to MAR to confirm and clarify that both issuers and those acting on their behalf must maintain their own insider lists; and to change the timeline with which issuers have to comply when disclosing certain transaction types undertaken by their senior managers/PDMRs. Although the detail is not entirely clear at this juncture and has yet to be published, there is an expectation that the timeline and procedure for disclosure will be tightened based on current legislation.

PACKAGED RETAIL & INSURANCE-BASED INVESTMENT PRODUCTS (PRIIPS)

PRIIPs has been in effect since 1 January 2018. The primary objective of the regulation is to implement proficient EU markets by helping investors to better understand and compare the main features, risks, rewards and costs of different PRIIPs. This achieved via the succinct and user-friendly Key Information Document (KID). This regulation applies to personnel or entities that (i) manufacture PRIIPs and (ii) advise on or sell PRIIPs.

However, since implementation, this regulation has proved complicated and expensive to maintain. Many firms and trade associations view it as overly ambitious as its breadth of product coverage overlaps with existing product specific regimes, simplifying and unifying the disclosure terms. For some products, PRIIPs is quite detailed and stringent - but for others it is too high level and does not provide sufficient guidance. To make matters more complicated for manufacturers and sellers, PRIIPs have conflicting consultation papers from the EC and FCA.

Proposed change by UK Parliament

In the latest announcement the Chancellor appears to take strides in the right direction, looking to solve outstanding market issues around the interpretation and application of the regulation in the UK. The announcement states: "Legislation to improve the functioning of the PRIIPs regime in the UK and address potential risks of consumer harm in response to industry and regulator feedback." At this juncture there is no further content on the exact nature of the propose changes however HMT will publish a policy statement July 2020.

Depending on what changes are made, firms that only deal with UK products could benefit immensely. However, those firms dealing with both UK and EU retail & insurance products will have to invest additional resources to perform inclusion and exclusion logic to support both the European regulatory obligations and the UK Parliament's stipulations.

EUROPEAN MARKET INFRASTRUCTURE REGULATION (EMIR) REFIT

EMIR originally came into force in February 2014, ushering in a plethora of changes for the derivatives markets. An iteration of this regulation went live in October 2017, primarily supporting the UnaVista Trade Repository EMIR Regulatory Technical Standards (RTS) system. Ever since then, the focus has been preparing for the EMIR REFIT regulation, part of the European Commission's wider regulatory fitness and performance programme (REFIT).

The primary objective of EMIR REFIT is to make targeted amendments to EMIR to make compliance more proportionate and less cumbersome, especially for Non-Financial Counterparties (NFCs). EMIR REFIT has received criticism regarding some of its application areas (such as pension schemes), with trade associations and firms split over the actual value of these changes. Another major drawback of EMIR was the complexities around trade repository data and reference data on the whole.

Proposed change by UK Parliament

- Recent announcements by Chancellor of the Exchequer appear to suggest EMIR REFIT changes to specifically address the existing issues faced by firms and consumers in the UK. Announcement states "Legislation to complete the implementation of the European Market Infrastructure Regulation (REFIT) to improve trade repository data and ensure that smaller firms are able to access clearing on fair and reasonable terms". These proposed changes, which are yet to be published in greater detail, could prove to be game changer for smaller firms with regards to accessibility of reference data and clearing information.

LONDON INTER-BANK OFFERED RATE (LIBOR)

As part of the 23 June announcement the Treasury published a ministerial statement relating to the planned LIBOR transition. The statement sets out the detail around the Government's approach to legislative steps that could help address 'tough legacy' contracts that cannot transition from LIBOR prior to the end of 2021 deadline. In particular, the Government will use the Financial Services Bill to introduce amendments to the Benchmarks Regulation 2016/1011, as amended by the Benchmarks (Amendment) (EU Exit) Regulations 2018 (the 'UK BMR'), to ensure that the FCA's powers are sufficient to manage an orderly transition from LIBOR.

SUMMARY

As the UK moves into the next phase of the Financial Services Future Regulatory Framework Review, a very positive statement was made around the inclusion of financial services stakeholders. It will be interesting to see in upcoming announcements to what the degree these stakeholders will be involved in shaping and driving ongoing regulation.

While there are some minor benefits to be realised following this initial announcement – for instance, the buy-in rules for CSDR that will reduce the cost of trading in the UK for UK settled stocks – we do not expect the majority of firms to see any reduction in either the cost or complexity involved conducting EU-related business.

While Brexit negotiations are still underway, there is a lack of clarity as to whether a deal will be reached or whether the industry should be planning for a no deal scenario - or even a further extension. However, Rishi Sunak has provided a clear statement of the UK government's position with respect to implementing EU regulation now that the UK has left the EU – in short, the UK Government is looking to broadly conform with EU regulations, but those elements that it believes do not make sense will not be implemented (to the extent that the UK government can impose such limitations).

In an environment where financial institutions are looking for greater global harmonisation of regulations, the question is whether this will see an upsurge in pressure for the EU to rethink some of these elements that the UK will not be implementing; or whether we are heading down a path of continued regulatory divergence between the UK and EU,
and all that implies.

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ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

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