WHITE & CASE

Financial Regulatory Observer

The Financial Regulatory Observer regularly sets spotlights on selected topics driving the regulatory and technological changes in the financial industry.

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EU Banking reforms imminent

The Banking Reform Package marks a milestone in the new EU regulatory landscape. **Stuart Willey**, **Willem Van de Wiele** and **Paul Alexander** provide an update on the most important changes on the road to regulatory reform.

On 27 June 2019, a series of measures referred to as the Banking Reform Package comes into force, subject to various transitional and staged timetables. The adoption of the banking reform package concludes a process that began in November 2016 and marks an important step toward the completion of the European post-crisis regulatory reforms, drawing on a number of international standards agreed by the Basel Committee, the Financial Stability Board and the G20.

The reforms look at SME financing, sustainable financing and infrastructure financing, and treatment of software in recognition of the rise of digitalization.

The banking reform package updates the framework of harmonized rules established following the financial crisis and introduces changes to the Capital Requirements Regulation (CRR), the Fourth Capital Requirements Directive (CRD), the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR).

Leverage ratio and implications for G-SIBs

The reform package introduces a binding (Pillar 1) leverage ratio of three percent of Tier 1 capital, in line with the internationally agreed level. Banks must meet this ratio in parallel with their own risk-based capital requirements.

Because a three percent leverage ratio requirement would constrain certain business models and lines of business, leverage ratio requirements may be reduced for certain types of exposures, such as public lending by public development banks and officially supported export credits.

The leverage ratio should not undermine the provision of central clearing services and, as such, the initial margin—which institutions receive from their clients on centrally cleared derivatives transactions and pass on to central counterparties (CPPs)—should be excluded from the calculation of the total exposure measure.

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> **The banking reform package marks an important step toward the completion of the European post-crisis regulatory reforms**

The reform package includes an additional leverage ratio buffer requirement for institutions identified as global systemic important institutions (G-SIBs). This requirement must be met with Tier 1 capital. The ratio is set at 50 percent of the applicable risk-weighted G-SIB buffer.

This leverage ratio was calibrated for the specific purpose of mitigating the comparably high risks that G-SIBs pose to financial stability.

The recitals to the regulation indicate that the European Banking Authority (EBA) should carry out further analysis to determine whether it would be appropriate to apply the leverage ratio buffer requirement to other systematically important institutions (O-SIIs) and, if that is the case, in what manner the calibration should be tailored to the specific features of those institutions.

Pillar 1 net stable funding ratio

The reform package also introduces the concept of a net stable funding ratio (NSFR) in order to prevent overreliance by banks on short-term funding raised in wholesale markets to finance their long-term commitments. The NSFR should be expressed as a percentage and is set at a minimum level of 100 percent, which indicates that an institution should hold sufficient stable funding to meet its funding needs over a one-year horizon under both normal and stressed conditions.

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EU banking reform package came into force

The NSFR introduced by the reform package takes into account “some European specificities to ensure that the NSFR requirement does not hinder the financing of the European real economy”. These adjustments are recommended by the EBA and relate mainly to specific treatments for pass-through models in general and covered bond issuance in particular, trade finance activities, centralized regulated savings, residential guaranteed loans, credit unions, CCPs and central securities depositories (CSDs) not undertaking any significant maturity transformation.

There are also certain transitional measures relating to the treatment of short-term transactions with financial institutions.

In line with the discretion provided by the Basel Committee standards to reduce the required stable funding factor on gross derivative liabilities, the reforms have introduced a five percent stable funding requirement for these types of liabilities.

Treatment of software assets

In the current era of rapid digital transformation, software is becoming a more important type of asset for financial institutions, and this is reflected in the reform package. Generally, banks must deduct the value of software assets from their capital. However, the reform says that “prudently valued software assets, the value of which is not materially affected by the resolution, insolvency or liquidation of an institution”, should not be subject to the deduction of intangible assets from Common Equity Tier 1 items. The technical standards are to be adopted in this respect, and these “should ensure prudential soundness, taking into account the digital evolution, difference in accounting rules at international level as well as the diversity of the EU financial sector including FinTechs".

Changes to Pillar 2 capital

Pillar 2 capital requirements are bank-specific requirements that the prudential supervisors can impose in addition to the generally applicable minimum Pillar 1 requirements to cover risks a bank faces and which are not adequately addressed by the Pillar 1 requirements to which it is subject. The reform package confirms the conditions for the application of the Pillar 2 capital add-ons and the distinction between the mandatory Pillar 2 requirements and supervisory expectations to hold additional capital, also known as Pillar 2 guidance.

Changes to the macro-prudential toolbox

The reform package introduces a number of improvements to the macro-prudential toolkit in order to enhance its flexibility and comprehensiveness. These changes relate to an increase in the flexibility for regulators in the use of the Systemic Risk Buffer and the Other Systemically Important Institutions buffer; clarification of the scope of application of the Systemic Risk Buffer; clarification of the roles and responsibilities of regulators in tackling financial stability risks linked to exposures secured by mortgages on immovable property; reduction of the burden linked to the activation and reciprocation of macro-prudential instruments; introduction of a leverage ratio for G-SIIs; and introduction of the option to reflect progress with respect to the Banking Union in the calculation of the G-SII score.

Revised market risk framework: A staggered approach

The Basel Committee published its revised market risk framework, known as the Fundamental Review of the Trading Book (FRTB), in January 2016, covering rules for banks using internal models to calculate the own funds for market risk, and revised t again in January 2019.

In light of this, the reform package opts for a staggered approach regarding the introduction of the FRTB, whereby introducing reporting requirements for the FRTB approaches should be considered as a first step toward the full implementation of the FRTB framework in the EU.

€40bn

The requirement to set up an IPU applies when the total value of assets in the EU of the third-country group is at least €40 billion

> **The reform package introduces a number of Basel Committee standards developed over the last years, including those relating to large exposures, counterparty credit risk, exposures to central counterparties, exposures to collective investment undertakings and interest rate risk in the banking book**

The European Commission is expected to submit a legislative proposal to the European Parliament and to the Council by June 30, 2020, on how the FRTB framework should be implemented in the European Union to establish the own funds requirements for market risk.

The reform package introduces a number of Basel Committee standards developed over the last years. Notably, these standards relate to large exposures, counterparty credit risk, exposures to central counterparties, exposures to collective investment undertakings and interest rate risk in the banking book.

In addition to the proportionality introduced to the regulations on the treatment of market risk and NSFR requirements, small and non-complex institutions should be required to produce less frequent and detailed disclosures than their larger peers to reduce their administrative burden. The EBA shall be required to "make recommendations on how to reduce reporting requirements at least for small and non-complex institutions, to which end EBA shall target an expected average cost reduction of at least 10 percent but ideally a 20 percent cost reduction." It is worth noting that the reform package also introduces additional proportionality in the rules relating to remuneration.

Financial holding companies and intermediate parent undertakings (IPUs)

The reforms call for third-country groups operating in the EU to set up an intermediate parent undertaking (IPU) to allow for a holistic supervision of their activities, and if necessary to facilitate resolution within the EU.

Two or more institutions in the EU, which are part of the same third-country group, must have a single intermediate EU parent undertaking that is established in the EU.

The intermediate holding company shall be an authorized credit institution or a financial holding company or mixed financial holding company or (subject to certain conditions) a regulated investment firm.

Regulators may allow institutions to have two intermediate EU parent undertakings in instances when the establishment of a single IPU would be incompatible with the requirement for a separation of activities imposed by the rules or supervisory authorities of the third country in which the ultimate parent undertaking of the third-country group has its head office. This also includes instances when having a single IPU would make resolution less efficient than in the case of two intermediate EU parent undertakings.

The requirement to set up an IPU applies when the total value of assets in the EU of the third-country group is at least €40 billion regardless of whether or not such institutions are defined as G-SIBs. Institutions have until December 30, 2023, to comply with the IPU requirement.

EU branches of third-country credit institutions and investment firms are relevant for determining whether the activities of third-country groups exceed the €40 billion threshold. Branches do not have to be organized under an IPU, but will be subject to enhanced reporting.

Loss-given defaults on massive disposals

Massive disposals refer to situations in which banks sell large parts of a

> “The reform package introduces measures to support financing for SMEs and infrastructure projects

portfolio of non-performing loans (NPLs), typically as part of a multi-year program to reduce the bank’s non-performing exposure on its balance sheet.

A number of banks use internal models to quantify their own Loss-given Default (LGD)—the amount of money a bank loses when a borrower defaults on a loan)—and the higher these observed losses are, the higher the capital requirements they will face.

There have been concerns that massive disposals would not reflect the true long-term economic value of the underlying loans, and hence the observed losses could lead to an unjustified increase in the banks’ loss estimates.

The new rules will allow banks to adjust their loss estimates for a limited period and under strict conditions. This should make it easier for banks to clean up their balance sheets from bad assets, hence improving their lending capacity.

Banking reforms and ESG-related risks

The banking reform packages incorporates ESG-related risks to reflect the rise of sustainable finance and includes new mandates for the EBA.

- The European Banking Authority must report on how individual regulators should incorporate environmental, social and governance (ESG) risks into the supervisory process. The EBA's assessment should include (i) the development of a uniform definition of ESG risks (including physical and transition risks), (ii) the development of appropriate qualitative and quantitative criteria for the assessment of the impact of ESG risks on the financial stability of financial institutions in the short, medium and long term, (iii) the arrangements, processes, mechanisms and strategies to be implemented by the financial institutions to identify, assess and manage ESG risks and (iv) the analysis and methods and tools to assess the impact of ESG risks on lending and financial intermediation activities of financial institutions. EBA shall submit this report by June 28, 2021.
- The EBA must also prepare an assessment of whether a dedicated prudential treatment of exposures related to assets and other activities associated with environmental and/or social objectives would be justified. This assessment should be made on the basis of available data and the findings of the Commission Expert Group on Sustainable Finance.
- In particular, the EBA shall assess (i) methodologies for the assessment of the effective riskiness of exposures related to such assets compared to the riskiness of other exposures, (ii) the development of appropriate criteria for the assessment of physical and transition risks and (iii) the potential effects of a dedicated prudential treatment of exposures related to such assets on financial stability and bank lending in the EU. The EBA will submit its report by June 28, 2025 and on the basis of that report the European Commission shall, if appropriate, submit to the European Parliament and to the Council a legislative proposal.
- New disclosure
  As of June 28, 2022, large institutions that have issued securities that are admitted to trading on a regulated market of any Member State are required to disclose information on ESG risks, including physical risks and transition risks (the EBA report referred to above shall define such risks). Such information shall be disclosed on an annual basis for the first year and biannually thereafter.

Lending exposure for SMEs and infrastructure projects

The capital requirements regulation (CRR) currently contains a supporting factor for small and medium-sized enterprises (SMEs), which lowers the capital requirements for credit risk on exposures to SMEs of up to €1.5 million by 23.81 percent. The banking reform extends this reduction of 23.81 percent to exposures of up to €2.5 million and introduces a new SME supporting factor reduction of 15 percent for the part of SME exposures exceeding €2.5 million.

The reforms also introduce preferential treatment for infrastructure projects, lowering the capital requirements of specialized lending exposures by 25 percent.

Such investments must comply with a number of criteria to reduce their risk profile and enhance the predictability of cash flows. The lender must carry out an assessment of whether the assets being financed contribute to a number of environmental objectives, such as climate change mitigation and adaption, sustainable use and protection of water and maritime resources, transition to a circular economy, pollution prevention and protection of healthy ecosystems. The Commission will report on the impact of the own funds requirements laid down in the new CRR on lending to infrastructure project entities by June 28, 2022, and shall submit that report to the European Parliament and to the Council, together with a legislative proposal, if appropriate.

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As of 28 June 2022, large institutions with securities admitted to trading on a regulated market of any Member State are required to disclose information on ESG risks

Anti-money laundering and combatting terrorist financing

Some recent incidents highlighted the importance of continued efforts to prevent money laundering and to combat terrorist financing. As part of the reform package, the revised CRD stresses the role of prudential supervisors in identifying weaknesses within financial institutions and imposing appropriate sanctions.

In particular, the revised CRD states that “competent authorities should consistently factor money laundering and terrorist financing concerns into their relevant supervisory activities, including supervisory evaluation and review processes, assessments of the adequacy of institutions’ governance arrangements, processes and mechanisms and assessments of the suitability of members of the management body, inform accordingly on any findings the relevant authorities and bodies responsible for ensuring compliance with anti-money laundering rules and take, as appropriate, supervisory measures”.

The new regulations stress the importance of the role played by supervisors in AML and the importance of the exchange of information between the regulators and financial intelligence units. The European Commission has also launched a proposal to reinforce the competencies of the European Banking Authority with respect to AML.

Amendments to the Resolution Framework – MREL

The concept of MREL for banks—the minimum requirement for the own funds and eligible liabilities that each bank is required to meet and maintain in order to ensure that the capital structure of a bank is such as to render the bail-in tool effective upon resolution—had already been introduced by the BRRD. The reform package adds significant detail on the criteria for what constitutes “eligible liabilities”, the methodology for determining the MREL for a particular bank and the way in which information is reported and disclosed.

Introduction of the TLAC requirement to EU G-SIBs

CRR II implements the Financial Stability Board’s total loss absorbing (TLAC) requirement for Global Systemically Important Institutions (G-SII), which is the EU equivalent of a G-SIB. The transitional requirement—the higher of 16 percent of RWA or six percent of the leverage ratio exposure measure—shall apply immediately. The higher requirement—18 and 6.75 percent, respectively—comes into effect as of January 1, 2022.

Additional changes to the MREL subordination policy

Beyond the existing GSII bracket, the reforms have created a new category of so-called “top-tier banks” with a balance sheet greater than €100 billion, facing stricter subordination requirements. In addition, national resolution authorities may select other banks (non-GSII, non-top-tier banks) and subject them to top-tier bank treatment. The reform package contains MREL minimum Pillar 1 subordination policy for each of these categories. Under certain conditions, the resolution authority may now also impose an additional Pillar 2 subordination requirement.

€100bn

A new category of “top-tier” banks with a balance sheet greater than €100 billion

Certain changes to the MREL eligibility criteria

Certain debt instruments with an embedded derivative component, such as certain structured notes, should be eligible—subject to certain conditions—to meet the MREL to the extent that they have a fixed or increasing principal amount repayable at maturity that is known in advance while only an additional return is linked to that derivative component and depends on the performance of a reference asset. The reform package also introduces certain other amendments to the MREL eligibility criteria.

Penalties related to MREL breaches

The breach of MREL requirements by banks will result in restrictions on the distribution of resources to shareholders or employees. The reform package includes the following compromise: For the first nine months following a breach, restrictions might be applied only if certain conditions that are related to the nature of the breach are met. After nine months, the presumption is that the restrictions must be applied, but can be waived if strict conditions—related to market conditions and the broader financial stability—are met.

Sale of subordinated eligible liabilities to retail clients

The sale of MREL-eligible instruments to retail clients shall be subject to a number of conditions and limitations, on the understanding that Member States shall not be required to apply these restrictions to liabilities issued before December 28, 2020.

All of the following conditions must be fulfilled: the seller must perform a suitability test in accordance with MiFID II; the seller must be satisfied, on the basis of that test, that such eligible liabilities are suitable for that retail client; and the seller documents the suitability in accordance with MiFID II.

In addition, when the financial portfolio of the retail client does not exceed €500,000 at the time of the purchase, the seller shall ensure that the retail client does not invest an aggregate amount exceeding ten percent, and the initial investment amount invested in one or more of the instruments is at least €10,000.

However, Member States have the right to set a minimum denomination amount of at least €50,000, taking into account local market conditions and practices along with existing consumer protection measures within the jurisdiction of that Member State.

MREL reporting and disclosure requirements

In order to ensure transparency, institutions should report to regulators and make regular public disclosures of their MREL, the levels of eligible and bail-in-able liabilities and the composition of those liabilities, including their maturity profile and ranking in normal insolvency proceedings.

Home-host balance

The reform package contains clarifications regarding the powers of the home supervisor of a banking group and the supervisors of Member States where a subsidiary of the banking group is located (home-host balance). These rules include a “safe harbor” clause, which enables host authorities to request a higher internal MREL, part of which would not be subject to mediation between the home and host authorities.

Other amendments to the Bank Resolution Framework

Introduction of the concepts “resolution entity” and “resolution group”

The reform package introduces the concepts “resolution entity” and

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> **The reform package adds significant detail on “eligible liabilities,” the methodology for determining the MREL for a particular bank and the way in which information is reported and disclosed**

“resolution group”. In line with the TLAC standard, the Single Point of Entry (SPE) resolution strategy and the Multiple Point of Entry (MPE) resolution strategy are maintained. Under the SPE resolution strategy, only one group entity, usually the parent undertaking, is resolved, whereas other group entities, usually operating subsidiaries, are not put under resolution, but transfer their losses and recapitalization needs to the entity to be resolved. Under the MPE resolution strategy, more than one group entity might be resolved. Hence, a clear identification of entities to be resolved (“resolution entities”), that is, the entities to which resolution actions could be applied, together with subsidiaries that belong to them (“resolution groups”), is important in order to apply the desired resolution strategy effectively. In addition, that identification is relevant for determining the level of application of the rules on loss-absorbing and recapitalization capacity that institutions and entities should apply. Resolution authorities will be required to identify resolution entities and resolution groups as part of the resolution planning.

Resolution stay

The Bank Recovery and Resolution Directive (BRRD II) allows resolution authorities to suspend certain contractual obligations of institutions and entities for a maximum of two days.

The reforms allow the relevant resolution authority to exercise these powers in a pre-resolution phase, which can be from the moment it determines an institution is failing or likely to fail; if a private sector measure, which it believes will prevent the failure, is not immediately available, and if it believes applying the suspension will prevent a deterioration of the institution’s financial condition.

This power cannot include payment or delivery obligations to central banks, central counterparties authorized in the EU and third-country CCPs recognized by ESMA and payment and settlement systems.

Contractual recognition of the resolution stay requirement

In the absence of a statutory cross-border recognition framework, Member States should require that institutions include a contractual term in relevant financial contracts recognizing that the contract may be subject to the exercise of powers by resolution authorities to suspend certain payment and delivery obligations, to restrict the enforcement of security interests or to temporarily suspend termination rights (the resolution stay requirement). A similar requirement already applied with respect to the bail-in tools.

Contractual recognition of the effects of bail-in tools

Under the existing BRRD, banks must already include a clause in contracts governed by third-country laws recognizing the effects of the bail-in tools.

The reform package recognizes that there might be instances, however, where it is impracticable for institutions to include those contractual terms in agreements or instruments creating certain liabilities, in particular liabilities that are not excluded from the bail-in tool under the BRRD, covered deposits or own funds instruments.

Under certain circumstances, it could be considered impracticable to include contractual recognition clauses in liability contracts. These circumstances include cases where it is illegal—under the law of the third country—for an institution or entity to include such clauses in agreements or instruments creating liabilities that are governed by the laws of that third country. Other cases may include instances when an institution or entity has no power at the individual level to amend the contractual terms as they are imposed by international protocols or are based on internationally agreed standard terms, or when the liability that would be subject to the contractual recognition requirement is contingent on a breach of contract or arises from guarantees, counter-guarantees or other instruments used in the context of trade finance operations. However, a refusal by the counterparty to agree to be bound by a contractual bail-in recognition clause should not be considered as a cause of impracticability.

EBA will further determine the conditions under which a waiver can be granted from the requirement to include the contractual recognition clauses. Liabilities, for which the relevant contractual clauses are not included, should not be eligible for MREL.

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EC is due to submit a legislative proposal on the implementation of the FRTB framework to the European Parliament

Stuart Willey
Partner, London

T +44 20 7532 1508
E swilley@whitecase.com

Willem Van de Wiele
Counsel, Brussels

T +32 2 219 16 20
E willem.vandewiele@whitecase.com

Paul Alexander
Local Partner, Milan

T +39 020 068 8334
E palexander@whitecase.com

No-deal Brexit: Challenges for trading venues and their participants

There is no silver bullet for maintaining cross-border trading if the UK leaves the EU without a deal, as **Julia Smithers Excell** and **Kristen DiLemmo** explain.

The date of Brexit has been delayed until (at least) October 31, 2019, but there is little sign that financial services access between the UK and the EU 27 will become clearer during the extension. This presents a particular challenge for trading venue participants trying to determine how—if at all—they may continue cross-border on-venue trading in the event of a no-deal Brexit.

While a number of UK trading venue operators have become licensed on the continent, the answer is not as simple as drawing a line between the UK and EU 27 participant bases and pushing each to its local venue. Many market participants, particularly major sell-side institutions, will need to continue trading cross-border in order to service their global clients.

The complexities surrounding cross-border trading post-Brexit arise, in part, due to the lack of a single-equivalence decision that would put UK venues and their participants on a level playing field with the EU. There are three key challenges regarding equivalence for trading venues and their participants in a no-deal Brexit: regulatory licensing; the mandatory trading obligation for shares and derivatives; and regulatory reporting.

These challenges relate to all three types of EU trading venues: regulated markets (RMs), which include mainstream stock exchanges; multilateral trading facilities (MTFs); and organized trading facilities (OTFs).

Regulatory licensing: UK venue—EU 27 participant

The impact of regulatory licensing is twofold: it determines a venue operator's ability to offer its platform into a jurisdiction, and a local participant's ability to trade on the platform cross-border.

After Brexit, UK trading venue operators will lose their right to access EU 27 participants under a single EU framework, and will instead have to look to the rules of each Member State. Although the Markets in Financial Instruments Regulation (MiFIR) introduced pan-EU licensing for third-country firms, UK firms cannot use this until the European Commission (EC) deems the UK's regulatory regime "equivalent" to EU standards.

So far, the EC has not expressed a willingness to deem the UK equivalent post-Brexit amid concerns about preferential treatment of third-country firms. Consequently, a UK trading venue operator needs to consider whether making its platform available amounts to carrying on a regulated activity in each target Member State and, if so, whether any local law exemptions might be of use.

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New Brexit extension

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> **While the permanent and Brexit-based temporary exemptions in several Member States cover trading activities, this still needs to be assessed on a case-by-case basis**

This divergence between Member States is complicated further by new Brexit legislation. A number of Member States have announced their own versions of the UK's temporary permissions regime, whereas others—such as Ireland and France—already have exemptions in place that facilitate a degree of third-country access. However, some Member States—such as the Netherlands—have excluded the operation of MTFs and OTFs from the list of activities that UK firms can perform without authorization.

UK trading venue operators therefore face the challenge of either complying with a patchwork of rules, or taking a risk-based approach to continuing access for a subset of Member States or participant types.

Assuming that a UK venue operator makes its platform available in a Member State, a local participant needs to consider its UK licensing position when it trades on the UK platform. This is likely to be relatively straightforward, as many EU 27 firms should be able to use either the UK's temporary permissions regime (TPR) or its overseas persons exclusion (OPE) to continue trading on UK platforms.

Regulatory licensing: EU venue—UK participant

The challenges are similar for EU 27 venues with UK participants. Both the TPR and OPE are potentially available for EU 27 MTF and OTF operators to continue accessing UK participants. However, each route has limitations: the OPE would narrow the categories of participant that could remain on the venue, while the TPR carries an expectation that the trading venue operator will eventually apply for full

“Market participants will need to consider the impact of the Share Trading Obligation (STO) and Derivative Trading Obligation (DTO) on their trading activity

UK authorization. The UK’s Financial Conduct Authority (FCA) has clarified that EEA market operators (including RM operators) will either need to rely on the OPE or apply to become a recognized overseas investment exchange to continue accessing the UK market.

From the UK participant’s perspective, it will need to consider its licensing position in the venue’s home Member State. While the permanent and Brexit-based temporary exemptions in several Member States cover trading activities, this still needs to be assessed on a case-by-case basis. In the Netherlands, for example, own-account dealing on a Dutch trading venue can be exempt from licensing, but the exemption does not expressly cover agency or client trading.

Mandatory trading

Apart from issues surrounding access, participants also need to consider how the mandatory trading obligation will impact their cross-border trading. This is particularly relevant for UK firms trading with EU 27 counterparties or through their EU 27 branches (and vice versa).

Share Trading Obligation (STO)

Article 23 of MiFIR broadly requires investment firms to trade shares that are admitted to trading on an EU trading venue (TOTV) on an RM, MTF or systematic internalizer (SI), or on a third-country trading venue that the EC has deemed equivalent. To date, the EC has deemed certain venues equivalent in Australia, Hong Kong, Switzerland (on a temporary basis), and the US.

As part of the UK’s on-shoring of EU legislation, the UK will have its own STO that mirrors the MiFIR requirements. This means that UK STO instruments will have to be traded on a UK venue, or on an equivalent third-country venue.

If a share is traded on a UK venue and an EU 27 venue, it could be subject to both STOs. When this happens, there might not be a mutually suitable trading venue for a UK firm trading with an EU 27 firm: an EU 27 venue would not work for the UK firm, and a UK venue would not work for the EU 27 firm.

Likewise, there might be a conflict between the two STOs for a firm with a presence in both the EU 27 and the UK. For example: an Italian bank wishes to trade, via its London branch, a share that is dual-listed on the London Stock Exchange and the Frankfurt Stock Exchange. The share will be subject to the UK STO because of its UK listing, and to the EU 27 STO because of its German listing. Because the London branch’s seat is in Italy, it must satisfy the EU 27 STO by executing the trade on an EU 27 venue. However, the UK branch must also satisfy the UK STO by executing the trade on a UK venue.

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ESMA announced that it will only consider shares issued by EU 27 firms as falling within the EU 27 STO

Mutual equivalence decisions are the solution to this clash of STOs. The UK seems willing to grant STO equivalence to EU 27 trading venues, which would mean that UK STO instruments could be traded on either UK or EU 27 venues.

But there is a clear expectation of reciprocity, which the European Securities and Markets Authority (ESMA) appears reluctant to support. ESMA announced on May 29, 2019 that, with the aim of minimizing overlaps, it would only consider shares issued by EU 27 firms as falling within the EU 27 STO. In response, the FCA pointed out that many EU 27-issued shares are dual-listed on UK venues, and would still be subject to overlapping STOs. ESMA continues to encourage the FCA to clarify its position on the application of the UK STO well ahead of the current Brexit deadline of October 31, 2019.

Derivative Trading Obligation (DTO)

The DTO under Article 28 of MiFIR requires firms to conclude transactions in certain derivatives on an EU trading venue, or on a third-country trading venue that the EC has deemed equivalent.

The DTO raises similar issues to the STO, including a clash between EU 27 and UK obligations, but with a few key differences. Derivatives, unlike shares, can be traded on OTFs, which would expand the scope of venues and participants affected by the competing obligations.

As with the STO, the EC has deemed some venues in the US and Singapore equivalent for DTO purposes, but has not signaled a willingness to deem any UK venues equivalent post-Brexit.

Without a clear resolution, market participants will need to consider the impact of the STO and DTO on their trading activity. It may be that firms subject to clashing obligations can only trade DTO/STO instruments on venues that the EC and FCA have both deemed equivalent. This might be impractical, as it would require mutual membership of a third-country venue and could trigger local licensing issues. For example, high-volume trading on US swap execution facilities (SEFs) might require CFTC authorization.

Regulatory reporting

Investment firms trading TOTV instruments are subject to transparency and transaction reporting requirements. These requirements differ depending on whether the firm is trading OTC or on-venue, which means that a no-deal Brexit could impact how and when a participant reports.

Transparency reporting

Articles 20/21 of MiFIR require investment firms to make public certain information relating to OTC trades in TOTV instruments. This post-

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Going forward, EU 27 firms will be subject to both the EU and UK transaction reporting requirements when they trade out of a UK branch. The same will apply to UK firms with an EU 27 branch

trade transparency obligation does not apply when trading on an RM, MTF or OTF, as the venue operator does the reporting.

Trades on a third-country venue are treated as OTC trades—meaning that the participant needs to transparency report—unless ESMA determines that the venue has comparable transparency standards. As it needs to consider hundreds of venues, ESMA opined in 2017 that participants do not need to transparency report trades on any third-country venues until it is able to assess more of them.

In March 2019, ESMA clarified that this transparency reporting reprieve would extend to UK venues post-Brexit. The FCA reciprocated shortly afterwards. This means that participants trading on-venue across the EU 27-UK border will not be subject to transparency reporting requirements as though the trades were OTC.

While this piece of the equivalence puzzle seems to be sorted out, the arrangement is only temporary: it remains to be seen how many UK venues will be deemed transparency-equivalent when ESMA completes its formal assessments (and vice versa).

Transaction reporting

When an investment firm trades a TOTV instrument either on-venue or OTC, it must submit a detailed transaction report to its home regulator. This extraterritorial requirement captures a firm’s branch trades globally, and it also pulls third-country firms into scope when they trade from EU branches.

Today, EU firms with branches in other Member States must report all of their in-scope trades—head office trades and branch trades—to their home regulator. This is done either by connecting directly to their regulator, or through the services of an approved reporting mechanism (ARM).

Going forward, EU 27 firms will be subject to both the EU and UK transaction reporting requirements when they trade out of a UK branch. The same will apply to UK firms with an EU 27 branch.

In practice, this will mean that a firm subject to double-reporting will either need to contract with an ARM to send transaction reports to two regulators, or establish a direct connection to its host regulator.

A medley of equivalence decisions

A no-deal Brexit will have a significant impact on both EU 27 and UK trading venue participants. When thinking about how to continue cross-border trading, participants need to consider not only regulatory licensing, but also clashing or duplicative obligations. A smooth transition would require not only a single-equivalence decision, but rather a medley of them. There are few signs that UK and EU authorities are working toward this level of coordination.

Julia Smithers Excell
Partner, London

T +44 20 7532 2229
E julia.smithers.excell@whitecase.com

Kristen DiLemmo
Associate, London

T +44 20 7532 2481
E kristen.dilemmo@whitecase.com

New UK peer-to-peer lending rules catch up with innovation

Within a decade, the UK's peer-to-peer (P2P) financial services sector has moved from an offbeat outsider to an increasingly significant and permanent player in loan and equity markets as **Jonathan Rogers**, **Carsten Lösing**, and **Kristen DiLemmo** explain.

Total lending facilitated by UK P2P platforms during the past 12 months was £6.7 billion, according to data provider Brismo. On the equity side, P2P platforms have notably been used to allow an issuer's customer base to participate in funding rounds alongside institutional capital. The growing cheer of the market in the UK has found its echo internationally, too, with platforms now established in multiple jurisdictions. However, the expansion both in scale and business model complexity has inevitably attracted regulatory scrutiny. On June 4, the UK's Financial Conduct Authority (FCA) published Policy Statement 19/14, which set out a package of rule changes to apply to the UK loan and equity P2P markets. The changes focus on remedies for the several potential harms that the FCA identified:

□ Confidence and investor participation could be threatened by poor performance or the disorderly failure of a platform;

□ Investors buy products that are not suitable for them;

□ Poor customer treatment;

□ Asset prices that are too high, or where the asset quality is too low.

£6.7bn

Total lending facilitated by UK P2P platforms during the past 12 months
Source: Brismo

This article focuses on three of the remedial measures that the FCA has imposed.

Holding business model evolution to account

By way of evolution from the original P2P premise of privately negotiated lending/borrowing terms, many platforms now include an element of intermediation, whether by setting the price of P2P investments, advertising a target rate of return or determining a 'basket' of loan assets.

While permitting these investor friendly enhancements, it seems the FCA considers they should come with a responsibility for platform operators to deliver on what has been sold. Accordingly the new rules are designed to ensure that operators price loans fairly and appropriately, invest assets within advertised parameters, and achieve target rates of return. These new rules are prescriptive in areas such as credit risk assessments, basis of pricing, timing of revaluations and provision of information on portfolio parameters.

In implementing all of this, those firms that set prices will doubtless have in mind the new requirement for an annual 'outcome report' that will have to report default rates and actual performance against target rates of return.

Despite the new rules, the overall impression on reading CP19/14 is that the FCA has reconciled itself to innovation and for example decided not to ban target return rates or transfers of loans in default. This allowance comes however at the price of an enhanced rule book and a level of investor disclosure that will better enable firms to be held to account for their business models.

Marketing restrictions and appropriateness

The FCA has determined that loan based P2P platforms should in respect of retail investors face the same marketing restrictions and conduct 'appropriateness assessments' as already apply to certain non-readily realizable investments such as unlisted stocks, unregulated funds and life policies.

Broadly speaking, this means that a P2P firm will only be able to offer products to retail investors if they have passed an appropriateness test and also qualify as either high net worth, sophisticated investors or restricted investors. The latter, broadly speaking being investors who have certified that they won't invest more than 10% of their net assets in P2P loans over a 12 month look back and 12 month look forward period).

This proposal appears to have generated a large response to the FCA's consultation, but the FCA has sided with consumer protection and dismissed claims that P2P loans have a different risk profile to other investments, or that these restrictions would reduce competition and accessibility.

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> **The great speed of expansion in the P2P market inevitably prompts the need for greater regulatory scrutiny**

> “The FCA wants to see contingency funds being better managed within a firm’s risk management framework

However, the FCA has in the face of responses received conceded that the marketing restriction will not prevent the provision of preliminary marketing information about the loan based P2P asset class, provided it falls short of being an offer that can be accepted. This information could include specifics of what is offered in terms of target rates/price, term, risk categorization, security or mitigation measures.

Managing over reliance on “contingency funds”

One of the innovations of the loan based P2P market is the use of contingency funds to compensate borrower defaults, whether funded by contributions derived from borrowers, investors or a platform’s own funds. Perhaps in recognition of the law of unintended consequences, the FCA has concluded that this innovation designed to benefit investors, could have the effect of distorting their understanding the market’s true risk. For example, a strong marketing statement such as, ‘no investor has ever lost any money’ is likely to be underwritten in part by the operation of a contingency fund alongside the performance of the underlying assets. The FCA’s concerns are that:

- Actual default rates are not being reported;
- Investors can come to see a target rate of return as effectively guaranteed; and
- In reliance on their contingency fund, platforms do not take enough care in calculating target rates of return.

To address these concerns, the FCA has determined a package of measures that focus principally on greater transparency around the application of contingency funds. Despite some push back through the consultation process, the trigger point for the new rules is strict and will include contingency payments used to smooth over delayed or enforced borrower repayments. These measures include mandatory pre-investment disclosures such as risk warnings and a policy statement setting out the detail of how a contingency fund will operate, as well as post-investment measures such as investor notifications of a contingency pay out, past performance data not being adjusted for contingency payments and a quarterly report on how much a contingency fund has been used.

On the prudential side, the FCA wants to see contingency funds better addressed within a firm’s risk management framework – and warns that offering enforceable rather than discretionary contingency cover will likely be insurance.

The new package is good news

The overall package of rules presented by the FCA in PS19/14 is a significant step forward in terms of regulatory expectations on P2P firms and will raise the barrier for new entrants. This should be seen in a positive light, with the FCA seeking to support the ongoing resilience and consumer proposition of this fast-developing market.

2019
4
June

FCA published Policy Statement 19/14 setting out a package of rule changes to the UK loan and equity P2P markets

Jonathan Rogers
Partner, London

T +44 20 7532 2163
E jorogers@whitecase.com

Dr. Carsten Lösing
Local Partner, Hamburg

T +49 40 35005 265
E cloesing@whitecase.com

Kristen DiLemmo
Associate, London

T +44 20 7532 2481
E kdilemmo@whitecase.com

Crypto-assets market: Regulators keeping a watchful eye

The impact of crypto-assets on the global financial system continues to be a subject of debate for regulatory and supervisory authorities. **Julia Smithers Excell** and **Laura Kitchen** provide a summary of the latest publications.

On 14 May 2019, the European Central Bank's (ECB) Crypto-Assets Task Force added to the growing body of published work on crypto-assets in the financial markets. Its paper, entitled "Crypto-Assets: Implications for financial stability, monetary policy, and payments and market infrastructures," follows similar publications by the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA). Shortly afterwards, the Financial Stability Board (FSB) published a report entitled "Crypto-assets: Work underway, regulatory approaches and potential gaps," and the International Organization of Securities Commissions (IOSCO) separately published its own consultation paper on "Issues, Risks and Regulatory Considerations Relating to Crypto-Asset Trading Platforms".

An evolving crypto-asset market

What is most striking about the ECB paper is its assessment that the risks and potential implications of crypto-assets in the current market are limited and/or manageable within the existing regulatory and oversight frameworks in the euro area. This conclusion may be surprising given the level of regulatory scrutiny surrounding crypto-assets in recent months. But, while acknowledging that the current regulatory framework may be sufficient in managing known risks (excluding AML and consumer protection risks), the Crypto-Assets Task Force is clear that this assessment is not, and cannot be, static. It recommends that the ECB continues to monitor, raise awareness and develop preparedness for an evolving crypto-assets market. This message echoes the call made by G20 Ministers of Finance and Central Bank Governors in March 2018 for international standard setting bodies to continue monitoring crypto-assets and their risks, and assess the need for multilateral responses (as referenced in the IOSCO report).

The IOSCO report identifies eight priority areas based on the core issues and risks related to crypto-asset trading platforms (CTPs) highlighted during its consultation:

- Access to CTPs and participant on-boarding
- Safeguarding participant assets, including custody arrangements
- Identification and management of conflicts of interest
- Transparency of operations
- Market integrity, including the rules governing trading on the CTP, and how those rules are monitored and enforced
- Price discovery mechanisms
- Technology, including resilience and cyber security
- Clearing and settlement

Equally importantly, the IOSCO report also sets out corresponding toolkits for supervisory authorities to consider when seeking to regulate CTPs.

IOSCO adds that the eight key considerations depend on the operational model of the CTP and may already be mitigated or addressed by existing regulatory frameworks. The IOSCO report focuses on secondary market trading of crypto-assets on CTPs and does not discuss issues related to initial coin offerings (ICOs).

2019
14
May

ECB publishes its report on "Crypto-Assets: Implications for financial stability, monetary policy, and payments and market infrastructures"

Emerging regulatory approaches

While it is clear from the ECB paper that the ECB considers the regulation of the crypto-asset market on a European level to be broadly functional and adequate, IOSCO recognizes that other global jurisdictions are considering new or tailored requirements to account for the novel and unique characteristics of CTPs. For example, the IOSCO report points out that some jurisdictions have established, or are in the process of establishing, a specific framework for CTPs that offer trading of crypto-assets that fall within their regulatory remit. Annex A of the IOSCO report provides a list of information published by key jurisdictions regarding their regulatory frameworks applicable to CTPs. Some jurisdictions such as Canada and Hong Kong are considering creating a new regime or adapting the existing one by tailoring requirements and/or exemptions. In certain jurisdictions, such as Japan, the payment services framework applies to the trading of crypto-assets whereas in other jurisdictions, such as China, engaging in ICO activities is prohibited.

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> **It is important to ensure that the evolution of business models in crypto-assets does not circumvent the regulatory framework or compromise its effectiveness in the future**

Differences in prudential treatment

The FSB addresses this developing global divergence in regulatory frameworks, and the potential risks and challenges that it poses. The FSB report provides an update on the work of the following international organizations: the Basel Committee on Banking Supervision (BCBS), Committee for Payments and Market Infrastructures (CPMI), IOSCO, Financial Action Task Force (FATF) and the Organisation for Economic Co-operation and Development (OECD).

The FSB recognizes that, at a national level, supervisory authorities have chosen varying approaches, reflecting differences in national market developments and underlying legal and regulatory frameworks. The FSB report also highlights the challenges in assessing the significance of potential gaps that may arise from an absence of international standards or recommendations, given the rapidly evolving nature of the crypto-asset ecosystem and related risks. It argues that adopting a forward-looking approach in monitoring crypto-assets can help provide a basis for identifying potential gaps and areas to prioritize and focus on.

In fact, the ECB, FSB and IOSCO all allude to the difficulties supervisory authorities face globally in attempting to clarify the prudential treatment of crypto-assets across the various sets of risk categories (counterparty risk, credit risk, market risk, liquidity risk, etc.). They acknowledge that there is no international agreement on how to define crypto-assets and no common taxonomy, which results in variations in the legal status of crypto-assets globally. The ECB points out that the European regulation on capital requirements for credit institutions and investment firms (CRR) is not tailored to crypto-assets given their high volatility. It suggests that crypto-assets should be deducted from common equity tier one (CET1) capital by way of a conservative prudential treatment, similarly to other assets classified as "intangible assets" under the accounting framework.

The importance of regulatory collaboration

The ECB paper expresses concern that disjointed regulatory initiatives could trigger regulatory arbitrage and ultimately hamper the resilience of the financial system to crypto-asset market-based shocks.

To mitigate this risk, the FSB states in its report that one of its two focus areas is the preparation of a directory of regulators on crypto-assets (the other focus area being the monitoring of risks to financial stability). The FSB delivered this directory to G20 Finance Ministers and Central Bank Governors in April 2019. The aim of the directory is to provide information on the relevant regulators and other authorities in FSB jurisdictions that are dealing with crypto-asset issues and the aspects covered by them.

Information sharing is also integral to IOSCO's work on crypto-assets, and the purpose of its report is to set out the approaches taken or being considered by regulatory authorities in IOSCO members' jurisdictions to allow authorities to consider (and possibly benchmark) their own efforts.

What's next?

The FSB shares the ECB's view that crypto-assets do not currently pose a material risk to global financial stability. However, the FSB, ECB and IOSCO all recognize the importance of keeping a watchful eye on the crypto-asset market, particularly as new products and services develop. In terms of next steps, IOSCO intends to continue to monitor the situation, with a view to ensuring the risks, issues and key considerations identified continue to be appropriate and relevant. The FSB intends to submit a monitoring note to its Standing Committee on Assessment of Vulnerabilities (SCAV) in September 2019, including developments in stablecoins and tokenization. The ECB intends to address any risks relating to crypto-assets that are not covered by Pillar 1 (i.e., should CET1 deductions not apply to crypto-assets) via supervisory assessment. The ECB also states that it is in a position to impose ring-fencing segregation for the European financial market infrastructures that it owns and controls, subject to risk considerations. The ECB regards such supervision as important in ensuring that the evolution of business models in crypto-assets does not circumvent the regulatory framework or compromise its effectiveness in the future.

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FSB to submit a monitoring note to SCAV on the development of stablecoins and tokenisation

Julia Smithers Excell
Partner, London

T +44 20 7532 2229
E jsmithersexcell@ whitecase.com

Laura Kitchen
Associate, London

T +44 20 7532 1794
E lkitchen@whitecase.com

Outsourcing: Final countdown to implementation

New guidelines reflect the rise of outsourcing by financial institutions in a new era of disintermediation and technological change. **Carsten Lösing**, **Julia Smithers Excell** and **Kirsten Donner** provide an overview of the latest changes and their implications for risk management.

In February 2019, the European Banking Authority (EBA) published its final guidelines on outsourcing arrangements. The guidelines aim to establish a more harmonized framework for the outsourcing arrangements of financial institutions in the EU.

One of the aims of the guidelines is to ensure appropriate risk management and due diligence as a result of the increasing use of outsourcing by financial institutions, in particular when it comes to payments and fintech companies. The guidelines have also adopted the recommendation on outsourcing to cloud service providers, published in December 2017.

From a German regulatory perspective, the concepts introduced by the guidelines are not entirely new. In part, they restate existing German risk management requirements with respect to outsourcing, which are based on the German Banking Act (KWG), the minimum requirements for risk management (MaRisk), as well as Section 26 of the German Payment Supervisory Act (ZAG).

However, the EBA has significantly increased the level of detail of the risk management requirements and expressed expectations that go beyond what is currently stated by German law or expected by the administrative practice of the supervisors.

In particular, this relates to the governance framework, the preliminary outsourcing risk analysis, contractual requirements, sub-outsourcings and information obligations vis-à-vis the competent supervisory authority. In addition, the number of institutions affected will also be significantly expanded. Overall, the analysis, monitoring and documentation effort involved in outsourcing has increased.

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> **The European Banking Authority (EBA) outsourcing guidelines aim to establish a more harmonized framework for the outsourcing arrangements of financial institutions in the EU**

2019
February

EBA published its final guidelines on outsourcing arrangements

Extended scope of addressees

While the scope of MaRisk is limited to credit and financial services institutions and domestic banking branches of foreign companies, the EBA guidelines have a broader scope that for the first time includes payment institutions (including payment initiation service providers) and electronic money institutions. So-called account information service providers (AISPs) are exempt from the outsourcing requirements.

Material changes

While the MaRisk link the (non-) applicability of higher risk management requirements to the qualification of an outsourcing arrangement as “material” or “non-material,” the guidelines introduce the concept of “critical and important functions.”

Many of the EBA's guidelines only apply to the outsourcing of these functions. In order to enable a uniform classification into “critical” and/or “important” functions, the EBA has specified a detailed catalogue of criteria in section four of the guidance.

For instance, the outsourcing entity must apply due diligence before concluding a contract and ensure that the service provider has the necessary knowledge, skills and resources—both technical and financial—to provide the outsourcing services.

The guidelines also specify other factors that must be taken into account. For example, the service provider must have a sufficient organizational structure and relevant regulatory approvals to perform critical and important functions in a reliable and professional manner.

In case of sub-outsourcing, the service provider must provide certain information to the outsourcer such as how its ability to meet its contractual responsibilities will be affected by the sub-outsourcing.

The EBA guidelines also include requirements on the minimum content for outsourcing agreements, many of which have been controversially negotiated between outsourcing parties in the past years. In this respect EBA now clearly states, for instance, that the contract should contain provisions on the permission of sub-outsourcing, including respective information obligations and notification periods to allow an appropriate risk analysis, termination for regulatory cause—for instance, when instructions are given by the competent authority.

The EBA also requires the establishment of "outsourcing registers". Such registers must be maintained for all outsourcings irrespective of their qualification as "critical and important". However, the contents vary and are prescribed by the guidelines.

For example, outsourcers must determine a reference number for each outsourcing agreement in the register and provide a brief description of the function. In case of outsourcing of critical and important functions, the register must contain the dates of the most recent and next scheduled audits and, where applicable, the names of any sub-contractors to which material parts of a critical or important function are sub-outsourced. This includes the country where the sub-contractors are registered, where the service will be performed and, if applicable, where the data will be stored. The register will help the outsourcer oversee and manage associated risks but will also help regulators assess concentration risks since the outsourcer should, upon request, make available to the competent authority details of all existing outsourcing arrangements.

The EBA states that the supervisory requirements must also apply to outsourcing within the group of the outsourcing institution. This applies even if the outsourcing only takes place within the same system for institutional protection because the EBA believes these outsourcing operations are no less risky than outsourcing to third parties and are therefore subject to the same regulatory framework as outsourcing to service providers outside the group.

This puts it at odds with BaFin, which states in its MaRisk explanations that in case of group outsourcings a group-wide risk management would have a risk mitigating effect.

Another innovation concerns outsourcing to third countries. For example, it is planned that the relevant supervisory authorities conclude a cooperation agreement, e.g., in the form of a "Memorandum of Understanding," which guarantees that confidentiality and data protection for the company to which the activity is outsourced are equivalent to those of the outsourcing institution.

2019
30
September

EBA's outsourcing guidelines come into force

Countdown to implementation

The guidelines come into force on September 30, 2019, and will apply to outsourcings "entered into, reviewed or amended" after that date, handing institutions a tight time frame in which to make the necessary governance and risk management arrangements.

In addition, institutions and payment institutions should review and amend existing outsourcing arrangements with a view to ensuring that these are compliant with the guidelines by December 31, 2021. Compliance breaches should be reported to the competent authority, including the measures planned to complete the review or the possible exit strategy.

Although the analysis, monitoring and documentation effort required to implement the EBA guidelines is substantial, institutions may also consider the upside:

- The review process is comparable to an inventory that will give the institution the chance to rethink its current outsourcing structures and associated risks.
- Institutions have a chance to renegotiate existing contracts or consider a change of service providers, to access new innovative technologies and therefore follow supervisors' demand for changes in legacy IT systems.
- With the detailed position of EBA on outsourcing arrangements and the respective compliance of competent national authorities, institutions have a substantive position in contract negotiations with respect to the regulatory requirements on outsourcing.

Dr. Carsten Lösing
Local Partner, Hamburg

T +49 40 35005 0
E cloesing@whitecase.com

Julia Smithers Excell
Partner, London

T +44 20 7532 2229
E julia.smithers.excell@whitecase.com

Dr. Kirsten Donner
Associate, Berlin

T +49 30 880911 520
E kdonner@whitecase.com

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