CENTRAL BANK OF IRELAND

Circulated to Commission Members
on 23 January 2017

Paper No. 11 of 2017

FOR INFORMATION

BREXIT TASK FORCE: DECEMBER 2016 UPDATE

Financial Stability Division

Brexit Task Force

BREXIT TASK FORCE: DECEMBER 2016 Report – Overview and Update

Following the results of the 23 June 2016 Brexit referendum, the Bank's Financial Stability Committee requested that an internal Task Force on Brexit implications be established on a permanent basis to monitor and assess developments in this area. The subsequently established Brexit Task Force (BTF) also facilitates information sharing across divisions and allows the Bank to take an integrated approach in dealing with any relevant challenges arising from the UK's decision to leave the European Union.

The quarterly reports of the BTF will provide updates on political, economic and financial market developments since the referendum, risks arising for firms supervised by the Bank and issues arising for the Bank itself in particular pertaining to authorisations. Within these reports, the BTF aims to provide updated information on these topics alongside more in-depth analysis of issues and policy questions arising from Brexit. Special topics included in this report are regulatory equivalence and the Bank's risk appetite regarding authorisations of new firms, with a particular focus on [redacted] and Central Securities Depositories.

The attached Q4 2016 report was finalised as at 13 December 2016 for discussion by the Financial Stability Committee on 20 December 2016. The cut-off date for data was 2 December 2016. Some updates since December 2016 are worth noting. The main development since then has been Prime Minister May's speech on 17 January 2017 outlining her vision for Brexit in which she confirmed that the UK will leave the single market. The Prime Minister set out her preference for a transitional arrangement and the possibility of the UK becoming "an associate member of the Customs Union in some way" although it remains unclear what type of interim arrangements, as well as longer-term trading arrangements, between the UK and EU will emerge from the negotiations. Maintaining the Common Travel Area with the Republic of Ireland was one of the 12 key points outlined in Prime Minister May's strategy.

In the run up to Prime Minister May's speech, sterling weakened in foreign exchange markets, although it strengthened in the immediate aftermath of the speech. Accordingly, the value of sterling against the euro was, on 18 January 2017, four per cent weaker than at the cut-off date for the report discussed in December 2016 by the FSC and was 13 per cent weaker than the day before the Brexit referendum. Against the dollar, sterling fell to a 30-

year low of €1.1988 early on Monday 16 January 2017. The speech was received positively by markets, however, and sterling rallied to between $1.23-1.24.

Over the period since finalisation of the report, the FTSE 100 rallied strongly, rising more than nine per cent on the weaker sterling and more positive global sentiment generally, before paring some of these gains slightly following Prime Minister May's speech to sit around 7 per cent higher. The index has risen by 23 per cent since its post-referendum trough on June 27. Gilt yields remain relatively range-bound since 2 December 2016, having risen by up to 70bps at the longer end following the US election, which sparked a global sell-off in yields. The 10-year Gilt is around 6bps lower at 1.31 per cent.

Finally, at an appearance before a Treasury Select Committee on 10 January 2017, Mark Carney indicated that some slight upward revisions to UK growth forecasts may be included in the February 2017 inflation report.

The Commission is requested to note the overview and update of the Brexit Task Force: December 2016 Report.

Contents

Executive Summary

- It is expected that Article 50 will be triggered by the UK before the end of March 2017. On the EU side, the principles of no negotiations before notification and that access to the Single Market requires acceptance of all four freedoms have been reiterated on numerous occasions. On 17 January 2017, Prime Minister May confirmed that the UK will leave the single market. The Prime Minister set out her preference for a transitional arrangement and the possibility of the UK becoming "an associate member of the Customs Union in some way" although it remains unclear what type of interim arrangements, as well as longer-term trading arrangements, between the UK and EU will emerge from the negotiations.
- The UK economy has broadly outperformed expectations as set out in the Bank of England's post-referendum August Inflation Report. This included a strong market response to the MPC's post-referendum policy package, near-term activity indicators making substantial recoveries from Q3 levels and GDP growth of 0.5 per cent in Q3. As a result, substantial positive revisions were made to near-term growth forecasts in the November Report. The Governor of the Bank of England suggested in mid-January that further upward revisions might be included in the February Report.
- UK commercial real estate values weakened following the referendum with some more recent signs of stabilisation. Survey evidence indicates that there are expectations in the UK that a significant number of firms will seek to re-locate, and these numbers are particularly high for Northern Ireland.
- In financial markets, the passage of time makes it more difficult to disentangle Brexit-specific developments. There has been further sterling depreciation following increased expectation of a 'hard' Brexit and in mid-January sterling was around 13 per cent weaker against the euro than on the day before the referendum. Irish bank equities have been mixed over the review period, with Bank of Ireland recouping more than half of its 40 per cent post referendum drop and AIB's share price falling c. 15 per cent over the period. While UK REITs appear to have stabilised following post-referendum volatility, in many cases share prices remain substantially (c.20 per cent) lower than pre-vote values.
- The Central Bank's outlook for the Irish economy was revised down in the immediate aftermath of the referendum, with 0.2 and 0.6 per cent shaved off GDP growth rates in 2016 and 2017, respectively. The latest October projections are in line with these initial estimates. Higher frequency data developments have been mixed. On the consumer side, the ESRI/KBC Bank Consumer Sentiment Index declined to a 20-month low in October and headline PMI indicators have also softened since June. Within IEA a Global Vector Autoregression (GVAR) model has been developed to simulate the effects of shocks on the UK economy.
- Despite recent moderation, total returns on Irish commercial property remain higher than many international peers and Irish commercial property agents continue to report substantial Brexit related queries. While the majority are likely to be preliminary scoping exercises at this stage, there are some concerns whether the country, and Dublin in particular, has sufficient office space, housing and any other necessary infrastructure to facilitate any increase in occupier demand that may occur as a result of Brexit.
- [redacted]

[redacted]

- The latest relevant developments regarding international banks, insurance firms, markets directorate firms and payments firms are almost entirely related to authorisations activity. Engagement with supervised firms and relevant authorities at a UK and European level regarding Brexit has continued throughout the review period and will continue for the foreseeable future.
- Overall, authorisations-related activity has continued to increase across the Bank over the review period. This remains mostly in the form of firms seeking information, [redacted] In addition to this increased volume, there has been a broad variety of firms seeking information which could potentially lead to requests for authorisation by entity-types not currently supervised by the Bank such as Central Securities Depositories.
- An overview of issues relating to the Central Bank's risk appetite in relation to authorisations is provided. [redacted]
- The work underway includes assessment of overall risk appetite and assessment of risks associated with specific institution types [redacted] and Central Securities Depositories.
- The report includes a special feature on equivalence of financial regulations. Certain EU financial regulations envisage the possibility for third countries to obtain 'equivalence' to EU legislation. Whether or not equivalence is available -and what it implies- varies across sectors. There are currently around 40 equivalence requirements in place in total and as such potential for use of equivalence by UK-based firms varies widely across individual sectors.
- Following Brexit the UK becomes a third country under UCITS and AIFMD and as such passport rights in relation to relevant funds and the management companies will no longer be available. The fact that many UK entities have established Irish funds, and are familiar with both the AIFMD and UCITS regime which the Central Bank has put in place, may lead to moves to establish Irish fund management companies where they wish to continue selling within the EU. Irish UCITS funds currently marketed in the UK may also require UK authority approval.
- MiFID II, which is expected to come into effect in January 2018, will establish various gateways to the EU market for third country entities. If the UK does not negotiate an EEA membership, its firms could then be expected to meet the regulations of a third country entity under MiFID II or to establish a subsidiary if they wish to re-locate to Ireland. Access to the UK market by Irish investment firms may also be reduced and will depend on UK authorities' decisions regarding non-UK regulated persons. However, access to large EU investors may be enough of an incentive for the UK to implement the MiFID II regime notwithstanding Brexit, which in turn may result in certification as equivalent by EU authorities.

1. Introduction[1]

Following the Brexit referendum, the Central Bank's Financial Stability Committee (FSC) requested that a Task Force on Brexit implications be established on a permanent basis to monitor and assess developments in this area. In September 2016 the Brexit Task Force (BTF) presented its first report to the FSC. This report provided an update on political, economic and financial market developments since the referendum, risks arising for firms supervised by the Bank and issues arising for the Bank itself in particular with respect to authorisations. Going forward, the BTF will aim to provide updated information on these topics alongside more in-depth analysis of issues and policy questions related to Brexit. Issues identified for this second report are regulatory equivalence and the Central Bank's risk appetite regarding authorisations of new firms, with particular focus on [redacted] and Central Securities Depositories.

This second Report of the Central Bank's Brexit Task Force (BTF) follows the second meeting of the group on 21 November. The layout of the Report is as follows. Section two provides an update on political developments, the performance of the UK economy and property market and financial market movements over the past three months. Section three discusses the changes to the outlook for the Irish economy and property market in the context of Brexit. Section four provides an overview of latest developments in relation to firms supervised by the Credit Institutions, Insurance, Markets and Consumer Protection Directorates, respectively. In Section five, information relating to queries received by the Central Bank in relation to potential applications for authorisations is presented. Section six provides an overview of considerations regarding the Central Bank's risk appetite and in-depth analysis of risks associated with specific institution types including [redacted] and Central Securities Depositories. Section seven provides an overview of equivalence regimes available under EU legislation, followed by in-depth analysis of access to the EU market for third country firms under UCITS, AIFMD and MiFID.

Minor updates to the report discussed by the FSC on 20 December are included in order to take into consideration the speech of Prime Minster May on 17 January and associated financial market developments.

[1] The following Divisions are represented on the Brexit Task Force: BSSD, CPD, FMD, FRG, FSD, IEA, IFFS, INSA, MPD, ORD, Risk, PPG, PSSD, RES, SMSD. The report has also benefited from discussions with the Department of Finance. The Chair (Mark Cassidy) and Secretariat (Ellen Ryan) are provided by FSD.

2. Political and Market Developments

2.1. Political developments

2.1.1. EU/UK level developments and the negotiation process

The UK Prime Minister (PM) May signalled at the Annual Conservative Party Conference, on 2 October, that Article 50 will be triggered by the UK before the end of March 2017. In an address to Confederation of British Industry (CBI) on 21 November, the UK PM signalled a pro-business agenda, hinted at transitional arrangements to avoid a 'cliff edge' and, on corporation tax, stated the aim was the lowest rate in the G20. More recently, Prime Minister May outlined her vision for Brexit in a speech on 17th January in which she confirmed that the UK will leave the single market. The Prime Minister set out her preference for a transitional arrangement and the possibility of the UK becoming "an associate member of the Customs Union in some way" although it remains unclear what type of interim arrangements, as well as longer-term trading arrangements, between the UK and EU will emerge from the negotiations. Maintaining the Common Travel Area with the Republic of Ireland was one of the 12 key points outlined in Prime Minister May's strategy.

With regard to the EU approach, the principles of no negotiations before notification and that access to the Single Market requires acceptance of all four freedoms have been reiterated on numerous occasions by the EU institutions and EU leader's including President Junker, Chancellor Merkel and the EU's lead Brexit negotiator Michel Barnier. Recent comments from Michel Barnier also indicate that the time period for negotiating the terms of the UK's EU exit may be limited to 18 months or less. Once Article 50 is lodged the formal EU separation process sets a two-year renewable deadline, however, before negotiations with the UK can begin the EU must agree its negotiating mandate and ratify any draft exit agreement in the European Parliament, between Member States, and in Britain.

[redacted]

2.1.2. Political developments from an Irish perspective[2]

The outcome of the UK referendum on EU membership presents a number of challenges for the Irish Government. The priority areas for the Government have been set out by the Taoiseach and Government Ministers on numerous occasions, and relate to the economy, Northern Ireland, the

[2] The BTF is grateful to the Department of Finance for providing the information for this section of the report.

Common Travel area, and the EU itself. Preparations are currently intensifying at both political and official level and include the Cabinet Committee on Brexit, Budget 2017, All-Island Civic Dialogue and the North South Ministerial Council.

Cabinet Committee on Brexit

The new Cabinet Committee on Brexit, chaired by the Taoiseach, with Ministers supported by Secretaries General, has met on a number of occasions. In order to deepen analysis at whole of Government level six Sectoral Workgroups have been established to progress issues [redacted]

Budget 2017

Budget 2017 set out a number of measures under the banner of 'Getting Ireland Brexit ready'. These included retention of the 9 per cent VAT rate for the hospitality sector, a package of measures to help the Agrifood sector, further resourcing of Enterprise Ireland and IDA Ireland, extension of benefits to the self-employed, changes to the tax regime for entrepreneurs, and additional funding for Revenue to help scope out future customs options, with the aim of minimising possible costs for business while maximising the facilitation of trade. In terms of the broader public finances, the Minister announced the establishment of a rainy day fund and new debt-GDP target of 45 per cent by the mid-part of the next decade.

All-Island Civic Dialogue

On 2 November, the first All-Island Civic Dialogue hosted by the Taoiseach and Minister for Foreign Affairs was held. The outcome of the dialogue will inform the next phase of the Government's consultation process with wider society. Further all-island sectoral dialogues are to take place in the coming months. The second plenary of the All-Island Civic Dialogue will take place in 2017. The chair of the Central Bank's Brexit Task Force represented the Bank at the Dialogue.

North South Ministerial Council

On 18 November, the twenty third plenary meeting of the North South Ministerial Council (NSMC) took place in Armagh. The Council had a discussion on the implications of the result of UK referendum on membership of the EU. The Northern Ireland Executive and the Irish Government agreed common principles to guide further work in this area. On 25 November, at the British Irish Council summit in Cardiff, the Taoiseach met again with First Minister Foster and Deputy First Minister McGuinness, as well as Secretary of State Brokenshire and First Minister of Scotland, Nicola Sturgeon.

2.2. UK economic and property market developments

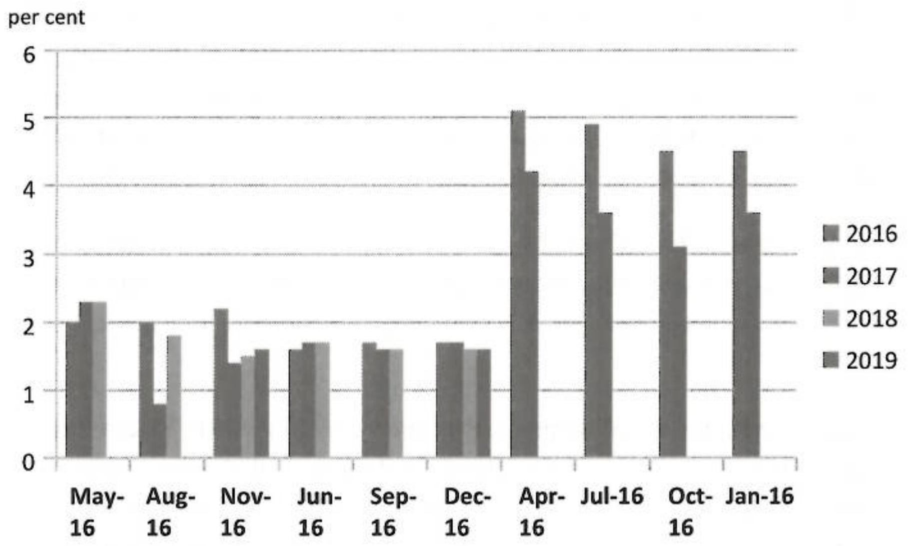
In its August Inflation Report, the first following the pro-Brexit vote, the Bank of England made substantial downward revisions to its growth forecasts. The downward revision for 2017 between

May and August was from 2.3 per cent to 0.8 percent with a corresponding revision for 2018 from 2.3 per cent to 1.8 per cent. However, since August there has been a strong market response to the MPC's post-referendum policy package and near-term activity indicators, such as the Market/ CIPS indicator of expected output, have made substantial recoveries from Q3 levels (see Chart 2.2.2). UK GDP grew by 0.5 per cent in 2016 Q3 which was a limited fall on Q2 growth and above levels projected in the Bank of England's August Inflation Report. As a result, short term growth forecasts were revised upwards in the Bank of England's November Inflation Report to 2.2 per cent and 1.4 per cent in 2016 and 2017, respectively see Chart 2.2.1. The Bank of England expects net trade to support GDP growth in the near term given the 21 per cent depreciation in sterling over the past twelve months. However, uncertainty regarding possible future changes to the UK's trading arrangements and the ways in which firms will respond to both the final Brexit outcome and the uncertainty surrounding it make it difficult to estimate magnitudes for this effect.

Downward revisions were also made to growth projections for 2018 from 2.3 per cent in May to 1.5 per cent in November. This primarily reflects the impact of lower real income growth on household spending, uncertainty over future trading arrangements and the risk of material reduction in access to EU markets by UK-based firms. The Bank of England also highlights current elevated levels of business uncertainty. The Confederation of British Industry's (CBI) broad-based indicator of demand uncertainty remains above its long term average, although it has fallen markedly over the last quarter (see Chart 2.2.3). In line with this, measures of investment intentions have fallen further over the past quarter. Unemployment is also expected to rise to 5.5 per cent by 2018 and to stay at this level up until the end 2019.

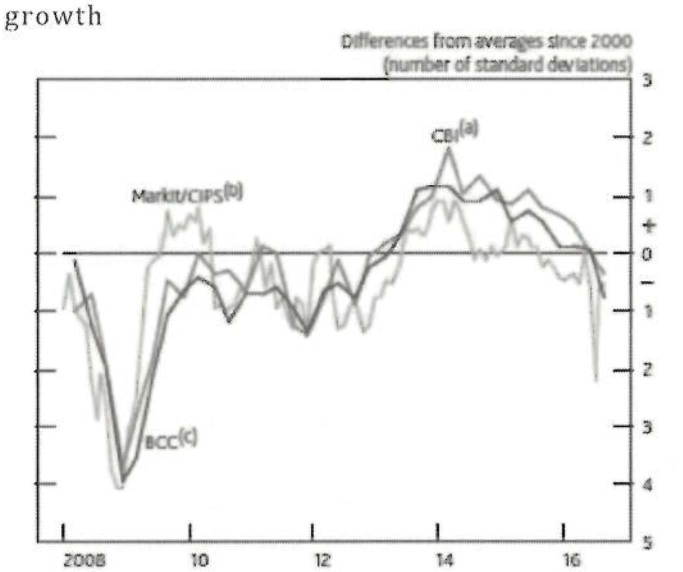
The inflation outlook from the November Report is broadly in line with that of the August report, with inflation expected to continue to rise over the near term. Downward pressure from subdued domestic demand is expected to be offset by higher import prices associated with sterling depreciation. As laid out in Section 2.3, comments from a number of MPC members suggest that the Bank of England will look through most of this inflation on the condition that such action supports economic growth. This slightly more hawkish stance has led to some market re-pricing since the previous report, with one hike by early 2018 now expected.

Chart 2.2.1: Evolution of UK, Irish and euro area growth forecasts



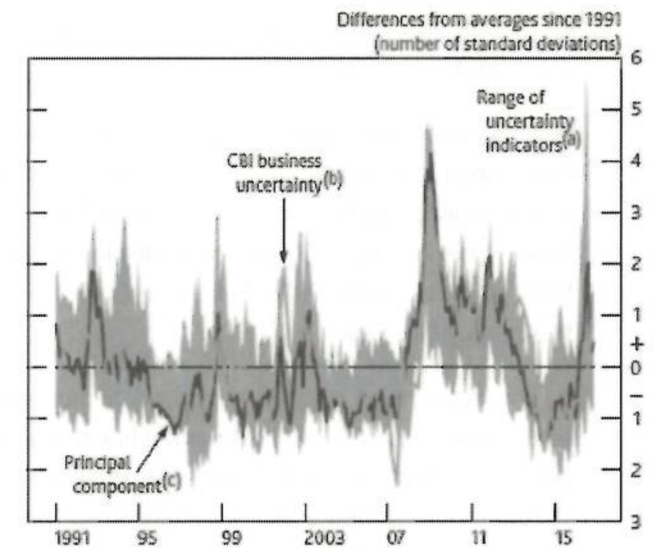
Sources: BoE Inflation Report, ECB Economic Bulletin, Central Bank of Ireland Quarterly Bulletin.
Note: January figures for Ireland are preliminary and subject to revision. They are discussed further in Section 3.1

Chart 2.2.2: Survey indicators of expected growth



Source: Bank of England Inflation Report

Chart 2.2.3: BoE and CBI uncertainty measures



Source: Bank of England Inflation Report
Note: Blue fill reflects range of available uncertainty indicators and purple line is first principal component extracted from these.

As noted in the previous BTF report, he UK commercial property market has shown signs of weakening since the referendum (Chart 2.2.4). The latest data show UK commercial real estate (CRE) values were relatively stable in October 2016, with monthly capital values increasing for the first time since the EU referendum. According to MSCI/IPD, commercial property capital and rental values both grew 0.1 per cent in the month, compared to a fall of 0.2 per cent and an increase of 0.2 per cent, respectively, in September. On an annual basis, however, CRE values continued to weaken. Year-on-year capital values were 2.7 per cent lower in October, following a fall of 2.2 per cent fall in September. The equivalent October 2015 figure was an increase of 8.6 per cent. The largest fall came in the retail market where capital value declined 4.5 per cent over the past year.

Annual rental inflation eased further to 2.4 per cent in October 2016, from 2.7 per cent in September and 4.3 per cent a year ago. In terms of sectoral performance, rents in the office and industrial sector posted annual growth of 3.7 per cent, compared to 0.9 per cent in the retail market.[3]

Despite the continuing moderation in commercial property value growth, recent survey evidence hints at a more positive outlook. According to the RICS 2016 Q3 *"UK Commercial Property Market Survey"*[4], sentiment is recovering slightly after the sharp deterioration seen at the end of Q2 in the wake of the EU vote. Projections for both rental and capital values returned to positive territory but remain significantly more subdued relative to the start of the year. Nevertheless, expectations improved to some extent across most parts of the UK, although feedback remains cautious in London.

The survey included a question on whether respondents had seen any evidence of firms looking to relocate away from the UK in response to the EU referendum outcome. Nationally, 86 per cent said that they had not seen any such enquiries, while 14 per cent reported that they had. When the results were disaggregated, NI (36 per cent), the West Midlands (27 per cent) and Central London (26 per cent) returned the highest proportion of respondents which had seen evidence of firms considering relocation.

Another interesting question centred around whether RICS members expect to see an increase in firms moving away from the UK over the next two years. On a UK-wide basis, a significant one-third of participants did feel some firms would look to relocate part of their business in response to the Brexit vote. Again, NI (71 per cent) displayed the highest share of respondents who felt firms were likely to move. Meanwhile, in Central London, 47 per cent expect some businesses to relocate over the coming two years.

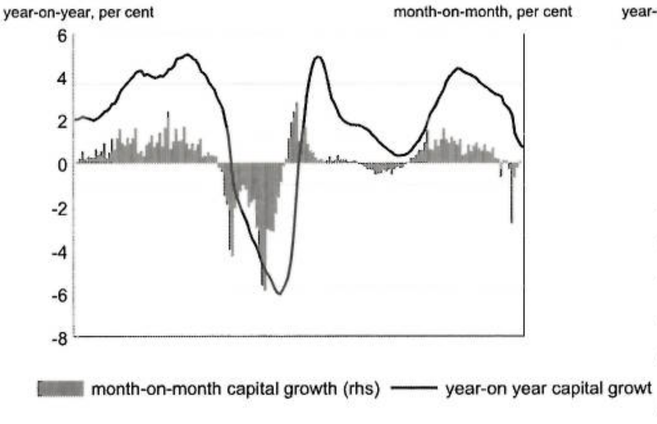
In the residential market has been a moderation in the pace of price growth since the EU referendum (Chart 2.2.6). Residential house prices were 5.2 per cent higher year-on-year in October 2016 according to Halifax, down from 8.4 per cent in July and from the 9.7 per cent a year ago. October 2016 data are also available from Nationwide, showing an annual growth rate of 4.6 per cent, versus 5.2 per cent in July and 4 per cent a year earlier. Regionally, London house prices

[3] Year-on-year growth in office, industrial and retail rents was 4.3, 3.9 and 0.8 per cent, respectively, in September 2016, and 8.5, 4.7 and 0.9 per cent, respectively, in October 2015.

[4] See http://www.rics.org/Global/RICS%20UK%20Commercial%20Property%20Market%20Survey%20-%20Q3%202016.pdf

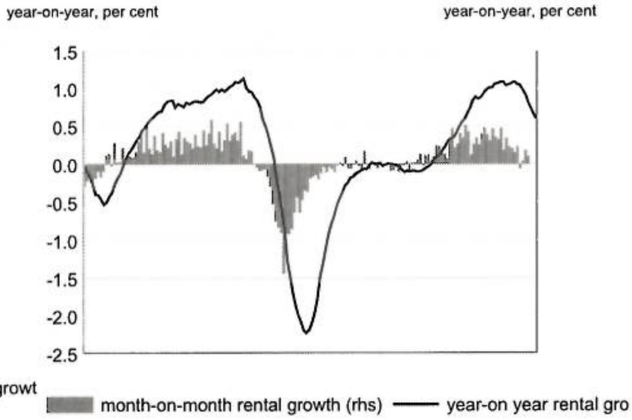
recorded a large quarter on quarter fall of 2.5 per cent, while house price inflation is also showing signs of easing in Wales and the North of England.

Chart 2.2.4: UK commercial property capital growth: year-on-year and month-on-month



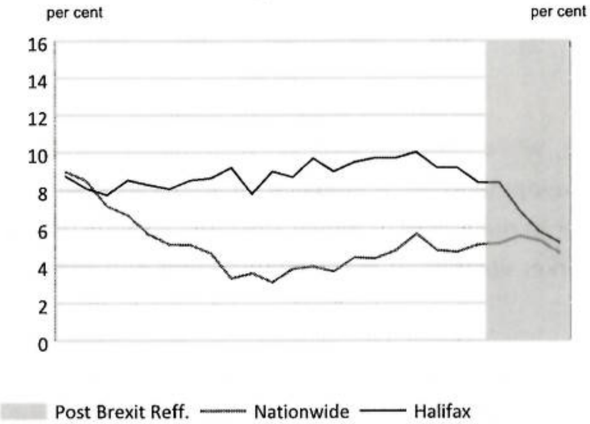
Source: MSCI/IPD and Central Bank of Ireland calculations

Chart 2.2.5: UK commercial property rental growth: year-on-year and month-on-month



Source: MSCI/IPD and central Bank of Ireland calculations

Chart 2.2.6: Annual growth in UK house prices



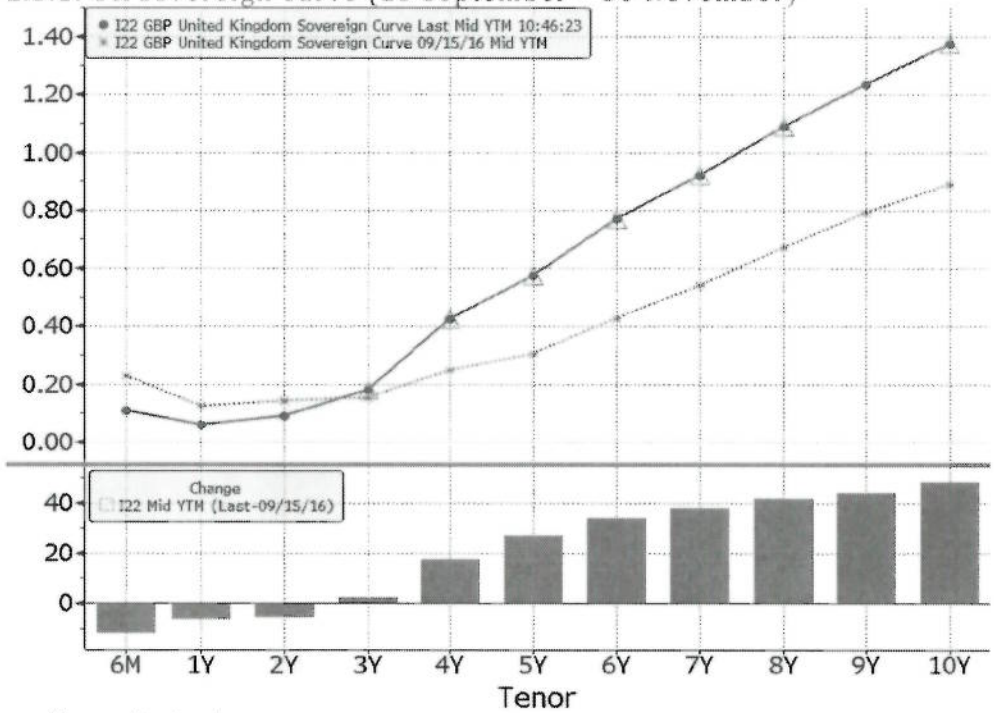
Source: Nationwide and Halifax

2.3. Financial market developments

The following section provides an update on the impact of the Brexit referendum on financial markets. The review covers the period since the vote, 23 June, concentrating on developments since the last FSC discussion, at end-September. The cut-off date for data was 2 December although an update on more recent developments has been added to the report. Throughout the following analysis it should be noted that a number of other significant market events (such as the outcome of the US election) have occurred over the review period. It is therefore difficult to disentangle these developments and to explicitly identify Brexit-related moves, with market pricing reflecting the overall impact of these events.

Over the review period, comments from a number of BoE officials indicating that the central bank would allow inflation to overshoot, if this supported economic growth, led to a re-evaluation of the potential path of the BoE's policy interest rate. A hike, rather than a cut, is now seen as the most likely interest rate decision by the BoE, with one rate increase by early 2018 now expected, as indicated by interest rate options data. This re-evaluation, among other factors, has contributed to the steepening in the UK gilt curve (Chart 2.3.1).

Chart 2.3.1: UK sovereign curve (15 September - 30 November)

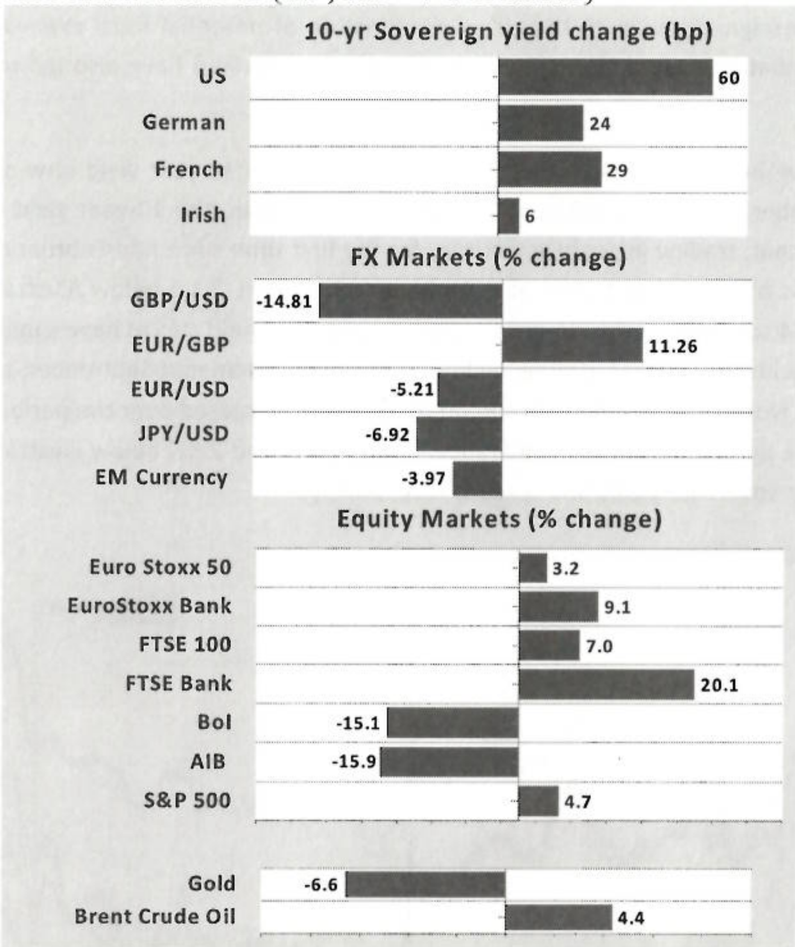


However, as detailed above, while concerns over Brexit remain close to the forefront of investor considerations, political developments on a global scale also garnered attention over the period. Chart 2.3.2 depicts a number of main market moves since the 23 June, immediately prior to the day of voting. While current market volatility is low relative to long run averages, a number of political risk factors are now apparent.

First, the victory of Donald Trump has resulted in longer dated sovereign yields moving higher, which has also supported currency strength in the US, and to a lesser extent in the UK. In the euro area, a number of political risk factors, most notably the 'No' vote in the Italian constitutional referendum, in addition to the French presidential election, are leading to increased spreads of many sovereigns over Germany. The banking sector in Italy has also been adversely affected by balance sheet concerns. In addition, the share prices of Irish banks (namely AIB and BOI) remain below their pre-Brexit vote levels by 20 per cent and 25 per cent respectively, as illustrated in section 1.3 below.

While there has been some recovery in share prices of UK REITs since the referendum a number remain substantially below pre-referendum values. Irish listed REITs also experienced an initial share price drop following the announcement of the referendum result. While there was a recovery in subsequent weeks, REIT share prices have been declined again of late, though the more recent declines may not be entirely Brexit-related

Chart 2.3.2: Main market moves (23 June – 7 December)



Looking forward, events likely to influence market moves include the 14 December FOMC sitting, at which markets are assigning a 100 per cent probability to the Fed raising rates to a range of 50bps-75bps. This will potentially mark a further divergence in monetary policy action from the euro area, with the ECB having announced an extension of the current Asset Purchase Programmes out to end-2017 at its 08 December meeting, albeit with the pace of purchases reduced from €80bn per month to €60bn. The aforementioned political risk events can also be seen as potential risk triggers over the coming months. The inauguration of president-elect Trump, and any further indication on his future policy stances, will also be monitored by market participants, in addition to any further developments relating to Brexit.

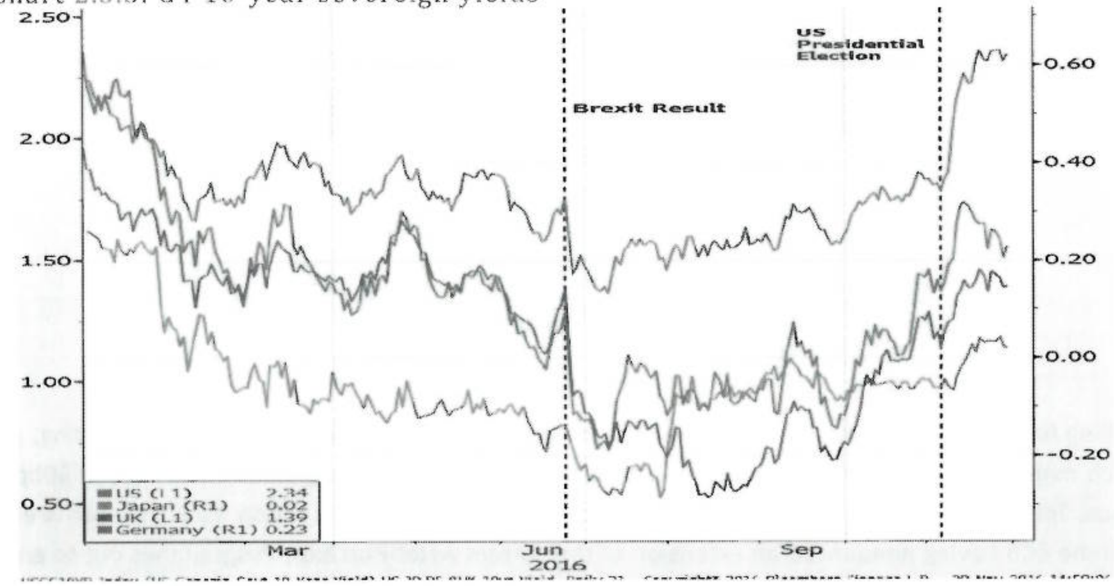
The following section now discusses in detail four asset classes – sovereign bonds, foreign exchange, equities (including the financial sector) and real estate.

2.3.1. Sovereign Bond Market

Throughout the previous review period, a strong flight to quality bid following the Brexit vote saw the trend of falling long-term yields persist. Over the review period, however, this trend has been reversed, with a strong curve steepening bias evident in fixed income markets. This steepening was initiated by a number of factors. First, the Bank of Japan moved to a yield curve management approach, whereby the sovereign 10-year yield is being steered higher, and maintained close to 0 per cent. Second, the victory of Donald Trump in the US presidential elections, has led investors to price in higher inflation due to plans for fiscal expansion, which would be most likely funded through longer-dated sovereign issuance. In the UK, a combination of potential fiscal expansion, and more notably, higher inflation expectations (owing to the weaker sterling) have also led to longer-dated bonds selling off.

US treasuries have been mostly affected by this trend, with the 10-year yield now c. 60bps higher than mid-September, currently trading at 2.34 per cent. In Japan, the 10-year yield is now trading just above 0 per cent, trading in positive territory for the first time since mid-February. Finally, in the UK, the 10-year is priced 50bps higher at c. 1.39 per cent. Chart 2.3.3 below illustrates the recent increase across G4 sovereign yields. In the euro area, sovereign yield curves have similarly steepened over the period, with the German 10-year yield c. 15bps higher than mid-September, trading at close to 0.23 per cent. Notably, while the Irish spread to Germany increased over the period, increased by just 5bps over the period, outperforming France. Charts 2.3.4 and 2.3.5 below illustrate the trend in euro area 10-year sovereign yields and spreads respectively.

Chart 2.3.3: G4 10-year sovereign yields



2.3.2. Foreign Exchange Markets

In the weeks after the Brexit vote, the fall in sterling was the most prominent and persistent market mover. Over the review period, sterling was again negatively impacted by Brexit sentiment, most notably following Prime Minister May's indication that Article 50 would be triggered in March 2017, and the increased expectation of a 'hard' Brexit. Having fallen over 6 per cent on a trade-weighted basis in the weeks immediately following the vote, sterling fell another c. 3 per cent in the aftermath of the Conservative Party conference. However, following the Trump victory, and amid a series of better than expected economic data releases, sterling has rallied, gaining against a trade-weighted basket of currencies. At mid-December, sterling was just 6 per cent weaker on a trade-weighted basis since the vote, having fallen by close to 9.5 per cent at its post-vote trough.

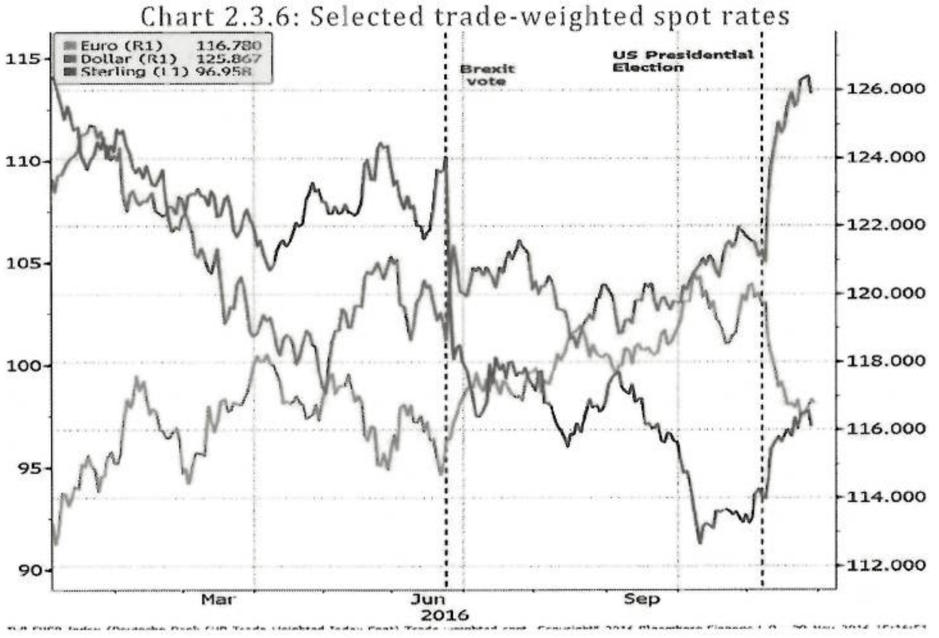
The US dollar has been the strongest performing reserve currency over the review period, up by over 5 per cent since mid-September. The Trump victory proved a catalyst for much of this appreciation, as expectations around increased fiscal spending and inflation resulted in a steeper interest rate hiking path being anticipated by market participants. Chart 2.3.6 below illustrates the trend in trade-weighted spot rates of the euro, sterling and the US dollar over 2016.

Since the update was filed on December 2, sterling has fallen by around 4% against the dollar, the euro and on a trade weighted basis. This weakness has been closely correlated to periods of increased speculation that a 'hard Brexit' strategy will be pursued by the British government, with sterling falling to a 30-year low of $1.1988 early on Monday January 16, following press reports that PM Teresa May would outline 'hard Brexit' plans within an upcoming speech. The speech was received positively by markets, however, and sterling rallied to between $1.23-1.24.

Chart 2.3.4: Euro area 10-year sovereign yields

Chart 2.3.5: Euro area 10-year sovereign spreads

Chart 2.3.6: Selected trade-weighted spot rates



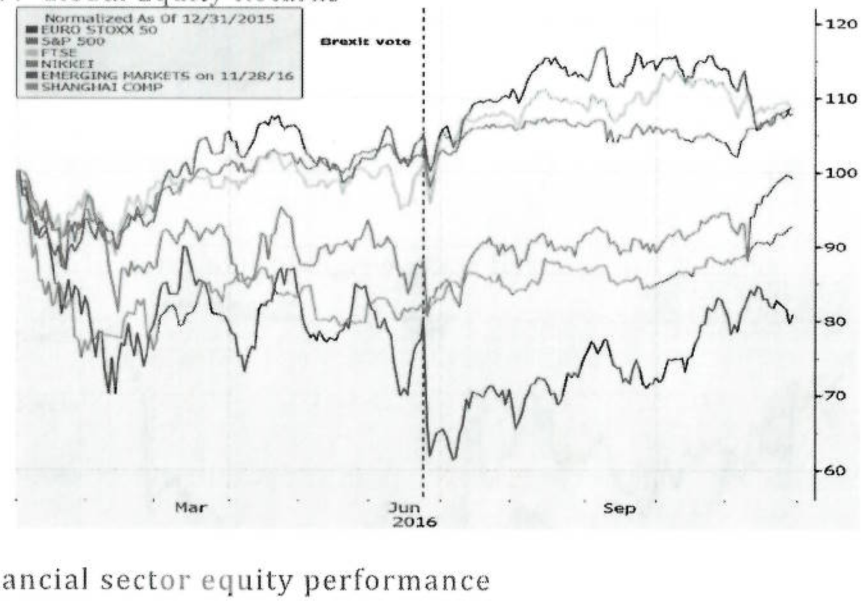
The euro has weakened over the period on a trade-weighted basis, and is c. 1.5 per cent weaker than its mid-September level. Much of this move can be attributed to the interest rate differential between the euro area and the US, which has encouraged investor rebalancing away from the euro area to other, higher yielding, jurisdictions.

2.3.3. Equity Markets

Equity performance over the review period has been relatively strong. Following the victory of Donald Trump, markets have reacted in a relatively sanguine manner, other than a brief intraday sell-off, which was quickly reversed. The exception to this performance has been within emerging market equities, which fell by c. 6 per cent in the week following the US vote. However, since this initial sell-off, emerging market equities have begun to regain some of these losses. Chart 2.3.7 below illustrates the general recovery in global equity markets since the Brexit vote.

Since the above update was filed on 2 December, the FTSE 100 rallied strongly, rising more than 9% on the weaker sterling and more positive global sentiment generally, before paring some of these gains slightly following Teresa May's speech to sit around 7% higher. The index has risen 23% since it post-referendum trough on June 27.

Chart 2.3.7: Global Equity Returns



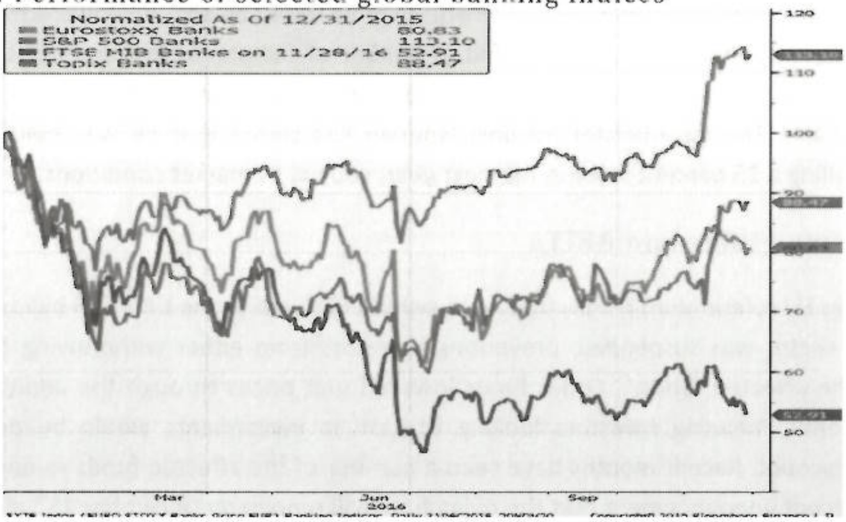
2.3.4. Financial sector equity performance

Over the period, the US financial sector has performed strongly, in light of the potential for the removal of a number of regulatory frameworks following the election of Donald Trump. The US banking sector, as measured by the S&P 500 Banking Index, has gained c. 19 per cent since Trump's victory. However, there is a wide divergence between the performance of UK bank equities. The equities of large and internationally diversified banks are up on their pre-Brexit levels, with HSBC and Standard Chartered up by c. 18 per cent and 12 per cent compared to their pre-Brexit vote levels respectively. However, smaller and more domestically based banks have underperformed, with Shawbrook and RBS down 31 per cent and 35 per cent on their pre-vote levels respectively.

Performance of the European banking sector, however, has been mixed over the period. A number of banks, particularly in the core, have benefitted from the recent uptick in yields, with the banking sector outperforming the broader market index over the period[5]. Italian banks, however, continue to underperform, with concerns of non-performing loans weighing on equity valuation. Chart 2.3.8 below illustrates the performance of global financial indices over 2016.

Irish bank equities have also been mixed over the review period. Bank of Ireland's (BOI) share price, which is heavily exposed to the UK [redacted], fell by close to 40 per cent in the days immediately following the Brexit vote. Since then, however, BOI has recouped a portion of this loss, and is now 25 per cent lower since the Brexit vote. However, BOI's share price has underperformed in recent weeks in line with the recent underperformance of non-core bank equities. Chart 2.3.9 below illustrates the underperformance of AIB and BOI share prices relative to the Eurostoxx bank index during 2016.

Chart 2.3.8: Performance of selected global banking indices



[5] Performance in other regions has been weak over the period, most notably in Italy. A number of factors, including the impending constitutional referendum and its implication for reform, and the overhanging issue of non-performing loans in the region, has resulted in the Italian banking sector, as measured by the FTSE MIB, being c. 10% down over the period

Chart 2.3.9: Performance of selected Irish banks

Allied Irish Banks' (AIB) share price ([redacted]) fell by a more modest 20 per cent in the days post-Brexit, with the bank retracing all of this loss over the remainder of the summer. Since mid-September, however, AIB's equity price has been on a downward trend, falling c. 15 per cent over the period. This comes amid a number of factors, including proposals for a cap being placed on the mortgage lending rates, and the preparation by the State for a possible offer of shares in the Bank. Finance Minister Michael Noonan has stated that he was holding open the possibility of selling a 25 percent stake in AIB next year, subject to market conditions.

2.3.5. Property Funds and REITs

Shortly after the EU referendum result, trading in seven CRE funds in the UK's £25 billion commercial property fund sector was suspended, preventing investors from either withdrawing or depositing money from the affected funds.[6] Other funds lowered unit prices through the addition of a "fair value adjustment", meaning investors looking to cash in investments would be doing so at a considerable discount. Recent months have seen a number of the affected funds re-open, however, and with the recent announcement that the Aviva fund will reopen on December 15th all seven funds which were closed will have re-opened.[7]

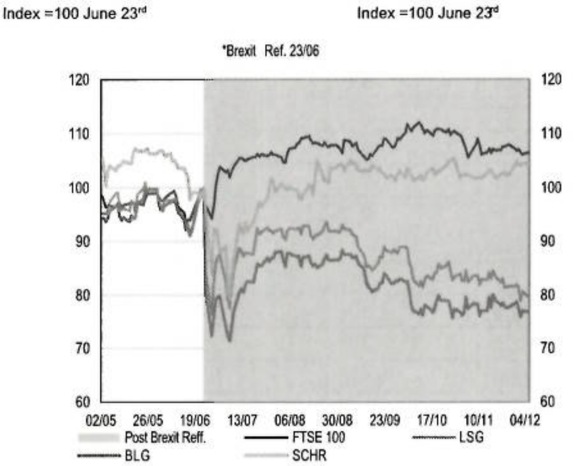
Many listed UK REITs saw their share prices drop substantially in the closing days of June, including Land Securities, British Land and Schroders, which declined by 23.5, 28.6 and 20.7 per cent respectively in the days following the referendum. While there has been some recovery in the months since, (Schroders is currently 5 per cent higher than its eve-of-vote level), Land Securities and British Land are still c.20 per cent off their pre-referendum values. Meanwhile the FTSE 100, which lost about 5 per cent of its value in the days following the Brexit decision, was 6.5 per cent higher in early December (Chart 2.3.10).

Irish listed REITs also experienced an initial share price drop following the announcement of the referendum result. While there was a recovery in subsequent weeks, REIT share prices have been declined again of late, though the more recent declines may not be totally Brexit-related (Chart

[6] Property funds managed by firms such as Aviva, Standard Life, Henderson Global Investors, Canada Life, Columbia Threadneedle/Ameriprise and M&G were amongst the affected.
[7] See "All UK commercial property funds closed by Brexit vote reopen".

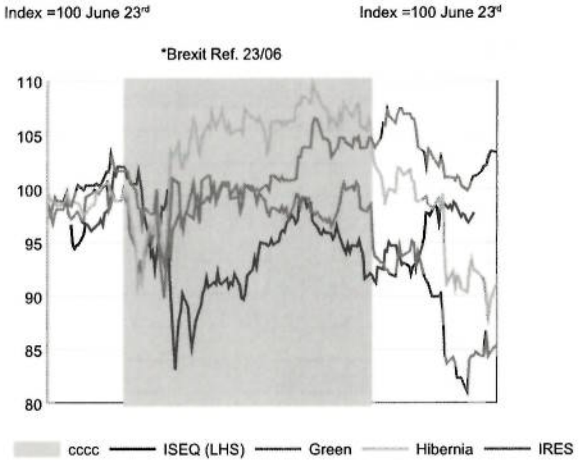
2.3.11). According to the latest data, Green REITs share price is down 19 per cent on its June 23rd level, while Hibernia and IRES are down 12 and 7 per cent, respectively. In contrast the value of the ISEQ has been increasing since early November, and is now just 2 per cent below its pre-referendum level.

Chart 2.3.10: UK REIT share prices vs. FTSE 100



Source: Datastream and central Bank of Ireland calculations
Notes: LSG = Land Securities Group, BLG = British Land Group and SCHR = Schroder Real Estate. Last observation December 5th

Chart 2.3.11: Irish REIT share prices vs. ISEQ index



Source: Datastream and central Bank of Ireland calculations
Notes: Last observation December 5th

3. Impact on Irish Economy

3.1. Macroeconomic impact

3.1.1. Central Bank forecasts

The Bank published its last set of macroeconomic forecasts in October (Quarterly Bulletin No. 4, 2016). These are summarised in the Table below. The projections accounted for likely assumed short-term Brexit related effects with 0.2 and 0.6 per cent shaved off GDP growth rates in 2016 and 2017, respectively. Some newer preliminary forecasts for the forthcoming Quarterly Bulletin (including projections for 2018) are shown below. *These forecasts are unpublished and are subject to revision.* The outlook remains similar for 2016 but lower (by 0.3pp) in 2017 largely reflecting weaker external demand conditions. Overall strong, albeit moderating, growth rates are expected (towards 3 per cent) in the short-term. Inflation is quite a bit lower than envisaged back in the autumn partly reflecting the weakness of sterling.

The economy continues to perform well as evidenced by strong labour market data. The *Quarterly National Household Survey (QNHS)*, published in November, showed employment growth of 0.7 per cent in the third quarter, with broad based gains across sectors. This brought the year-to-date increase in employment to 2.7 per cent. The unemployment rate dropped to 7.9 per cent in the third quarter and, more recently, was estimated to have declined to 7.3 per cent in November – its lowest level since 2008. These data give little indication of any pronounced Brexit effects in the economy to date, although other higher frequency data sources are more mixed.

Table 3.1.1: Growth Outlook - Quarterly Bulletin No.4 and Preliminary Outlook for Bulletin No.1 2017

Growth Rates, %	2015	2016f	2017f	*2016e preliminary*	*2017f preliminary*	*2018f preliminary*
Consumption	4.5	3.8	2.2	*3.6*	*2.4*	*2.1*
Government	1.2	2.5	1.1	*8.2*	*2.0*	*2.4*
Investment	32.7	14.0	7.0	*13.0*	*6.8*	*6.9*
Underlying Domestic Demand	4.9	3.9	2.7	*4.5*	*3.0*	*2.8*
Exports	34.4	5.6	4.4	*5.5*	*4.1*	*3.9*
Imports	26.7	7.8	4.7	*7.8*	*4.8*	*4.7*
GDP	26.3	4.5	3.6	*4.6*	*3.3*	*3.0*
GNP	18.7	4.5	3.1	*4.5*	*2.7*	*2.4*
BoP Current Account (% of GDP)	10.2	8.1	8.1	*8.4*	*8.5*	*8.3*
Unemployment rate (%)	9.4	8.3	7.7	*8.0*	*7.1*	*6.4*
Labour force	0.5	1.5	0.8	*1.3*	*0.7*	*0.7*
Employment	2.5	2.6	1.5	*2.8*	*1.7*	*1.5*
Inflation HICP rate (%)	0.0	0.0	1.0	*-0.2*	*0.5*	*1.3*

Domestic demand is the main driver of growth this year and over the forecast period. The preferred metric - underlying domestic demand - is projected to rise by over 4 per cent this year before moderating to close to 3 per cent over the period to 2018.[8] This is driven by the favourable outlook for consumer and investment spending supported by strong gains in incomes. Net exports are expected to act as a slight drag on output this year, before turning positive over the forecast horizon. Overall, we expect to see growth in the region of 4½ per cent this year, with GDP growth closer to 3 per cent in 2017 and 2018.

Higher frequency data developments since the Brexit referendum have been mixed. Labour market data aside, there are some signs of moderation throughout the economy. On the consumer side, the ESRI/KBC Bank Consumer Sentiment Index declined to a 20-month low in October before recovering marginally in November and it appears that consumers are finding it more difficult to assess their economic circumstances. Retail sales growth have slowed, with sales effectively flat in the quarter to October. VAT receipts, although still up in year-on-year terms to October, have surprised on the downside. While some moderation in consumer spending was anticipated, there appears to be increasing evidence of Brexit related effects both in terms of sentiment and the potential for increased cross border shopping and online purchases following the weakening in sterling.

On the output side, headline PMI indicators have softened since June. However, the degree to which these indicators are correlated with wider economic activity in Ireland is questionable given the fact that a limited number of (very large) companies can directly impact the growth rate. Manufacturing output was down by 0.7 per cent in the first 10 months of the year according to the monthly industrial production series (which is volatile). Within this, output in the traditional sector was down by 1.4 per cent over the same period indicative of more difficult operating conditions for those firms most exposed to the UK market.

[8] This measure excludes volatile components of investment spending from domestic demand and appears to be more closely correlated with movements in employment. See Box B, Quarterly Bulletin No.1, 2016.

Monthly merchandise trade data have been much softer this year. In the first 9 months of the year, exports (in nominal terms) were up 4.9 per cent with imports up 1.8 per cent. More traditional sectors (such as food and beverages) are reporting smaller increases in exports. It is important to stress however the significant dis-connect between these data and National Accounts aggregates due to the effect of contract manufacturing. The latter do not show up in the merchandise trade data as these reflect the physical movement of goods across borders whereas National Accounts trade data are based on trade on an ownership basis.

Exchequer tax receipts (in the year to October) have performed reasonably well, rising by 4.7 per cent over the year due in part to strong corporate and excise taxes. Certain key tax categories such as income tax and VAT receipts however have underperformed (although still registering year-on-year increases). These trends need to be closely monitored in November - a key tax month.

Within IEA, a number of modelling developments have taken place. In particular, a GVAR (Global Vector Autoregression) model has been developed to simulate the effects of shocks to the Irish economy. The model estimates the impact of four different shocks on the Irish economy, which includes a fall in UK GDP. This shows that GDP in Ireland responds considerably more negatively than either the US or the euro area to a 1 per cent fall in UK GDP, with an elasticity of about 0.3 per cent. The GVAR results are fairly similar to the estimates presented for Ireland in the Bulletin cited above. The latter estimates were based on a Bayesian VAR model.

3.1.2. Department of Finance and ESRI ongoing analysis

As part of Budget 2017 the Department of Finance published Sectoral Analysis titled 'UK EU Exit –An Exposure Analysis of Sectors of the Irish Economy'. The analysis shows that the sectors most affected by Brexit are generally small scale indigenous enterprises, with high levels of regional employment and relatively low profit levels. In terms of indigenous sectors, Food and Beverage, Electrical Equipment, Materials manufacturing and 'Traditional' Manufacturing are highly dependent on the UK both as a source of exports and for overall turnover.

On 7 November, following on from the 2015 study 'Scoping the Possible Economic Implications of Brexit on Ireland', the Department of Finance and ESRI published a report titled 'Modelling the Medium to Long Term Potential Macroeconomic Impact of Brexit on Ireland'. The potential economic impact of Brexit under a number of scenarios is presented in the paper. These are (i) a Norwegian type arrangement (EEA); (ii) a Swiss type free trade agreement (EFTA); and (iii) WTO rules. The paper indicated that, regardless of the type of exit scenario, the impact on economic growth is negative relative to a 'no-Brexit' baseline, with the largest effects occurring in the first five years.

The ESRI has also independently taken one scenario from that work, the (WTO) trade scenario, and completed some further analysis, titled 'The Product and Sector Level Impact of a Hard Brexit across the EU' outlining that trade in food and textiles would be hardest hit under this scenario, this report was published on 24 November.

3.2. Property sector

According to the latest available IPD data (2016Q3), total returns on Irish commercial property remain higher than many international peers. Similarly, although capital and rental value growth has waned in recent quarters, it is still quite robust at 9.8 and 9 per cent respectively (Chart 3.2.1).

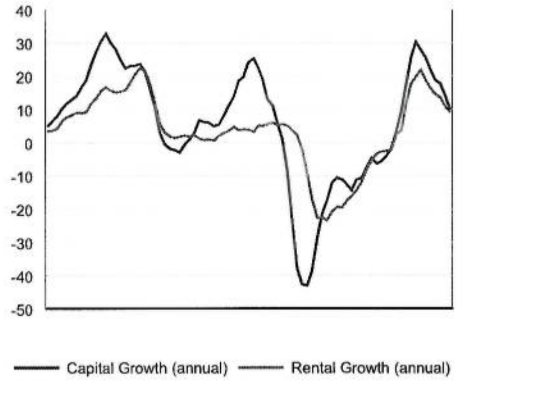
Irish commercial property agents continue to report a brisk flow of Brexit related queries. While the majority are likely to be preliminary scoping exercises at this stage, it is important that the country and Dublin in particular, has sufficient office space, housing and any other necessary infrastructure to facilitate any increase in occupier demand that may occur as a result of Brexit.

To this end, CBRE have been investigating concerns that Dublin may not have enough office stock to cater for Brexit-related relocations. According to their findings, 373,000 square metres are currently under construction in 29 individual schemes, of which just over one fifth is currently reserved. Upon completion, this extra capacity will add approximately 10 per cent to the stock of office accommodation in the capital. A further 433,000 square metres, in 37 individual schemes has a grant of planning permission and could also be commenced if required, which should give comfort to potential occupiers that Dublin is more than capable of providing sufficient high quality office accommodation if required.

While relocation activity has been rather muted to date, recent figures from the Law Society suggest the legal industry show that fears of market access are having an effect on UK businesses and their service providers. Overall, the Law Society reported a record 1,347 new additions to their register in 2016, an increase of more than 500 on the previous 2008 record. Of these, 810 were UK solicitors compared to only 70 in 2015. English and Welsh solicitors may enrol in Ireland without the need for further qualifications given the close similarities between the legal systems in both countries. Solicitors who want to retain rights of audience in the Court of Justice of the European Union need to be registered in an EU member state. Such early moves serve to highlight Dublin's appeal as a key relocation option, given the similarities between the business and legal systems, and could, according to Goodbody stockbrokers, increase the speculation surrounding the likelihood of firms opening offices in Dublin which will fuel further demand for office space here.

Chart 3.2.1: Ireland commercial property capital and rental growth

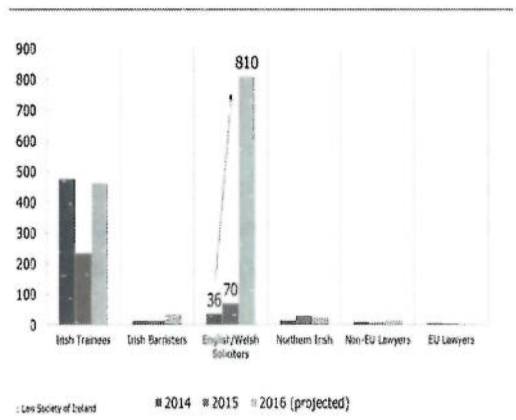
year-on-year, per cent | year-on-year, per cent



Source: MSCI/IPD and Central Bank of Ireland calculations

Chart 3.2.2: Increase in the number of UK solicitors registering in Ireland

year-on-year, per cent



Source: Law Society of Ireland

In terms of an impact on the residential market, one of the main issues surrounding Brexit concerns supply and the ability of the market here to cope with a surge in demand for accommodation should there be a widespread relocation of UK based firms/workers here. It is likely that this would put further upward pressure on prices, at a time when there is a severe shortage of units for sale or rent.

4. Sectoral Developments

4.1. Banking

4.1.1. Domestic Banks (SIs)

BSSD's engagement with domestic banks has intensified in line with the banks' own consideration of the impact of the outcome of the referendum on their respective business models and operations. As noted in the September 2016 report, Brexit effects are manifesting themselves differently on the domestic banks versus the international banks.

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

4.1.2. International Banks

The Central Bank continues to see increased levels of engagement regarding potential authorisations, notifications and licence applications from international banks. The intensity of some of these engagements has increased with meetings being held jointly with BSSD, BSAD and IFFS representatives in some instances, as a number of institutions look to assess the different types of activities for which they may seek approval. These activities include [redacted] and new banking activities, as well as notifications that banks are looking to expand current operations already established in Ireland. [redacted] Any bank increasing in size beyond €30bn will become a significant institution under the SSM methodology, and will be directly supervised by the ECB / SSM once a comprehensive assessment, which includes an asset quality review and a stress test, is undertaken.

[redacted] These enquiries generally come under three broad headings: i) new entrants seeking first time authorisations; ii) currently authorised firms seeking to expand existing operations in Ireland; and iii) firms reversing plans to wind down operations in Ireland as a result of the Brexit vote.[9]

The enquiries vary in type from applications for full bank licences, to branches and investment firms. [redacted]

4.1.3. Internal Considerations

Banking supervision is actively engaging with other areas of the bank (notably Markets, Insurance and Policy & Risk in particular), as well as directly with the SSM, to ensure that there is a good understanding and a consistency in approach to engaging with firms post Brexit. Meetings are also being scheduled with the UK PRA and FCA for early in the New Year.

[redacted]

As with other areas of the bank, the resourcing challenges faced in banking are sizeable and will intensify as a result of Brexit, particularly as the Central Bank will both be trying to retain and attract resources that are likely to be wanted by firms moving business to Ireland.

4.2. Insurance

4.2.1. Queries on Authorisations

The main activity in the Insurance Directorate as a direct result of the Brexit vote has been in relation to the number of queries for possible new authorisations. Currently INS are working on [redacted] applications [redacted] However, there are another [redacted] applications in the pipeline [redacted] It is expected that several applications from larger firms will be received in the first half of 2017 as they desire certainty over their business planning.

[9] Applications for authorisations across different sectors are considered in more detail in section 5.

Currently the [redacted] contingency plans have been made to provide resources as further applications are received.

There is a large variety in potential applications in terms of size and types of business model but nothing that is beyond the current range of undertakings already authorised by the Central Bank. However, many of the queries relate to Lloyds of London Market business which could see an increased concentration for the Central Bank of this type of risk.

4.2.2. Update on the impact on and preparedness of entities

The majority of Irish regulated entities have little or no direct business with the UK, although many high impact non-life firms do sell a portion of their business there, particularly in Northern Ireland. For the companies not selling in the UK the impact of Brexit will be limited to the impact on financial markets in general and any economic slowdown in the markets to which they sell. As noted elsewhere in the report it is difficult now to identify the direct impact of Brexit on financial markets and economic performance but the experience to date has not been outside the levels allowed for in the stress testing performed by undertakings.

For those Irish undertakings that sell into the UK there is potential for their business model to be affected. The extent of the impact will largely depend on the proportion of their sales that are to the UK and whether those sales are made via a branch or by using the passporting arrangements available within the EU. The undertakings assessments of the impacts and the plans they are making are being monitored by supervisory teams as part of their regular contact with the undertakings. [redacted]

Currently the Insurance Directorate is finalising it plans for 2017 and included in the proposals are several items related to Brexit

- [redacted]
- The Cross Border team will investigate the preparedness of the entities it supervises that are directly impacted by Brexit and review the stress scenarios;
- A case study of the Northern Ireland market will be undertaken by the Domestic Non-Life section as many of these companies sell on an all-Ireland basis;
- The Domestic Life team will perform an impact assessment on their entities, although these do not have any sales to the UK; and
- A general review of the stress testing undertaken as part of the ORSA process will be performed to assess the overall quality and range and this will include an assessment of the coverage of possible Brexit scenarios.

4.2.3. Potential impact on Irish consumers of UK companies exiting the Irish market

A significant amount of premium is written by UK entities selling into Ireland across life and non-life business and using both branches and passporting arrangements. Some of these entities have already contacted the Central Bank in relation to setting up subsidiaries to continue sales. However, some business based in Gibraltar have been offering business on a passporting basis, though volumes of sales vary significantly from period to period, and these seem less likely to set up Irish subsidiaries.

Hence it seems likely that the Irish insurance consumer will only suffer some limited impact from Brexit as the majority of businesses from the UK or Gibraltar currently selling in Ireland look to be making arrangements to continue doing so. However, there may be a small reduction in competition in some markets if some companies currently selling in Ireland cease doing so.

4.3. Markets Directorate

The key risks for the Markets Directorate following the Brexit referendum have to date focused on the potential increase in applications for authorisation and the corresponding implications for staffing and ongoing supervision. There has been a significant increase in the volume and complexity of Brexit related queries received and a large number of authorisations meetings have taken place. Many of these engagements have been preliminary in nature. [redacted]

Enquiries to the Markets Directorate thus far indicate that potential migrations of UK based firms to Ireland could occur across multiple sectors. A total of [redacted] Brexit related enquiries have been received from various sources including legal firms, the IDA and the entities themselves. Table 4.3.1 provides a breakdown of the types of the enquiries received.

A diverse cross-section of entity types and business models has emerged, [redacted] Cross-Bank initiatives have already commenced with two separate Taskforces established to assess our expectations and processes [redacted] and CSDs. Relevant Taskforces are made of representatives from IFFS, PSSD, MPD, FSD, Risk, Banking and Legal.

The Markets Directorate faces significant staffing challenges in relation to the additional resources required to review applications and understand clearly the risks inherent in these businesses, including how they are managed and mitigated. Technical skills and supervisory expertise will be required for the authorisation and ongoing supervision of other complex entity types such as Multilateral Trading Facilities ('MTFs') and Systematic Internalisers ('SIs'). It is expected that Brexit and the expanded scope of MiFID II will increase the numbers of MTFs and SIs in Ireland.

Table 4.3.1: Brexit related enquiries by entity type

Entity Type	Number of enquiries
[redacted]	[redacted]
[redacted]	
[redacted]	
[redacted]	

[redacted]		[redacted]	
[redacted]		[redacted]	
[redacted]		[redacted]	
[redacted]		[redacted]	
[redacted]		[redacted]	
[redacted]		[redacted]	
[redacted]		[redacted]	

4.4. Consumer protection

Consumer Protection (CPD) is responsible for the authorisation of Payment Institutions (PI) and Electronic Money Institutions. Since the last report in September, CPD have seen a moderate increase in Brexit-related enquiries, [redacted] While the vast majority of pre-application meetings have been with existing UK authorised PIs/EMIs, CPD have also received a few enquiries from firms who are not yet authorised and who are considering their options as a result of Brexit.

The enquiries/meetings dealt with to date have been a broadly even mixture of both PI and EMI enquiries [redacted] All firms that opted for meetings appear to be seriously considering applying for authorisation in Ireland [redacted] have indicated that they intend to apply. The main topic of these meetings is the firms seeking to understand our authorisation process, how it works and the service standard timeframes that apply. Some have asked is there any 'special' route or process for firms already authorised (which there is not) and some asked how the Central Bank would cope if there was a 'rush' of applicants. Many of the firms made initial contact via the Fintech and Payments Association of Ireland (FPAI) and feedback from the FPAI has indicated that the firms have found the meetings useful and that the authorisation process would not be a barrier to them.

Whilst the purpose of these meetings is for the Central Bank to provide an overview of its authorisation process, the potential applicant firms have also typically provided a broad overview of their existing business. The activities outlined at these meetings do not appear to be significantly different to those which our existing authorised PIs/EMIs undertake, and we have yet to come across any particularly radical or new activities being proposed. However, it will not be clear as to the business model that an applicant proposes to put in place unless and/or until an application for authorisation is submitted. Any increase in applications will have an impact on resources and expertise in both CPD's authorisation and supervision teams.

5. Authorisation Activity

5.1. Overview

This section has two purposes, firstly it is a collation of information from Supervisory Divisions on engagement with firms and other activity in the context of Brexit[10], secondly it highlights some potential implications of increased authorisation activity for the CBI.

The Supervisory Risk Policy team within the Supervisory Risk Division will collate this information on a regular on-going basis. The team welcomes feedback as to the content of the document and any suggestions for additional information to be added. It has been decided by Senior Management in PRD that this information is strictly confidential and cannot be shared without approval, beyond the Taskforce.

The document is divided into two sections:

- The first provides a high level overview of the Brexit related pipeline in each division as at 28th November 2016 and a commentary on some related developments.
- The second outlines some high level considerations of increased Brexit related authorisations work.

As at 28th November the CBI has received the following number of Brexit related authorisation queries:

Table 5.1.1: Brexit related enquiries received across divisions

Sector	Number of Brexit Related Enquiries As At	
	28th November	*17th October*
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]

[10] These figures have been provided by Divisions on a best efforts basis and provide an indication of Brexit related activities/engagements in each Division.

[11] Payment Institution/ Electronic Money Institution

[12] CPD have revised down their figures since October due to reclassification of some engagements.

Of the [redacted] Brexit related enquires, as at 28 November 2016, the engagement breakdown is as follows:

Table 5.1.2: Brexit enquiry method of engagement

Sector	Meetings	Phone call/other	Total
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]

Table 5.1.3: Brexit enquiry form of engagement

Sector	Initial/Information seeking	Firm intentions to apply for authorisation	Application received/activities expanded	Total
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

5.2. Banking

Banking have had Brexit-related contact from [redacted] banks since the UK vote. This contact encompasses a wide and diverse group of entities parented in eight different countries, both within the SSM and from 3rd country jurisdictions within the EU and globally. At this current stage all enquiries have been information seeking rather than the submission of hard proposals. Discussions have taken place with [redacted]

[redacted] currently authorised entities have discussed increasing their activities in Ireland as a result of the vote, while [redacted] entities have discussed reversing plans to wind down current operations in Ireland as a result of Brexit.

The remainder have focused on conversations with senior management around their intentions to explore the idea of conducting banking operations in Ireland and what would be required in terms of the authorisation process.

5.3. Insurance

Insurance Directorate has had a significant increase in the volume of enquiries around authorisations since the Brexit vote. [redacted]

The majority of these enquiries are for a base to write new business as part of Pan-European operations rather than the movement of existing books of business as a result of Brexit. [redacted]

It appears at this stage that the majority of the business models being proposed are models we would have seen before and would have the necessary skillset to effectively oversee. Of course others lines of business may be introduced that will require development/addition of existing skillsets/experience.

Outside of resourcing the broader challenges will include:

- Increase in the amount of cross-border business being written from Dublin will increase the complexity of the authorisation. However, this is not new for the Directorate and therefore models currently used can be expanded;
- Potential new business lines being introduced that will require development of greater understanding within the Central Bank to give effective oversight (e.g. a significant increase in Lloyds market business). This will require additional resource or training;
- Potential for firms seeking authorisation with an internal model – as yet under Solvency II all authorisations have been under the standard formula. However, as the internal model would need to change due to the establishment of Irish operations there would still be a clear need for oversight;
- Firms expecting a "light touch" in terms of authorisation as they were already authorised by the PRA. This can be solved through clear communication and reinsurance that a lot of the same information would be required;
- Impact on the Irish insurance market of a number of firms needing significant management, including the potential impact on wages and ability to retain staff at the Central Bank;
- Need to grow the size of Insurance Supervision should there be a number of significant businesses that locate in Ireland as a result.
- There is also the possibility that post the Brexit vote, firms (particularly from America but new start-ups too) which would have traditionally gone to the UK would look to set up a base in Dublin. Therefore, this could mark a permanent increased level of authorisation activity (depending as ever on the outcomes of the Brexit negotiations).

In terms of resources the volume of potential authorisations is significantly above that which has been seen over the past few years. As such, should the pipeline that has been seen materialise into actual applications; then this will have a significant impact on the Directorate.

The directorate has started planning for this increase in expected demand as follows:

[redacted]

- Consideration of resources needed in 2017 planning for department;
- Use of external actuarial resource to undertake technical reviews;
- Potential request for additional headcount, either temporarily or permanent (if it is likely that further authorisations will materially increase the business that needs to be supervised).

5.4. Markets

5.4.1. IFFS

IFFS continues to receive a significant volume of queries in relation to authorisation processes, although the level has dropped by about 50 per cent during November, compared to October. These relate to a range of firm/entity types which are currently examining a potential relocation from the United Kingdom.

The queries have typically been submitted via state agencies (for example, IDA Ireland) and local legal firms. However, in some instances the queries have been submitted directly from the entities concerned. Most enquiries continue to be mainly in respect of MiFID Investment firms with some of the more recent ones from larger sized internationally-branded firms. [redacted]

The total number of Brexit related enquiries to date is [redacted] and IFFS has met with [redacted] firms. In addition, [redacted] meetings are being planned.

IFFS has broken down the enquiries by business model type as follows (October briefing):

In terms of the types of business being enquired about approximately [redacted] per cent - [redacted] per cent relates to business models we are familiar with in terms of authorisation and supervision. The remaining [redacted] per cent [redacted] per cent is made up of the following types of entities:

CCP
There are no CCPs authorised by the CBI at present. [redacted]

MTFs or exchanges
Although there are a limited number of these firms operating in Ireland at the moment, this business model relies on significant IT infrastructure which the CBI would need to develop the expertise to oversee.

Systematic Internalisers
There are only 11 of these currently operating in Europe at present and none in Ireland. Under MIFID II, the CBI anticipates that we will receive applications for such business models to operate in Ireland. Again the CBI would need to develop the expertise to oversee.

General Clearing members, Central Securities Depositories, EMIR trade repositories
These are other examples of complex MiFID entities that may seek authorisation here. All of these would require expansion of CBI expertise. [redacted]

CFD Provider
[redacted]

5.4.2. SMSD

The enquires received in SMSD have been almost entirely for business models/entity types that the Central Bank is used to dealing with and assessing on a business as usual basis. [redacted]

[redacted]

In terms of investment funds, the indirect effect of new service providers establishing in Ireland will be an increase in the volume of authorisations or re-domiciliation of UK funds to Ireland.

It was also noted that any increase in the number of market participants located in Ireland (for example if IFFS authorise more MiFID firms, including high frequency traders, multilateral trading facilities) would result in an increase in reporting received in the Markets Integrity Unit of SMSD.

[redacted]

5.5. Consumer protection
CPD have had contact from [redacted] firm's/industry bodies in relation to Payment/e-money institutions. If a large percentage of enquiries convert to applications, resources will be stretched, though there is no evidence of this to date. A contingency resource bid has been proposed.

6. Special Topic 1: Risk appetite

As was noted in previous TF reports, Brexit may result in a number of UK-based entities seeking authorisation from the Central Bank to maintain access to the Single Market, depending on the nature of the agreement ultimately reached between the UK and the EU. Supervisory divisions have already seen an increase in exploratory discussions with institutions across a number of sectors (see Section 5) and these discussions have been at information seeking stage rather than concrete proposals in the vast majority of cases. [redacted]

- [redacted]
- [redacted]
- [redacted]

Notwithstanding the above it is important to be prepared, and give consideration to potential key issues, key policy considerations and key decision points in advance of the receipt of a formal material application for authorisation. Accordingly, and consistent with our publicly stated position of standing ready for such applications, and so that we can prioritise consideration of the elements outlined above, a number of Bank wide workstreams have commenced. Specifically, work underway on matters arising from Brexit includes;

1. [redacted]
2. [redacted]
    - [redacted]
    - [redacted]
3. Markets policy issues (MPD-led)
4. Individual authorisation inquiries (IFFS-led)

The outputs from these workstreams[14], in particular (1) and (2) above should inform a coordinated discussion at senior management levels [redacted] for approving new authorisations or amendments to existing authorisations arising from Brexit. [redacted]

6.1. Risk Appetite

[redacted]

[14] Going forward it would be the intention to involve colleagues from INSS, INSA and BSSD as we haven't substantially engaged with colleagues in those areas at this point.

[redacted]

[redacted]

[redacted]

[redacted]

- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]

[redacted]

[redacted]

[redacted]	[redacted]
[redacted]	- [redacted] - [redacted] - [redacted]
[redacted]	[redacted] - [redacted] - [redacted] - [redacted]
[redacted]	[redacted] - [redacted] - [redacted] [redacted] - [redacted]
[redacted]	[redacted] - [redacted] - [redacted] - [redacted] - [redacted] - [redacted] - [redacted] - [redacted] [redacted] - [redacted] - [redacted] - [redacted]
[redacted]	[redacted] [redacted] [redacted] [redacted]
[redacted]	[redacted] [redacted]

6.2. [redacted]

[redacted]

- [redacted]
- [redacted]
- [redacted]

[redacted]

1. [redacted]
2. [redacted]
3. [redacted]

[redacted]

[redacted]

6.3. Central Securities Depositories workstream

CSDs are regulated under a specific piece of legislation, the European Union CSDR. They can be of two types: one with and one without a banking licence. A CSD without a banking licence will need to arrange for payment agents to handle the settlement (in the case of commercial bank money) or connect to T2S for central bank money settlement. CSDs must operate a Security Settlement System, which requires specific designation from the Minister of Finance (under the transposition of the Settlement Finality Directive), and the Minister of Jobs, Enterprise and Innovation under Uncertificated Securities Regulation (USRs).

The Central Bank has limited experience and supervisory expertise regarding CSDs. To-date our involvement is limited to CREST, operated by Euroclear UK & Ireland. [redacted] The Central Bank is the T2S "distributing agent" for Ireland, but to date Ireland has no active connections. An applicant CSD would therefore likely become the first connection. This in turn would have implications in terms of IT planning and project management.

Work carried out so far with regard to CSDs can be divided into two separate streams:

1. Policy stream, led by MPD, and focusing on legislation, regulation and transposition. This started with the active support of the Department of Finance in processing the level 1 through Council & Parliament during Irish Presidency, [redacted] It terminated with the transposition by the Department of Finance, [redacted]
2. Supervisory stream. [redacted] This work stream can be further divided into three branches:
    a. Internal responsibility: to determine who within the Central Bank would receive the application, process the authorisation, and ultimately supervise the CSD. It was agreed that IFFS would be the supervisory lead.
    b. SSS: one of the core functions of the CSD is operator of a Security Settlement System. This is distinct from the CSD, [redacted].
    c. Banking licence. The regulation supports two CSD models: one which is a pure CSD, and the other that holds a dual licence (CSD + Bank). [redacted]

At present there are no effective technical standards enabling the Central Bank to accept and authorisation application by a CSD. However, it is expected that these will come into force in April 2017, and applications may be expected from that point onwards. To coordinate and progress the supervisory work PSSD & IFFS (with the technical support of MPD) have established a supervisory task force to explore issues and draft a work-plan. The task force has a wide internal membership, across all potentially affected areas in the Bank, including banking supervision. The first meeting, held Monday 28/11, highlighted need for:

- raining on both the content of the CSDR text and in terms of business models and CSD functionalities. Training will be provided by MPD in the coming weeks;
- Terms of Reference, which are being presently drafted;
- a template for the approval process: we are currently working off the [redacted] and subsequent AAR as a reference model.

7. Special Topic 2: Equivalence

7.1. Sectors and equivalence regimes

Certain EU financial regulations envisage the possibility for third countries to obtain 'equivalence' to EU legislation.

Whether or not equivalence is available -and what it implies- varies across legislations. In some cases, the EU legislation has included a "third country regime" which allows non-EEA firms to provide services into the EEA if their home country regulatory regime is "equivalent" to EU standards. In other cases, equivalence clauses serve other limited purposes (e.g. risk-weights to be applied by EU institutions to exposures to third-country firms for the calculation of prudential ratios).

Equivalence determination involves the relevant European Supervisory Authority providing technical advice to the European Commission (DG FISMA) on how the third country's laws and regulations compare to the corresponding EU requirements[15]. In practice, this means the EU assess whether the legal, regulatory and/or supervisory regime of a third country is as good as its own. The European Commission then puts its proposed decision, based on the technical advice, to a vote of EU member states.

Many commentators[16] believe that UK financial institutions cannot rely on equivalence between UK and EU because it is an inherently uncertain and lengthy process (it took Canada 3 years to become equivalent under EMIR for the purpose of its legal and supervisory regime for CCPs), unstable (equivalence can be revoked in 4 months) and has a narrow focus (tends to relate to specific aspects of the relevant legislation such as specific exposures or products rather than a blanket application to a regime).

Although equivalence of a country's supervisory and legal regime is the critical factor in determining whether or not a third country firm can provide services within the Union it is not always the only requirement. For example, in EMIR, ESMA's board ultimately decides whether or not to recognise a third country CCP, this is subject to significant analysis to ensure that the measures which the Commission has prescribed in its equivalence decision are adhered to on a case by case basis.

There are currently around 40 equivalence requirements in place in total[17]. The Table below outlines a high level overview of the key regulations, their equivalence regimes (if any), and their relevance to individual sectors.

[15] http://ec.europa.eu/finance/general-policy/global/equivalence/index_en.htm

[16] https://www.ft.com/content/265ab62e-4842-11e6-8d68-72e9211e86ab

[17] http://ec.europa.eu/finance/general-pol icy/docs/global/equivalence-table_en.pdf

Table 6.1.1: Overview of equivalence regimes

Legislation	Equivalence Decision	Banks	Funds	Insur.	Invest Mgmt	FMIs	Other
Accounting Standards For Prospectus And Consolidated Reporting	Third country GAAP with IFRS	■	■	■	■	■	■
AIFMD	Authorisation of a non-EU AIFM- extension of passport to non-EU AIFMs and non-EU AIFs		■		■		
Benchmark Regulation	Benchmark administrator - use of benchmark within the EU						■
BRRD	No equivalence regime	■					
CRR	Exposures to third country investment firms and exposures to third country credit institutions and exposures to third country clearing houses and exchanges	■			■	■	
	Exposures to central governments, central banks, regional governments, local authorities and public sector entities	■			■		
CSDR	Equivalence of CSDs	■	■	■	■	■	■
Electronic Commerce Directive	No equivalence regime	■	■	■	■	■	■
Electronic Money Directive II	No equivalence regime	■		■	■	■	■
EMIR	Bilateral exchange of margin and other risk mitigation techniques	■	■	■	■	■	■
	Equivalence of CCPs	■	■	■	■	■	■
	Equivalence of Trade repositories	■	■	■	■	■	■
	Reporting of exchange traded and ITC derivatives	■	■	■	■	■	■
EMIR	Mandatory clearing of certain OTC derivatives	■	■	■	■		■

Financial Collateral Directive	No equivalence regime	■			■		
Insurance Mediation Directive	No equivalence regime			■			
MiFIR / MIFID II	Trading obligation for investment firms	■			■		
	Obligation to trade on regulated markets, OTFs or MTFs	■			■		
	Trading obligation procedure	■			■		
	Mechanism to avoid duplicative or conflicting rules	■			■		
	Access for 3rd country CCPs and trading venue					■	
	Investment firms providing investment services to EU professional clients and eligible counterparties	■			■		
	Transactions executed with eligible counterparties	■			■		
Mortgage Credit Directive	No equivalence regime.	■					
Payment Services Directive I & II	No equivalence regime	■				■	
Single Euro Payments Area	No equivalence regime	■				■	
SFTR	Trade repositories	■	■	■	■	■	■
	Reporting of security financing transactions	■	■	■	■	■	■
Solvency II	Equivalence regime which provides for third countries being deemed equivalent in respect of: - Group supervision - Group SCR - Reinsurance arrangements with TC providers			■			
UCITS Directive	No equivalence regime		■				

7.2. UCITS/AIFMD

This section provides information specifically in relation to the UCITS and AIFMD regimes where a UK investment manager manages and markets UCITS and/or Alternative Investment Funds (**AIFs**) in the EEA.

Post Brexit the UK becomes a third country under both regimes and passport rights in relation to the fund (UCITS or AIF) and the management company (UCITS Management Company or AIFM) are no longer available.

7.2.1. Undertakings for Collective Investment in Transferable Securities Directive ('UCITS Directive')

UCITS are domiciled in the EEA and are managed by an EEA UCITS Management Company. The UCITS regime provides a product passport which allows UCITS be sold cross-border throughout the EEA. It also provides a management company passport which allows a UCITS Management Company (ManCo) manage UCITS in other Member States. Post Brexit, UK authorised UCITS will lose the UCITS status and under the UCITS regime will be classified as Non-EU AIFs. UK UCITS Management Companies will not be able to act as the management company for UCITS in other Member States.

The UCITS Directive does not have a third country regime. In light of the above the following scenarios are possible:

- Where a UK authorised Management Company markets its UK UCITS to UK investors only Brexit has no impact. The UK Management Company and the UK UCITS (AIF) will continue to be authorised in the UK. Indications are that the target market for the majority of UK UCITS is indeed domestic.
- Where a UK fund manager markets its EEA UCITS (i.e. UCITS authorised in the UK or in another EEA Member State) to EEA investors it could:
    - Establish a new UCITS Management Company in an EEA Member State and re-domicile the existing UCITS to that Member State to be managed by the new entity. In this scenario, the new ManCo could delegate investment management to the UK fund manager. Delegation will be possible provided the UK is considered to be an acceptable jurisdiction by the NCA in the relevant Member State and appropriate co-operation arrangements have been put in place between that NCA and the FCA. If Ireland is the relevant Member State, the new ManCo must comply with Irish authorisation standards, notably those referenced in the Central Bank's current work on organisation of fund management companies (CP 86). [redacted]
    - Enter into an arrangement with an existing UCITS Management Company in an EEA Member State pursuant to which the UK fund would also re-domicile. Delegation arrangements could be considered as above.
    - Seek approval from the relevant EEA Member States where the UK UCITS is currently being marketed to continue marketing as an AIF. This matter is addressed further in the context of the AIFMD regime.
- Where a UK manager has an established UCITS Management Company in an EEA Member State the impacts are minimal. Many UK promoters wishing to market UCITS on a cross border basis establish these products in EU locations, such as Ireland, Luxembourg or Malta. In most instances, the promoters establish Management Companies in those jurisdictions and delegate investment management to a UK investment manager. Post Brexit the delegation arrangements will require some consideration as set out above.
- Some additional considerations which may arise:

- **Target Funds –** Other UCITS may invest in UK UCITS in accordance with eligible asset rules. Investment in UK UCITS will be limited post Brexit which will impact many investment mandates of EEA UCITS Management Companies. Non-UK EEA UCITS Management companies may have appointed UK entities as investment managers/sub-investment managers and these arrangements must be considered as above.
- **UCITS Documentation:** Any changes to domicile, delegation arrangements and eligible assets will result in documentation changes.
- **UCITS brand:** Jurisdictions such as Hong Kong accept UCITS from EU Member States including the UK to market to local investors. The UK would lose this status unless an alternative arrangement was negotiated with these jurisdictions.

Delegation rules
The UCITS Directive delegation rules provide *inter alia* that investment management can only be delegated to entities that are authorised or registered for the purpose of asset management and subject to prudential supervision. Cooperation between the supervisory authorities is required if the entity is a third country undertaking. Delegation to UK entities post Brexit is unlikely to raise any particular concerns other than codifying the approach to ensure correct terminology and appropriate references to the UK in that context.

Irish UCITS marketing in the UK
Post Brexit Irish UCITS may not rely on the passport in order to market to UK investors. Different scenarios may arise but cannot be addressed here given the uncertainty. Absent any agreement on mutual recognition, Irish UCITS must seek approval from the UK authorities in order to market to UK investors.

One possible scenario highlighted in the media includes a master-feeder arrangement where a UK feeder fund is established to invest in a UK master fund. UK eligible asset rules currently permit this structure.[18]

7.2.2. AIFMD Alternative Investment Fund Managers Directive ('AIFMD')

The AIFMD provides a passport to EU authorised AIFMs which allows them manage AIFs within the EEA and market AIFs to professional investors in the EEA. Post Brexit, a UK AIFM will become a non-EU AIFM and will lose the right to passport its services and to market its AIFs across the EU.

Where a UK AIFM manages UK AIF and markets AIFs to UK investors only, Brexit has no impact.

Where a UK AIFM manages an AIF in another Member State, post-Brexit it must

- Seek approval from the NCA in that Member State to continue to manage the AIF as a non-EU AIFM; or
- Arrange for an EEA authorised AIFM to take over the management of the AIF and delegate the investment management and risk management to the UK AIFM. Delegation rules are addressed below; or
- Seek to change the AIF, structure permitting to an internally managed AIF where investment management is delegated to the UK entity.

[18] The current UK retail AIF rules permit EEA UCITS as eligible investments for UK AIFs.

Where a UK AIFM markets AIFs in an EEA Member State, post Brexit it must:

- Cease marketing unless it receives approval from each EEA Member State in accordance with Article 42 of AIFMD. Article 42, which allows non-EU AIFM to manage AIFs and to market AIFs to professional investors only is a Member State discretion under AIFMD. Some Member States have not adopted this Article. Member States which have adopted the Article have taken different approaches as to what is required in order to market in their jurisdiction.[19] Therefore, depending on the marketing strategy it may be more difficult for UK AIFMs to market AIFs in the EEA post Brexit.

Where a UK AIFM markets a UCITS to EEA retail investors, which now becomes an AIF, it must

- Cease marketing unless it receives approval from each EEA Member State in accordance with Article 43 of AIFMD. Article 43, which allows Member States to permit AIFMs market AIFs to their retail investors, is a Member State discretion. Many Member States are likely to have adopted it but the rules on marketing to retail investors may be quite restrictive.

AIFMD provides for a third country regime which will, when adopted, allow non-EU AIFMs to become authorised in an EEA Member State of reference and will extend the AIFMD management and marketing passports to the non-EU AIFMs. This third country regime is not yet in place. ESMA has provided its advice as required under Article 67 and this is under consideration by the European Commission. The ESMA advice includes its assessment of 12 third countries. If and when the third country regime comes into operation various steps would nevertheless be required to include the UK as an additional eligible third country. In that scenario a UK AIFM could seek authorisation in a Member State of reference and operate under a dual authorisation regime in order to comply with AIFMD and UK requirements.

Delegation rules:
Delegation rules under AIFMD are similar to those in UCITS although more prescriptive and subject to additional requirements in the AIFMD Level 2 Regulation. In the case of delegates in third countries, co-operation between the EU and non-EU authorities must be ensured. In effect the co-operation provisions require that there is an AIFMD model MoU in place [redacted]

7.2.3. Conclusion

The major issues which a UK UCITS Management Company or UK AIFM must consider post Brexit in light of the loss of the product and management passport are

- how best to re-organise the way investment funds will be managed and marketed;
- Whether to change domicile and use of delegation arrangements; and
- Amendments to investment parameters and mandates.

[19] Some Member States permit marketing by non-EU AIFM but not managing AIF in their territories.

The fact that many UK entities have established Irish funds and are familiar with both the AIFMD and UCITS regime which the Central Bank has put in place may lead to moves to establish Irish fund management companies.

7.3. MiFID

The section provides an overview of the current regime for the authorisation of third country firms ("TCF") under MiFID I and the strategies which UK firms may avail of to access European Markets under MiFID II.

7.3.1. Third country regime under MiFID I

Presently under MiFID I access to the market by TCFs is not harmonised. The cross border provision of investment services in the EU by a TCF is subject to the national rules of each Member State (MS) subject to the overriding principle that MS's cannot treat TCFs more favourably than EU firms. TCF that establish a branch in an EU MS do not currently benefit from the European passport to provide investment services throughout the EU. To date the creation of a local EU subsidiary, a separate legal entity that has obtained a full authorisation under MiFID in a MS, is the only way to obtain the passport.

Under MiFID II, as was the case under MiFID I, a TCF can still establish a subsidiary in Ireland whereby that subsidiary is a separate legal entity with a full authorisation and the subsidiary would have the benefit of a full EU passport to all client types. However, MiFID II will introduce a third country regime that would apply to the UK, as a third country, post Brexit. This would allow UK firms a number of potential additional gateways through which to access to EU markets. It should be noted however that none of these new gateways provide a passport in respect of retail and opt-up professional clients (i.e. a retail client who has requested to be considered a professional client).

Over 50 per cent of the EU's MiFID firms are based in the UK[20] and much of the UK's financial services law and regulation is derived from laws which apply in the EU. Under MiFID II the ability of a UK firm to offer investment services or perform investment activities, either on a cross border services basis or by way of an EU branch, will depend largely on the status of the relevant client. Specifically, under MiFID II different requirements apply depending on whether the relevant client is a) a retail client or an opt up professional client, or b) a per se professional client or eligible counterparty.

7.3.2. Existing gateways for Third Country Firms to establish in Ireland

Establishment of a Subsidiary

Many non-EU financial institutions have established MiFID authorised subsidiaries in the UK on the basis that the passporting regime enables them to access the markets of other EU jurisdictions. Post Brexit non-EU owners of UK entities could consider it preferable to move their main European regulated operations to a jurisdiction within the EU, in order that they can continue to benefit from the passporting regimes.

[20] See tables contained in *Report on Investment Firms*, European Banking Authority, December 2015.

A subsidiary incorporated in the EU will be entitled to serve all categories of clients throughout the EU, including retail clients. As a separate and independent legal entity governed by the laws of a Member State, a subsidiary is not considered as a third country firm and is therefore not subject to the rules which will apply to TCF market access in MiFID II. This may be the preferred option for some UK investment firms.

Substance requirements under MiFID I

The requirements for firms to have substance are outlined in both the Level 1 and Level 2 texts of MiFID I. Under Recital 22 of MiFID I competent authorities are required to withdraw authorisation where factors such as the content of programmes of operations, the geographical distribution or the activities actually carried on indicate clearly that an investment firm has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State within the territory of which it intends to carry on or does carry on the greater part of its activities.

Article 13 and 14 of the MiFID I Level 2 Commission Directive on organisational requirements and operating conditions for investment firms outlines the requirements which firms must comply with regarding outsourcing. Article 14 states that:

Member States shall ensure that, when investment firms outsource critical or important operational functions or any investment services or activities, the firms shall remain fully responsible for discharging all of their obligations under Directive 2004/39/EC and comply, in particular, with the following conditions:

(a) the outsourcing must not result in the delegation by senior management of its responsibility;

(b) the relationship and obligations of the investment firm towards its clients under the terms of Directive 2004/39/EC must not be altered;

(c) the conditions with which the investment firm must comply in order to be authorised in accordance with Article 5 of Directive 2004/39/EC, and to remain so, must not be undermined;

(d) none of the other conditions subject to which the firm's authorisation was granted must be removed or modified.[21]

In accordance with the Directive, the current Irish MiFID implementing regulations (Regulation 13(f)) states that the Central Bank shall not grant an authorisation unless the firm satisfies the Central Bank as to the organisational structure and management skills of the proposed investment firm and that adequate levels of staff and expertise will be employed to carry out the firm's proposed activities.

Regulation 13(h) states that the Central Bank shall not grant an authorisation unless the firm satisfies the Central Bank that the organisation of the business structure of the proposed investment firm is such that it and any of its associated or related undertakings are capable of being supervised adequately by the Central Bank.

---

[21] This text was transposed in Ireland under Regulation 105 of SI No. 60/2007.

The Central Bank completes thorough checks to ensure that firms seeking authorisation in Ireland have substance. When assessing firms under the MiFID pre-application process, the Central Bank considers the board composition, the staffing arrangements at the Irish office and the level and nature of outsourcing proposed in this regard. These are the three main ingredients on which the Markets Directorate determine where the heart and mind of the applicant firm are located.

Prior to an application for authorisation being filed, the Central Bank completes a pre-application process (i.e. receipt of a Key Facts Document, holding a preliminary meeting etc.) with the applicant in order to discuss the applicant's business model including the items referred to above.

In general, the gateway for accepting any MiFID application is that the 'heart and mind' be based in Ireland and that is mainly determined by:

- the regulated activity emanating from the State. Under MiFID Regulation 33(1) (f), the Central Bank could oppose the outsourcing of regulated or critical activity if it feels such outsourcing would materially impair the ability of the Central Bank to monitor the firm's compliance with all of the firm' obligations;
- the firm having a balanced board of executives and non-executives, thereby ensuring the executive representation are employed in the firm insofar that they carry out the day-to-day activities from there and are therefore resident in State. The Central Bank would also expect that board meetings to take place in Ireland thereby ensuring that key decisions pertaining to the firm take place in the State.

Substance Requirements under MiFID II

MiFID II maintains and enhances the substance requirements as outlined in MiFID I above. Recital 46 of MiFID II contains a similar provision to that outlined in Recital 22 of MiFID I. Additional text obliges firms to ensure that they remain fully responsible for discharging their obligations when outsourcing critical or important operational functions.

7.3.3. New Potential Gateways for UK firms to access European Markets

Under MiFID II Ireland will have the option[22] of requiring any TCF seeking to offer investment services or perform investment activities to retail clients and opt up professional clients in Ireland to establish a branch in Ireland and obtain a prior authorisation from the Central Bank ("authorised branch"). MiFID II sets out a number of conditions that must be fulfilled before such an authorisation can be granted.[23] There is no EU passport available for an authorised branch in respect of services to retail clients or opt up professional clients in other MS, which will mean that TCF may have to establish a branch in each MS where they wish to access retail markets. If MS do not wish to exercise this MS discretion, MS may continue to operate their existing national regime (which may or may not require the establishment of a branch).

MiFID II provides that a TCF may provide investment services to non-retail (eligible counterparties and per se professional clients) in the EEA where it is registered with ESMA. However, there are certain conditions including that the European Commission must have adopted an equivalence decision in respect of the TCF's home country and the home country must have entered into co-

[redacted].

[23] Article 39(2) MiFID II.

operation agreements with ESMA. The TCF could provide services through a branch or on a cross-border basis. Where a TCF has established a MiFID authorised branch in a MS to provide MiFID services, that firm will be permitted to provide its investment services to, and to perform investment activities throughout the EU for eligible counterparties and per se professional clients without the need to establish further branches, as long as that firm is established in a country whose legal and supervisory framework is recognised as broadly equivalent by the European Commission. At this point it is not clear when the equivalence related decisions will be addressed.

Will UK firms seeking to offer investment services to retail clients and opted up professional clients be able to access the EU via a branch in Ireland?

There is currently no local regulatory regime for third country branches of investment firms operating in Ireland. A decision needs to be taken in relation to whether or not to exercise the discretion outlined under Article 39 of MiFID II to require third country firms to set up a branch in Ireland. If this discretion is exercised firms in the UK may wish to establish a local branch in Ireland to service retail and opt-up professional clients here.

If the discretion is not exercised, then local law requirements may have to be established to deal with the issue of TCFs wishing to operate in Ireland. [redacted]

Will UK firms be able to access the EU market through registration with ESMA?

Access to EU markets will depend on how closely aligned the UK's legal and regulatory regime is to the MiFID II regime. The UK would need to ensure that its financial regulatory regime achieved similar outcomes to that of the EU regime if it wanted any immediate access. The FCA issued a statement explaining that EU laws will still apply to all firms under their jurisdiction, including those which are still to come into effect like MiFID II, up until Parliament and the ruling Government officially trigger a Brexit. This means that UK based financial services will have prepared to abide by all rules under MiFID II. The UK will continue to be a full member of the EU for at least two years. The implementation date for MiFID II is 3 January 2018, therefore UK firms will be obliged to comply with MiFID II rules from this date and will need to ensure that they have the relevant organisational and technical systems in place to do this. [redacted] Moreover, an equivalence decision on any third country may take some time.

Use of "exclusive initiative" rules

Many European jurisdictions do not regulate activities from off shore providers where there has been a reverse solicitation (i.e. the client has approached the firm). This is also reflected in MiFID II which allows customers in the EU to receive investment services provided by a TCF at their own exclusive initiative. Where a TCF provides services at a client's own exclusive initiative, those services are not considered to be provided within the EU. In those circumstances the requirement to seek authorisation will not apply. It should be noted that an initiative by a client will not entitle a third country firm to market new categories of investment product or investment service to that individual.

Organisational implications and impacts

The Central Bank is the body responsible in Ireland for both the prudential and conduct of business regulation of MiFID firms. Banks engaged in MiFID activities are also subject to supervision by the Central Bank. Once a subsidiary of a UK firm is authorised in Ireland, the firm will be subject to prudential supervision under the Central Banks PRISM Framework [redacted] The Central Bank supervisory process is carried out by a number of different approaches some of which would include:

- Analysis of various returns submitted to the Central Bank;
- Inspections (both general and themed);
- Review meetings;
- Risk rating of firms;
- Regular correspondence and engagement with firms under our supervision.

7.3.4. Conclusion

As highlighted above, MiFID II which is expected to come into effect in January 2018 will establish various gateways to the EU market for third country entities. If the UK should not negotiate an EEA membership, its firms could then be expected to meet the regulations of a third country entity under MiFID II or to establish a subsidiary here if they wish to re-locate to Ireland. Should the UK's exit from the EU affect the pass-porting regime, Irish financial service providers may only be able to access the UK markets to the degree allowed by arrangements made by the UK governing access by non-UK regulated persons which could create difficulty for Irish investment firms.

If the UK leaves the EEA, access to per se professional clients and eligible counterparties may be enough of an incentive for the UK to implement the MiFID II regime notwithstanding Brexit. This outcome would depend on the third country aspects of MiFID II being fully implemented at EU level, and on the willingness of EU authorities to certify the UK as equivalent and execute the necessary bi lateral agreements.

24 [redacted]