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Brexit: Key cliff edge risks in wholesale financial services

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Introduction

The Brexit process is presenting businesses, investors and banks with unprecedented challenges. The time pressure on firms to prepare themselves and their clients for the UK's exit from the EU is increasing. However, it remains unclear what kind of exit and future relationship arrangements will be agreed upon.

We welcome the decision of the European Council to proceed to discussions regarding transitional arrangements and the future relationship between the UK and the EU. The outcome of these discussions will have fundamental implications for businesses across Europe and beyond.

AFME has highlighted the need for transitional arrangements which would keep existing market arrangements in place for a limited period of time following the UK leaving the EU. This is necessary to provide certainty and stability to business and market participants as they prepare for the future arrangements that have yet to be agreed between the EU and the UK[1].

AFME members are concerned about the potential risks that Brexit can create for market efficiency and financial stability, in particular focusing on potential 'cliff edge' scenarios. This paper highlights a number of important cliff edge risks which need to be carefully considered and addressed, and proposes some potential solutions.

In this paper, we have focused on issues which we believe require intervention from policymakers and/or regulators and are not easily resolved by banks' own plans or industry solutions. We stress that the identified set of issues is non-exhaustive, as our members continue to analyse their business operations and the different regulatory challenges in preparing for Brexit.

Not every problem that is expected to arise from the UK's withdrawal from the EU can be classified as a 'cliff edge' risk. This paper therefore uses the following definition of "cliff edge risk":

> *A cliff edge risk is an issue that is expected to create (market) disruption or material impediments to business activities on the day of Brexit if no legislative or regulatory intervention is undertaken.*

Cliff edge risks can present themselves in two main ways. The first situation is where there is uncertainty about what rules are applicable. Markets dislike uncertainty, and are likely to react to uncertainty by reducing economic activity. The second situation is where there is certainty on the rules, but market participants have insufficient time to adjust to these new rules. These situations are mutually reinforcing in that the more uncertainty there is about the new rules, the harder it is for market participants to start the process of adapting to them.

While some of these cliff edge risks would be mitigated (in whole or in part) by a longer transition period, risks remain that need to be addressed irrespective of a transition. It is important to note that cliff edge risks arise, unless mitigated, at the point of UK exit and at the end of the transition period.

We consider that the Withdrawal Agreement is the most appropriate mechanism to solve for the cliff edge risks highlighted in this paper, although the principles of the Withdrawal Agreement may need to be supported by legislation in the UK, EU and EU27 Member States. Furthermore, in situations for which policymakers and regulators can take unilateral actions, then this should also be done.

We note that as of January 2018, there is less than 15 months before the UK will leave the EU. Businesses cannot wait until the last moment to achieve certainty on these issues. We urge EU and UK policymakers and regulators to agree transitional arrangements urgently and clarify actions to mitigate cliff edge risks and maintain financial stability.

[1] See AFME, The need for early clarity on a Brexit transition, September 2017, link

1 Cross border personal data transfers

Currently, many firms rely on data centres located in the UK to provide financial services across Europe and depend upon the ability to transfer personal data between the UK and EU27 to operate their businesses.

Restrictions on sharing of personal data between the EU27 and the UK as a result of Brexit could severely disrupt the ability of businesses to continue to transfer personal data post Brexit. For businesses to continue to operate on a cross-border basis, an arrangement is required to ensure the ongoing free flow of personal data post Brexit. As the European Banking Authority (EBA) has stated, "risks related to … data transfer and the protection of data with a third country could disrupt financial stability and market confidence."[2]

Businesses in the UK are in the process of implementing the General Data Protection Regulation (GDPR) which will take effect in May 2018 and continue to apply in the UK post Brexit by virtue of the EU (Withdrawal) Bill. Accordingly, the data protection framework in the EU and UK should be aligned. However, on the day of exit from the EU, the UK will become a third country, and its data protection framework will need to be recognised by the EU as providing an adequate level of protection. The UK will also need to provide recognition of the adequacy of the EU data protection framework.

The GDPR contains a provision for a third country to be recognised by the EU under which the Commission will need to take an 'adequacy decision'. Recognition by the EU following an adequacy decision will enable EU firms to transfer personal data to the UK without specific authorisation by a data protection authority.

The best way to provide legal certainty for firms intending to transfer personal data between the EU and UK is for mutual adequacy decisions to be made by the EU27 and UK. These need to be in place ahead of the UK's exit to ensure that there is no gap following the UK's withdrawal.

As the European Commission has noted, if an adequacy determination is not in place by the time of the UK's exit from the EU, businesses would have to seek to put in place alternative arrangements.[3] However, alternative arrangements such as seeking to amend contracts to include clauses permitting cross-border data transfers or putting in place Binding Corporate Rules as well as new tools for the transfer of personal data provided for under GDPR are likely to be very challenging to achieve in the time available.

2 Continuity of contracts

When the UK leaves the single market, existing passports enabling UK-based firms to engage in regulated activity in the EU27 (and vice versa) will cease. This calls into question the ability of banks to continue to service their clients under existing contracts. The Bank of England has highlighted this issue[4] and it has also been noted by the EBA and the European Central Bank. Firms may lose the permissions required to perform regular life cycle events in these contracts. With respect to derivatives, lifecycle events which are described in the contract, such as coupon payments and rate resets, can probably be performed, while other events involving a buy/sell notion, such as increases, decreases, novations and trade compressions, can probably not be performed[5]. In certain circumstances, an inability to perform a lifecycle event could entitle a party to terminate the relevant transactions, which could be problematic for the other party and potentially disruptive to the market. Clarity needs to be provided on this to provide certainty to clients that their services will continue. [6]

Around a quarter of uncleared OTC derivative contracts entered into by parties in both the United Kingdom and European Union could be affected. The gross notional amount outstanding of these affected contracts is around £26 trillion, of which £12 trillion matures after Q1 2019.[7] Impairment to the servicing of these contracts could disrupt market functioning and make it more expensive for firms and households to insure against risks.

[2] EBA, Risk Assessment of the European Banking System, 24 November 2017, p.17
[3] European Commission, Notice to Stakeholders, 9 January 2018, link
[4] See for example, Statement of the Financial Policy Committee meeting on 20 September 2017
[5] See ISDA Brexit and Contractual Continuity, link
[6] See AFME and UK Finance paper (2017), Impact of Brexit on cross-border financial services contracts, link
[7] Bank of England Financial Stability Report, November 2017, link

The preferred option is for the cross-border contracts which are in place at the point of Brexit to be grandfathered and allowed to continue to be serviced until maturity. This should preferably be done by an EU-UK agreed solution to avoid having to create nationally differing solutions. An EU-wide solution could be similar in form to that adopted through Council Regulation (EC) No 974/98 to address uncertainty around the introduction of the euro currency.[8]

If such contracts are not grandfathered, firms may need to novate contracts to new entities with the necessary regulatory permissions. Novations could not be done unilaterally and would require the consent of each counterparty. For each of the large dealers, this would require the agreement of a very significant number of counterparties who may themselves need to secure agreement with other involved parties. There are no precedents for these types of multiple large scale novations within an 18-month period and this would have a significant impact on clients who may suffer tax, accountancy, regulatory and other consequences as a result of novating transactions. These multiple large-scale moves occurring within a small window would be highly disruptive for clients and operationally very burdensome.

3 Choice of jurisdiction; recognition and enforcement of judgments

In the context of the legal underpinning of contracts, two aspects are important to note in relation to the implications of Brexit: i) choice of jurisdiction and ii) the recognition and enforcement of judgments.

The Recast Brussels Regulation provides an EU-wide framework for jurisdiction and the recognition and enforcement of judgments. This provides certainty that the parties' choice of court will be upheld and that a judgment of the court of one Member State will be recognised and enforceable in all other EU Member States.

This certainty is an important factor underpinning financial (and other) contracts. Absent an agreement to the contrary, the Recast Brussels Regulation would cease to apply to the UK, creating uncertainty as to the continued recognition of parties' choice of court and the ability to recognise and enforce judgments of an English court throughout the EU, and judgments of a Member State court in the UK. There is a very significant volume of financial services contracts where the parties have chosen the jurisdiction of the English courts. It is therefore important to provide clarity that continued recognition will be provided to the choice of jurisdiction throughout the UK and EU and that judgments of the courts of a Member State and of the UK will continue to be enforced throughout the UK and EU.[9]

4 Access to market infrastructure: recognition of CCPs

The UK leaving the EU will have major implications for derivatives clearing and transitional arrangements are necessary. In the absence of transitional arrangements, EU27 banks could find themselves in breach of regulation for maintaining positions in UK CCPs that would no longer be authorised or recognised under EU regulations. For instance, they could no longer clear OTC derivatives that are subject to the clearing obligation through UK CCPs. EU27 banks may also suffer increases to their regulatory capital requirements in respect of positions that are maintained at UK CCPs that are not authorised or recognised in the EU.[10] The same could apply to UK banks with positions in EU27 CCPs, depending on the UK regulatory regime.

Unless UK CCPs are recognised under EU legislation on the basis of an "equivalence" determination by the European Commission, EU27 banks would be required to hold a significantly increased amount of regulatory capital against positions in UK CCPs because the corresponding risk weights for such positions would increase.

Under current rules, the Commission is unable to grant equivalence until the UK is a third country, so there is a risk that UK CCPs are not recognised automatically from the date of Brexit. It is necessary to ensure that there is no gap.

[8] See Article 7 which provides that the substitution of the currency does not alter the denomination of legal instruments in existence at the date of substitution
[9] This issue has been addressed in more detail in a paper prepared by the Financial Markets Law Committee, link
[10] This may be mitigated to some extent by the proposed amendments to article 497 CRR, but certainty is required. The CRR amendments would not address the concern relating to the clearing obligation.

Therefore the Withdrawal Agreement (and supporting legislation in the EU and EU27 Member States) should deem that existing UK CCPs are recognised at the point of Brexit, on the basis that the UK should be fully equivalent at the point of exit. Alternatively, the transition period should be structured to enable UK CCPs to continue providing clearing services to EU27 banks under current arrangements until the equivalence determination is made. If this is not done, it is estimated that approximately €30-40bn of additional initial margin would need to be posted by banks, an increase of 40-50%.[11]

It has been argued that EU27 banks could move positions to EU CCPs, however this would seem unrealistic in the limited time available. Conflicts of national laws that would govern such transfer, differences in membership and authorisation between relevant CCPs and the length of time needed to plan, obtain consents and execute the transfer justify classifying this as a potential cliff edge risk.

Additionally, the UK should provide for the recognition of EU27 CCPs for the purposes of its regulation going forward. We welcome the Bank of England's recent clarification of the recognition regime and their stated presumption that non-UK CCPs operating in the UK will be able to continue to do so.[12]

It is also necessary to carefully consider the potential impact of Brexit on other market infrastructure including CSDs and trade repositories.

5 Recognition of resolution actions

The Bank Recovery and Resolution Directive (BRRD) establishes a common framework for the recovery and resolution of financial institutions across the EU. This is an important part of the efforts to ensure that banks can fail without losses being borne by taxpayers and minimising the impact on financial stability. It is important that resolution actions taken by authorities have effect in relation to liabilities governed by the law of another jurisdiction. The recognition of resolution actions and resolution stays across jurisdictions is therefore important for cross-border resolution to be effective, for example for bail-in to work and for transfers of business to be valid. For example, a resolution conducted in an EU27 Member State will need to be effective in the UK in order to take effect in respect of contracts governed by English law and assets located in the UK and similarly for UK resolution actions to be effective in the EU27.

Currently, the BRRD provides for the automatic recognition of resolution actions throughout the EU.[13] Absent an intergovernmental agreement for the mutual recognition of resolution actions, the automatic recognition would no longer apply as between the UK and EU27 following Brexit, although we expect that close cooperation between resolution authorities would continue. An end to automatic recognition creates issues for financial institutions, including:

- the potential requirement for EU27 banks to amend contracts governed by English law (and UK-based banks to amend contracts governed by the law of a Member State) to include contractual recognition of bail-in and resolution stays or having to re-issue them; and
- uncertainty regarding the continued eligibility of English law governed capital and debt instruments issued by EU27 banks to meet loss-absorbing capacity requirements (and instruments issued by UK-based banks under EU27 law).[14] It has been reported that EU27 banks have issued €126 billion in Additional Tier 1 and Tier 2 capital instruments under English law.[15] If these instruments are determined to be ineligible, this could significantly reduce the levels of eligible instruments and would either have to be amended or require banks to issue new eligible debt, potentially causing market disruption.

In order to support cross-border resolution and provide certainty regarding eligibility of instruments and requirements to amend relevant contracts, the EU and UK should agree to the mutual recognition of resolution actions. Absent such agreement, resolution authorities should engage with relevant firms and consider appropriate and proportionate arrangements to address existing liabilities.[16]

[11] BCG report (2017), Bridging to Brexit: Insights from European SMEs, Corporates and Investors, link
[12] See Bank of England announcement, 20 December 2017, link
[13] See article 66 BRRD
[14] See also EBA Opinion, 12 October 2017, link
[15] Euromoney, Regulation: English-law bonds could be excluded from MREL post-Brexit, link
[16] As expressed in the EBA opinion recommendations, link

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