

ECB BMCG meeting on 9 October 2018

BREXIT: CLIFF-EDGE RISKS IN INTERNATIONAL CAPITAL MARKETS

Introduction

- The UK is proposing to leave the EU Single Market in financial services when it leaves the EU.
- Cliff-edge risks will arise when passporting rights between the EU27 and the UK cease.
- They will arise most immediately if the UK leaves the EU without an agreement on 29 March 2019.
- If there is a transition period after Brexit, cliff-edge risks will still arise if no trade agreement is reached by the end of the transition period (ie the end of 2020).
- And even if there is a trade agreement, there will be cliff-edge risks if the agreement does not preserve existing passporting rights.
- When passporting rights cease, “there will be no Single Market access” (European Commission).

Ways of avoiding cliff-edge risks in general:

(i) Regulatory equivalence

- The UK originally proposed to the EU27 that there should be mutual recognition of market access, when existing passporting rights cease. This approach was rejected by the EU27.
- One alternative for market firms in the UK is to make use of EU provisions for regulatory equivalence for third countries. This is currently a patchwork:
 - It applies to some parts of the EU regulatory framework, but not others.
 - It requires a judgment by the European Commission, and this takes time to assess.
 - The determination of equivalence can be withdrawn at short notice.
 - The assessment is based on measuring outcomes, which are difficult to assess.
 - The determination is made unilaterally by the EU.
- The UK is hoping to negotiate enhancements.

Ways of avoiding cliff-edge risks in general:

(ii) Authorisation in both EU27 and UK

- If it is not possible for market firms to rely solely on regulatory equivalence, the other option is to ensure that, before passporting rights cease, market firms are authorised to provide financial services in both the EU27 and in the UK.
- The ECB, EBA and ESMA have all drawn attention to the need for market firms to be authorised to operate in the EU27 after passporting rights cease. In the case of the ECB:
 - it usually takes six months for a decision once an application is complete;
 - banks need to be capable of managing all material risks independently and at the local level;
 - sufficient staff need to be located locally, including risk management and front office;
 - part of the risk on “back-to-back booking models” should be managed and controlled locally.
- Market firms are in a better position to avoid cliff-edge risks if they are authorised to operate in both the EU27 and the UK.

Specific cliff-edge risks

- It appears that, when passporting rights cease, market firms will in general be able to carry out contractual obligations already agreed between EU27 and UK entities on cross-border financial contracts.
- But when passporting rights cease, there are specific cliff-edge risks, which include for example the risk that:
 - it may not be possible to perform some existing cross-border insurance contracts;
 - it may not be possible to service some cross-border OTC derivative contracts;
 - CCPs may no longer be recognised across borders;
 - holding and sharing each other's data may be in breach of national law;
 - liabilities under UK law may be considered in the EU27 like any other third country (eg under MREL);
 - data thresholds under MiFID II/R originally set for the EU may no longer be relevant;
 - automatic recognition of resolution actions under the BRRD may no longer apply;
 - delegation of fund management across borders between the EU27 and the UK may be restricted or suspended if there is no agreement on third country cooperation.

Ways of avoiding specific cliff-edge risks

- A private sector approach: “timely adaptation by the industry.” (European Commission)
- A public sector approach: “it would be difficult, ahead of March 2019, for financial companies on their own to mitigate fully the risk of disruption.” (Bank of England Financial Policy Committee)
- A joint approach: the UK has proposed a Temporary Permissions Regime (TPR) for up to three years after Brexit. There is currently no reciprocal TPR proposed by the EU27.
- The formation of the ECB/Bank of England working group on risk management over Brexit is an encouraging sign.
- Agreement is needed between the EU27 and the UK as soon as possible on avoiding specific cliff-edge risks to remove market uncertainty and prevent instability.

Supervisory cooperation to avoid systemic risks

- Continuing supervisory cooperation is needed between the EU27 and the UK: eg on market firms which pose a systemic risk.
- Regulatory dialogue is needed, while respecting the autonomy of EU27 and UK legislative processes.
- Transparency is needed to ensure a stable relationship in future.

Conclusion

- Cliff-edge risks in international capital markets arise when passporting rights cease.
- Market firms are in a better position to avoid cliff-edge risks if they are authorised to operate in both the EU27 and the UK.
- But there are a number of specific cliff-edge risks on which agreement is still needed between the EU27 and the UK to remove market uncertainty and prevent instability.

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Note: For more detail, see ICMA: *Brexit: Cliff-Edge Risks in International Capital Markets*: ICMA Quarterly Report for the Fourth Quarter of 2018 (to be published on 11 October).