ICMA
International Capital Market Association

Preparations for Brexit in international capital markets *By Paul Richards*

Summary

The purpose of this Quarterly Assessment is to provide an update for ICMA members on preparations for Brexit in international capital markets, with particular reference to cliff-edge risks in the event that the UK leaves the EU without an agreement. Brexit affects ICMA members in both the UK and the EU27, as well as more broadly.[1]

The Withdrawal Treaty and Political Declaration

1 The British Government reached agreement with the EU27 at the European Council on 25 November 2018 on a Withdrawal Treaty and on a Political Declaration setting out the Framework for the Future EU27/UK Relationship, subject to ratification by both the British Parliament and the European Parliament. If an EU27/UK agreement is not approved and the necessary legislation not enacted before Article 50 expires on 29 March 2019, the default position is for the UK to leave the EU without an agreement, unless Article 50 is extended (which would require unanimous agreement by the EU27 on the basis of a proposal by the UK), or revoked (which would require a unilateral decision by the UK).[2]

2 The Withdrawal Treaty is accompanied by a Political Declaration setting out the Framework for the Future EU27/UK Relationship. Unlike the Withdrawal Treaty, the Political Declaration is not legally binding. It is intended to lay the groundwork for future negotiations during the transition period after Brexit.[3] The transition period after Brexit, which is covered in the Withdrawal Treaty, is due to last from Brexit on 29 March 2019 until the end of 2020. But it could be extended beyond the end of 2020 once for up to one or two further years, if the UK and the EU27 agree by 1 July 2020. During the transition period, the UK would effectively be subject to EU rules, but without any say in making them.

3 The Political Declaration covers financial services only briefly, and at a high level of generality:

- "The Parties are committed to preserving financial stability, market integrity, investor and consumer protection and fair competition, while respecting the Parties' regulatory and decision-making autonomy, and their ability to take equivalence decisions in their own interest. This is without prejudice to the Parties' ability to adopt or maintain any measure where necessary for prudential reasons. The Parties agree to engage in close cooperation on regulatory and supervisory matters in international bodies."
- "Noting that both Parties will have equivalence frameworks in place that allow them to declare a third country's regulatory and supervisory regimes equivalent for relevant purposes, the Parties should start assessing equivalence with respect to each other under these frameworks as soon as possible after the UK's withdrawal

1. See the Brexit webpage on the ICMA website for further background.

2. On 10 December, the European Court of Justice ruled that the UK can "unilaterally revoke" Article 50 before it expires.

3. The British Government calls the transition period an "implementation period".

from the Union, endeavouring to conclude these assessments before the end of June 2020. The Parties will keep their respective equivalence frameworks under review."

- "The Parties agree that close and structured cooperation on regulatory and supervisory matters is in their mutual interest. This cooperation should be grounded in the economic partnership and based on the principles of regulatory autonomy, transparency and stability. It should include transparency and appropriate consultation in the process of adoption, suspension and withdrawal of equivalence decisions, information exchange and consultation on regulatory initiatives and other issues of mutual interest, at both political and technical levels."[4]

Cliff-edge risks in international capital markets

4 In preparing for Brexit, our focus at ICMA has been on addressing and avoiding cliff-edge risks in international capital markets. Cliff-edge risks will arise when passporting rights between the EU27 and the UK cease: most immediately, if the UK leaves the EU without an agreement on 29 March 2019; but cliff-edge risks will also arise, even if there is an agreement, at the end of the transition period. The key difference is that, if there is a transition period after Brexit, that will give market firms more time to prepare.

5 With the support of the ICMA Board, ICMA wrote an open letter to senior political leaders in the EU27 and the UK in June 2018 about cliff-edge risks in international capital markets. There was a detailed response from Valdis Dombrovskis, the Vice-President of the European Commission, in July and from the UK City Minister, John Glen, in August. An ICMA paper on cliff-edge risks in international capital markets was published in the ICMA Quarterly Report for the Fourth Quarter on 11 October.

6 The ICMA paper can be summarised as follows:

- 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 (ie most immediately if the UK leaves the EU on 29 March 2019 without an agreement, with the result that there is no transition period).
- The UK originally proposed to the EU27 that there should be mutual market access when 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 on regulatory equivalence for third countries. This is currently a patchwork, though it may be possible for the UK to negotiate enhancements after Brexit.
- If it is not possible to rely solely on regulatory equivalence, the other option is for market firms to ensure that, before passporting rights cease, they are authorised to operate both in the EU27 and in the UK.
- It appears that, when passporting rights cease, firms will in general be able to carry out contractual obligations already agreed between EU27 and UK entities on cross-border financial contracts. But specific cliff-edge risks will still arise when passporting rights cease.
- In the paper, we listed examples of specific cliff-edge risks relating, among others, to: CCPs; OTC derivative contracts; delegation of fund management; and data exchange.

7 We argued that the best way of avoiding these specific cliff-edge risks would be by agreement between the EU27 and the UK, and that agreement should be reached as soon as possible:

- In the UK, a Temporary Permissions Regime (TPR) is being introduced for a limited period after Brexit, in the event that the UK leaves the EU without an agreement, with the result that there is no transition period. This "will allow inbound firms to continue operating in the UK within the scope of their current permissions for a limited period, while seeking full UK authorisation. It will also allow funds with a passport to continue temporarily marketing in the UK."[5]
- In the EU27, there has so far been no equivalent to the TPR. However, on 13 November, the European Commission stated that it "will act, to the extent necessary, to address financial stability risks in the EU arising from the withdrawal of the UK without any agreement". And on 19 December, the Commission concluded that "only a limited number of contingency measures is necessary to safeguard financial stability in the EU27. These measures mitigate financial stability risks only in those areas where preparedness actions from market operators alone are clearly insufficient to address these risks by the withdrawal date."[6]

8 In the period running up to the end of 2018, progress was made in addressing some of the specific cliff-edge risks in international capital markets which will arise, if there is no EU27/UK agreement on Brexit. The extracts that follow are taken from relevant statements by the Bank of England and

4. Political Declaration setting out the Framework for the Future Relationship between the EU and the UK, paragraphs 37-39.

5. FCA, *Preparing Your Firm for Brexit,* FCA website. The UK is also proposing Temporary Recognition Regimes for CCPs, CSDs, credit rating agencies, trade repositories and data reporting service providers, among others.

6. European Commission: *Preparing for the Withdrawal of the UK from the EU on 30 March 2019: Implementing the Commission's Contingency Action Plan,* 19 December 2018. Other Commission quotes are from the same source or its earlier statement on 13 November 2018.

the FCA in the UK, and by the ECB, the European Commission and ESMA in the EU27, with particular reference to the risk of a "no-deal" Brexit:

Legal framework

9 There is now only a short time for enacting the relevant legislation in the UK for Brexit. The FCA has stated that, on Brexit: "EU legislation would cease to apply in the UK. Instead, the relevant legislation would be converted into UK law through the EU (Withdrawal) Act and amended by Government and regulators to ensure the UK continues to have a functioning regulatory regime. The Government has also proposed to provide the FCA and Bank of England with powers to smooth the transition to the new regime. In the event the UK leaves the EU with no agreement, it will be crucial that all the relevant statutory instruments intended to be laid by Government are in place by exit."[7]

10 The Bank of England has stated: "The EU (Withdrawal) Act has come into force. HM Treasury plans to take forward around 60 pieces of secondary legislation for financial services before March. Sixteen statutory instruments are particularly important to mitigate risks of disruption to users of financial services. As of 26 November, four of these have become law, including the temporary regimes to allow EU banks, insurers and CCPs to serve UK customers. Timelines remain tight to take forward the remaining secondary legislation."[8]

CCPs and CSDs

11 The ECB has stated: "Cross-border clearing of derivatives contracts is one area where financial stability risks may arise in a cliff-edge Brexit scenario without sufficient mitigating actions. If UK CCPs become non-recognised third country entities after March 2019, euro area clearing members of UK CCPs will be exposed to legal risks if they continue to use UK CCPs to clear both new and existing trades." [9]

12 On 13 November, the European Commission stated that "it will adopt a temporary and conditional equivalence decision in order to ensure that there will be no disruption to central clearing." On 23 November, ESMA stated that it "is engaging with the European Commission to plan, as far as possible, the preparatory actions for the recognition process of UK CCPs, in case of a no-deal scenario. ESMA has already started engaging with UK CCPs to carry out preparatory work. The aim is to ensure continued access to UK CCPs for EU clearing members and trading venues as of 30 March 2019, should all the conditions in EMIR, including any conditions set out in the equivalence decision, be fulfilled."

13 In response to the European Commission, the ECB stated: "These potential risks have now been addressed through the assurance provided by the European Commission that, if necessary, it will allow EU firms to continue to clear derivatives contracts with UK-domiciled CCPs, under strict conditionality and with limited duration." The Bank of England Financial Policy Committee also welcomed "the European Commission's recent statement that it is willing to act to ensure that EU counterparties can continue to clear derivatives at UK central counterparties (CCPs) after March 2019."

14 However, the Bank of England also stated: "Without greater clarity on the scope, conditions and timing of the prospective EU action, CCPs and their members could not determine whether the Commission's proposal fully removed the legal risks they face. As a result the derivatives contracts EU clearing members had cleared with UK CCPs would need to be closed out or transferred by the end of March 2019. That process would be necessary to ensure the safe operation of UK CCPs beyond that date. It would need to begin in December 2018 in order to mitigate the risk of material market disruption and respect CCP rulebooks." [10]

15 On 19 December, the European Commission adopted "a temporary and conditional equivalence decision for 12 months [from the withdrawal date if the Withdrawal Agreement is not ratified] to ensure that there will be no disruption in central clearing of derivatives. This will allow ESMA to recognise temporarily central counterparties currently established in the UK, allowing them temporarily to continue providing services in the EU. The Commission has concluded that EU27 companies need this time to have in place fully viable alternatives to UK operators." In parallel, ESMA published a statement to clarify its plans for the recognition of CCPs established in the UK as third country CCPs under EMIR, in the event of a no-deal Brexit, when the CCPs would become third country CCPs.[11]

16 In addition, the European Commission adopted "a temporary and conditional equivalence decision for 24 months to ensure that there will be no disruption in

7. FCA: *EU Withdrawal Impact Assessment*, November 2018. Other FCA quotes are from the same source.

8. Bank of England Financial Stability Report, 28 November 2018. Other Bank of England quotes are from the same source or from the record of the Financial Policy Committee published on 5 December 2018, except where otherwise noted.

9. ECB Financial Stability Review, 29 November 2018. Other ECB quotes are from the same source.

10. On 7 December 2018, ICMA, AFME, FIA and ISDA wrote to Commissioner Dombrovskis seeking further clarification on the Commission's statement regarding temporary equivalence for the purpose of recognition for UK CCPs.

11. ESMA is ready to review UK CCPs' and CSDs' recognition applications for a no-deal Brexit scenario, 19 December 2018.

services provided by UK central securities depositories. It will temporarily allow them to continue providing notary and central maintenance services to operators in the EU. This will allow EU27 operators that currently have no immediately available alternative in the EU27 to fulfil their obligations under EU law." ESMA also stated that it will follow a similar process for the recognition of the UK CSD as a third country CSD under CSDR, as planned for UK CCPs.[12]

17 On 19 December, the Bank of England published a statement, saying that the Bank "welcomes the adoption today of temporary equivalence decisions by the European Commission on the future UK legal and supervisory framework for CCPs and CSDs." The Bank also said: "Today's announcement is a crucial and positive step. It provides necessary clarity and addresses one of the most important financial stability risks associated with the UK's withdrawal from the EU. It also enables UK CSDs to be recognised so that they can continue providing notary and settlement services for securities issued under EU law."[13]

OTC derivative contracts

18 The Bank of England has stated: "In the absence of action, certain lifecycle events cannot be performed on cross-border derivative contracts after Brexit. The UK Government has legislated to ensure that these lifecycle events can continue to be performed after Brexit on derivative contracts that UK clients (such as non-financial companies) have with UK banks. However, national rules in some EU Member States may prevent UK clients and banks from performing certain lifecycle events on derivative contracts that they have with UK banks."

19 The ECB has stated: "The continuity of servicing uncleared cross-border derivatives contracts is unlikely to pose significant risks to financial stability provided that the private sector takes sufficient action. The performance of certain lifecycle events and the exercise of certain options are, however, subject to authorisation in certain euro area countries. But the private sector can take a range of actions to mitigate risks associated with no longer being able to carry out lifecycle events on the affected contracts: These include: (i) trading-related strategies including bilateral novations; (ii) holding contracts to maturity and using other mechanisms with non-UK counterparties to adjust hedges; (iii) early terminations; (iv) actions based on statutory schemes for the collective transfer of business to the EU27; or (v) pursuing authorisations based on EU national regimes designed to enable the cross-border provision of services from a third country." The ECB also noted that ESMA "has proposed regulatory technical standards in order to facilitate the novation of certain non-centrally cleared OTC derivatives contracts to EU counterparties during a specific time window, in case of a no deal scenario."

20 On 19 December, the European Commission adopted two Delegated Regulations [that will apply from the withdrawal date if the Withdrawal Agreement is not ratified], facilitating novation, for a fixed period, of certain OTC derivatives contracts with a counterparty established in the UK to replace that counterparty with a counterparty established in the EU. This allows such contracts to be transferred to an EU counterparty while maintaining their exempted status and thus not becoming subject to clearing and margining obligations under EMIR. Such contracts, pre-dating EMIR, are exempted from EMIR requirements. This act will ensure that a change of counterparty will not change that exempted status."

Insurance contracts

21 The ECB has stated: "Financial stability risks are not expected in the area of cross-border insurance contracts. UK insurance undertakings will lose their authorisation to conduct business in the euro area (and vice versa) in a cliff-edge scenario. But UK insurance companies servicing euro area policyholders have a number of options available to them to mitigate any disruption. These include portfolio transfer, establishment of a third country branch, relocation of a European company (Societas Europaea) or termination of contracts. These options are being actively used by firms. The vast majority of outstanding cross-border insurance contacts are covered by credible contingency plans, with the residual contracts primarily pertaining to non-life insurers."

Fund management

22 The Bank of England has stated: "The UK Government has legislated for EU asset management firms to continue operating in the UK after exit. Further legislation will provide a temporary permissions regime for EU investment funds to continue marketing in the UK." It has also stated: "EU rules allow asset managers to delegate the management of their assets to entities outside the EEA when a cooperation agreement is in place between the authorities. The European Commission has publicly encouraged ESAs to prepare such agreements with the UK. In the absence of a cooperation agreement, there is a risk of changes to asset managers' businesses that could be disruptive." And the FCA has stated: "Asset managers

12. ESMA plans to allow the UK CSD to continue to service Irish securities.

13. Bank of England statement on equivalence of the future UK legal and supervisory framework for CCPs and CSDs, 19 December 2018.

are dependent on cooperation agreements between the FCA and national competent authorities being in place to continue to manage portfolios for EU clients and funds."

Supervision and enforcement

23 On 3 October, the Chair of ESMA proposed to start negotiations with the UK FCA on MOUs, which "are essential to meet our regulatory objectives and allow information exchange for effective supervision and enforcement."[14] The European Commission has also encouraged the ESAs to begin preparing MOUs with UK supervisors to ensure all parties can exchange information immediately from exit. The aim here is to ensure that exchange of information about financial institutions and participants is possible immediately after the withdrawal date if there is no deal.

Data exchange

24 The ECB has stated: "Potential disruptions to personal data flows should be negligible as financial institutions are advanced in their planning and intend to rely on mechanisms available to them under the data protection legal framework, such as for example standard contractual clauses."

25 The Bank of England has stated: "The UK Government has announced its intention to continue to allow the free flow of personal data from the UK to the EU. Once in effect, this will reduce disruption to UK households and businesses' use of EU financial service providers." "The European Commission has indicated that it does not intend to take similar action to ensure the free flow of personal data from the EU to the UK in a no-deal scenario. This may restrict EU households and businesses from continuing to access UK financial service providers." The FCA has also stated: "Without action by EU authorities EU rules would limit the flow of personal data from the EU to the UK."

MREL

26 The ECB has stated: "Some uncertainty remains over the treatment of the stock of MREL securities issued under UK law, in the event that the UK decides not to recognise the resolution powers of the Single Resolution Board (SRB)." The ECB has added: "A mitigating factor for MREL shortfall risk is the case-by-case approach that would be taken by the SRB, which may entail extending the affected banks' transitional periods to meet MREL requirements. The UK could also solve the issue by unilaterally recognising the resolution actions of the SRB, and thus continuing to comply with the Key Attributes of Effective Resolution Regimes for Financial institutions developed by the Financial Stability Board."

Other risks

27 The Bank of England Financial Policy Committee has drawn attention to a range of other risks that could cause some, albeit less material, disruption to economic activity if they are not mitigated, including risks relating to "credit rating agencies, settlement finality protection for financial market infrastructure, UK banks' access to euro payment systems, the ability of EU firms to trade on UK trading venues and increased prudential requirements for banks and insurance companies."

28 In its Q&A on its Communication of 19 December, the Commission stated: "As indicated by the Commission in the Communication of 13 November, contingency measures shall be strictly limited to what is necessary to deal with major disruptions. They cannot offset some of the costs created by the application of two separate regulatory and supervisory frameworks, nor remedy delays that could have been avoided by preparedness measures and timely action by relevant operators."

Conclusion

29 The ECB has stated: "An orderly withdrawal of the UK from the EU poses a limited overall risk to euro area financial stability. But the uncertainty accompanying a cliff-edge Brexit could have the potential to pose a more significant downside risk to financial stability." The Bank of England has stated: "Since the EU referendum in 2016 the Financial Policy Committee and other authorities have identified risks of disruption to the financial system that could arise from Brexit and worked to ensure they are addressed."

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14. Steven Maijoor, Chair of ESMA: speech in Athens, 3 October 2018.