Brexit: avoiding a cliff edge in financial services

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Introduction

With less than six months until the UK leaves the European Union, businesses across Europe face significant political and regulatory uncertainty. Brexit is unprecedented in its scale and complexity and creates uncertainty for all sectors of the economy, but particularly for firms which have a large share of cross-border business including wholesale banks. This article focuses on the practical challenges which wholesale banks face in their preparations for 29 March 2019. To ensure an orderly withdrawal process and provide additional time for businesses to adapt, a transition period to the end of 2020 remains critical. It is important that an agreement on the Withdrawal Agreement is reached as soon as possible to provide certainty of the transition period.

In the absence of certainty that there will be a transition period, firms are implementing their contingency plans to ensure that they can continue to service their clients and a number of operational and practical challenges remain. These include significant risks that urgently require policymakers and regulators to work with the industry on solutions. Given the extremely tight timescales, these issues have to be addressed as a matter of urgency by policymakers and regulators to ensure an orderly withdrawal which minimises disruption to clients and consumers and safeguards financial stability across Europe.

1. Challenges in preparing for Brexit

With a significant proportion of Europe's capital market activity currently being conducted in the UK, the wholesale banking industry faces particular challenges during the Brexit process to continue to provide essential services to clients and maintain well-functioning markets.

Due to the continued uncertainty surrounding the UK's exit from the EU, banks have to plan for different scenarios and implement their contingency plans based on the worst case. At the time of writing it appears that there might not be certainty on a transition period until late in the process as any agreement will have to be ratified by the UK and European Parliaments. Therefore, firms are preparing for a 'no deal Brexit' scenario, which assumes the UK leaving the EU on 29 March 2019 without a transition period or access under the EU's existing third country equivalence framework.

Banks have taken significant steps to minimise the impact of a 'hard Brexit' on the provision of client services and disruption to the market including where necessary establishing or building up entities in the EU27. However, as discussed below there are a number of areas where we believe that action is required by policymakers and regulators to mitigate against risks of market disruption. For these identified risks, businesses require urgent clarity on actions that the European Commission, member states and regulators will take to ensure financial stability and avoid significant market disruption in such a scenario.

While we strongly welcome the announcements in the UK of a temporary permissions regime in the UK that provides additional time for EU27 firms to adapt and provisions to ensure that existing contracts can continue to be serviced in a 'no deal' scenario, it is vital that solutions are also found in the EU.

We also welcomed the establishment of the technical working group between the European Central Bank and the Bank of England and have written to President Draghi and Governor Carney to highlight the need to address cliff edge risks[1]. It is important that the working group can agree on the risks that need to be addressed and policymakers can agree on the need for solutions urgently.

We outline below a number of the challenges firms face in their preparations for Brexit on an operational and practical level.

a. Operational challenges

In their preparations for a 'hard Brexit' scenario, firms face significant challenges to operationalise EU27 entity or entities in the time available. This involves an array of activities such as establishing new legal entity and booking structures, obtaining required regulatory approvals, repapering clients, connectivity to local market infrastructure, IT, HR, premises etc.

Such transformation programmes are notoriously complex. PwC prepared a report for AFME in 2017 that shows that structural change programmes delivered to date can take four years or even longer to complete[2]. Banks are systemically important to the global financial system and it is critical that they continue to operate without errors or disruption to support financial stability and meet the expectations of customers, regulators, and other stakeholders. The reasons for lengthy implementation timelines include the complex nature of products and services provided, the need to make granular changes to technology coding and the heavily regulated environment, all of which affect client interactions.

Additionally, firms do not have a clear picture of the plans of other firms including market infrastructure and counterparties. Supervisors can assist firms by providing as much clarity as possible on their expectations.

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[1] https://www.afme.eu/globalassets/downloads/letters/gfma-brx-letter-to-ecb-and-boe-regarding-technical-working-group-on-brexit-risks.pdf

[2] PwC 2017, https://www.pwc.co.uk/assets/pdf/Operational_impacts_on_wholesale_banking_and_capital_markets_in_Europe_Jan_17.pdf

b. Cliff edge risks that need to be addressed

We have defined cliff edge risks as issues that can create market disruption or material impediments to business activities on the day of Brexit if no legislative or regulatory intervention is undertaken.

The below sections focus on three key cliff edge risks which we believe require addressing for global systemically important banks in the period around 30 March 2019 in the area of financial services to ensure financial stability and market functioning within Europe and globally.[3]

Continued access to central counterparties

Brexit will have major implications for clearing. In the absence of transitional arrangements or recognition under the European Market Infrastructure Regulation (EMIR), EU27 banks would find themselves in breach of regulations for maintaining positions in UK central counterparties (CCPs). Without any agreement, the UK would have a third country status, meaning that UK CCPs would no longer be authorised under EU regulations and EU27 participant banks would suffer punitive capital increases. Steven Maijoor, Chair of ESMA, has recently expressed his view that “we need to ensure continued access to UK CCPs for EU clearing members and trading venues”[4]

We agree that a solution is urgently required to ensure that there is no gap in the ability to access CCPs and to avoid increased capital requirements for exposures to UK CCPs.

It has been suggested that EU27 banks could move positions to EU CCPs. However, this would be unrealistic in the limited time available, would involve systemic risk, and it is questionable whether the market alone could supply sufficient liquidity for significant shifts of positions between CCPs. 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 make this a cliff edge risk. Clearing members and end-users would face legal, operational, and governance challenges in transferring positions and are likely to be adversely affected in relation to market liquidity.

[3] We discuss these and other risks in greater detail here: https://www.afme.eu/globalassets/downloads/publications/afme-brx-brexit-key-cliff-edge-risks.pdf

[4] https://www.esma.europa.eu/sites/default/files/library/esma70-156-787_wfe_speech_steven_maijoor.pdf

There is a real risk that, in the absence of clarity on a solution, EU participants will have to close out positions in advance of Brexit to ensure that CCPs have certainty that their participants are able to perform their obligations. This would have a significant impact on markets and clients of those participants and certainty on a solution is required before this process is commenced.

It is also important to address the implications of the UK leaving the scope of the Settlement Finality Directive ("SFD") for payment and settlement systems (including CCPs). Some Member States' transposition of the SFD do not include a regime for the designation of third country systems and therefore some EU Member States will no longer be required to ensure that their laws protect settlement finality and enforceability of collateral in UK-based systems from the impact of insolvency proceedings. This could impact, inter alia, the ability of EEA based clearing members to access UK Financial Market Infrastructure, such as CCPs and Continuous Linked Settlement (CLS) even if those CCPs are recognised under EMIR. It is therefore very important to enable the designation of UK-based systems including CCPs and CLS under the SFD to avoid significant potential disruption.

Contract continuity

Following the UK's departure from the single market, existing passports for financial services will cease. This calls into question the ability of banks to continue to service their clients under existing cross-border contracts and the risk of inconsistent legal treatments.

While we believe that firms should be able to continue to perform contractual obligations under existing uncleared derivatives contracts in most Member States, common 'lifecycle' events in relation to existing contracts cannot be performed. These events can include the exercise of options, transfers of collateral, unwinds or portfolio compression.[5] Such lifecycle events are frequent and the inability to perform them could impair the ability of banks and clients to manage exposures and risks, which is important both to market participants and regulators. For example, the EMIR regulatory technical standards mandate market participants to seek to engage in portfolio compression exercises.

[5] https://www.isda.org/a/ggKDE/ISDA_Brexit_Summary-of-Lifecycle-Events-Analysis.pdf

There are significant execution and timing challenges for firms to transfer legacy contracts to affiliates in advance of Brexit. The scale of this exercise would be unprecedented. Novating contracts does not only depend on firms, as there is the risk that clients and counterparties may delay or refuse consent to novation. Together with the International Swaps and Derivatives Association (ISDA) we have recently explained the challenges firms face when transferring contracts in greater detail.[6]

It is important to provide certainty to the market by permitting continued maintenance, risk management, performance, termination or disposal of existing contracts after Brexit. Ideally, the EU and the UK would include in the Withdrawal Agreement provisions allowing firms to continue to service these existing contracts after the end of the transition period and until their final maturity, disposal or completion. A less optimal solution would be to place a time-limit on the ability to service legacy contracts in a no deal scenario and after the end of the transition period. This would at least give firms more time to run off, terminate or transfer these contracts.

Cross-border data transfers

A third cliff edge risk is the significant uncertainty around the ability of firms to continue transferring personal data between the UK and the EU27 post-Brexit. After leaving the EU, the UK will become a third country and, without a bilateral agreement, would fall outside the EU's "safe data" zone under the General Data Protection Regulation (GDPR). This will make it more difficult for banks and businesses to transfer data between the EU27 and the UK. A transitional period could avoid a cliff edge enabling policymakers and firms to work out practical solutions that would avoid business disruption.

We published a briefing paper[7] on how to maintain the effective flows of personal data, explaining the implications of Brexit, the importance of this for firms and the limitations of private alternative options. There are three main concerns to highlight.

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[6] https://www.afme.eu/globalassets/downloads/publications/afme-isda-contractual-continuity-in-otc-derivatives-challenges-with-transfers.pdf
Also available in French: https://www.afme.eu/globalassets/downloads/publications/afme-isda-contractual-continuity-in-otc-derivatives-challenges-with-transfers-french.pdf
[7] https://www.afme.eu/globalassets/downloads/publications/afme-brx-effective-flow-of-personal-data-post-brexit.pdf

First, many firms that serve European clients rely on data centres located in the third countries to provide financial services across Europe and depend upon the ability to transfer personal data between the third country and EU27 to operate their businesses.

Second, the ability to transfer personal data between entities is also vital in order to comply with regulatory requirements, such as identifying suspicious transactions, assessing suitability, and combating money laundering, terrorist financing and market abuse.

Third, any gap in the ability for firms to transfer personal data due to lack of adequacy decisions in place will not only pose issues for intragroup transfers, but also in regard to sharing with vendors or suppliers, thereby severely disrupting the ability of financial market participants to serve clients on a cross-border basis.

The European Commission has previously stated that it would adopt an adequacy decision to allow for the continued transfer of personal data, if "the United Kingdom's level of personal data protection is essentially equivalent to that of the EU". However, as the Commission notes, "this decision could only be taken once the United Kingdom becomes a third country."[8]

We have proposed a solution where adequacy determinations are initiated by the EU27 and the UK as soon as practicable ahead of the UK's exit. We also urge the relevant authorities to commit to providing a temporary solution to avoid any gap while adequacy assessments are undertaken to ensure that there is no gap following the UK's withdrawal.

c. Risk of fragmentation

It is important to also consider further potential barriers to cross-border activities and trading in a 'no deal' scenario and beyond. In addition to the operational challenges and cliff edge risks identified above, there are a number of areas of uncertainty which could lead to a split in liquidity and greater fragmentation of European capital markets with consequential impacts for end users. For example, these include issues such as access to trading venues, the operation of the MiFID Share Trading Obligation, and implications of the Short Selling Regulation on market making in EEA sovereign debt.

[8] https://ec.europa.eu/info/sites/info/files/communication-preparing-withdrawal-brexit-preparedness.pdf

2. Conclusion

Banks face a number of significant challenges in their preparations for the UK exiting the European Union. While firms are implementing their contingency plans, substantial operational and regulatory hurdles make time a premium with only six months until the UK formally becomes a third country.

Given the ongoing political uncertainty, it is crucial for regulators across Europe to work together and engage with firms to assess risks and support practical solutions which enable markets to continue to serve the needs of end users in any Brexit scenario.

It is now time for European Member States, the European Commission and regulators to step forward to work with the industry to find solutions to minimise the potential cliff edge risks in the interests of supporting an orderly withdrawal and maintaining financial stability.