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The cliff edge risks from Brexit: what they are, how to mitigate them and what is done to mitigate them?

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Before the summer break, I used to start my talks on Brexit mentioning my hope that somebody from London would call it all off. I do not have this hope any more. This sad nonsense of Brexit will continue till the end. But I will take with me as a message from this meeting what Mrs McGuiness has just said: the UK used to be the most reluctant Member State but let's hope that it will be the closest third country.

I have been asked to speak here about the risks associated with Brexit, the ongoing work done at the European Parliament and elsewhere to mitigate it and whether it can be mitigated.

We all know that the United Kingdom will leave the Union on 29 March 2019 at 11 p.m. After that, it will become a third country, and this has huge implications for the financial sector, of course.

There has been already in February a series of notices issued by the Commission's Brexit preparedness group and explaining, in a number of areas related to financial services such as post-trade, banking, insurance, asset management, credit rating agencies, the exact legal implications of the UK being a third country.

This situation of the UK becoming a third country is the starting point for the reflection on cliff-edge risks from Brexit.

Let me first outline briefly the state of play of the negotiations and the context in which risks exist and preparation for Brexit has to be made.

The EU and the UK are continuing the work on key aspects of the withdrawal agreement and the framework for the future relationship. To date, serious divergences remain on the draft withdrawal agreement, in particular regarding the backstop for the Irish border and governance. There will be an EU summit on 18-19 October. If we reach by that day sufficient progress, then the European Council might decide to have an extraordinary meeting at the end of November to finalise the withdrawal agreement and the political declaration on the future framework.

Both sides strive to reach agreement but the current context is dominated by a high degree of uncertainty.

It is clear that the UK withdrawal will lead to disruption with or without a withdrawal Agreement. Of course, the most severe and disruptive outcome would be the no deal scenario.

What are exactly those risks?

EU and national institutions and agencies are devoting a lot of effort to mapping the risks to financial stability arising from different Brexit scenarios. While financial stability is fundamental, Brexit also means less integration, challenge to liquidity, access to markets, fragmentation, and all of this means long-term consequences.

The Commission is analysing the possible risks related to the UK withdrawal, together with other relevant European institutions and bodies such as the ECB/SSM and the European Supervisory Authorities.

Also, a technical Working Group has been set up between the Bank of England and the European Central Bank to look into any risk-related issues that could arise around 30 March 2019. This work is ongoing and a report is expected soon.

From the work done by those institutions, it seems that, broadly speaking, there are three main areas of risks relating to Brexit.

The first is this of access to clearing. UK CCPs will stop being authorised in the EU at the time the UK ceases to be a Member State. They will be third country CCPs and have to seek recognition under article 25 of EMIR in order to be allowed to keep providing clearing services in the Union.
Also, paragraph 3 of article 4 of EMIR states that the OTC derivative contracts that are subject to the clearing obligation shall be cleared in a CCP authorised or recognised under EMIR. Therefore, EU clients and members will no longer be able to use UK CCPs to fulfil the clearing obligation as long as they are no longer authorised and not yet recognised in the Union.
However, there will be no obligation for UK CCPs to off-board EU clients and members: those will still be able to retain accounts at UK CCPs.

The second issue is the continuity of those contracts which have been concluded between UK and EU27 market participants before Brexit and expire after the Brexit date. This issue concerns two main types of contracts: insurance contracts and Over The Counter (OTC) derivatives.

The third main area of risk relates to data transfers. This includes both data flows between firms and the access of supervisors such as ESMA to data provided by UK firms.

There are also issues relevant to specific Member States. For example, the third country regime in the Settlement Finality Directive is actually a national option, not used by all Member States. This might create issue for the access to UK payment systems of firms located in those Member States not having a third country regime for payment systems.
Another example could be Ireland having no Central Security Depository (CSD) and currently using Euroclear, the UK CSD. This CSD will no longer be authorised in the

EU after Brexit and therefore no longer authorised to offer services in the Union until its seeks recognition as a third country CSD. A solution to this issue will need to be found and reflection is ongoing.

Let me say that there are diverging views regarding the level of risks from Brexit. There are divergences in the assessments made by regulators. We see some tendency for UK regulators to see the risks to the financial stability of the EU arising from Brexit as higher than EU regulators do. There are also divergences in the assessments made by regulators and the industry, respectively. Typically, the industry considers the risks related to the potential loss of validity of contracts concluded between UK and EU firms before Brexit as a key issue needing public intervention while the Commission sees it as an issue that firms can largely manage by themselves.

However, whatever the actual magnitude of the risks, it is clear that preparedness will reduce the extent to which they will materialise. Brexit preparedness is matter for firms, supervisors and regulators, but industry work on Brexit preparedness is crucial.

Firms have a primary responsibility both in preparing for no-deal and for adapting to Brexit through the contingency planning that they are doing. The Commission has consistently encouraged all stakeholders to prepare for the UK withdrawal from the EU, and this encouragement was underlined again by the European Council of 29 June.

Many firms have been clearly doing their job. Large firms have been seriously working on their Brexit contingency planning, at multiple levels: at the level of individual products and services, at the level of legal structures and business models and at the level of communication with clients.

This is good. Contingency planning should continue and should be intensified where needed. It is true that a transition period might give more time for the adapting to Brexit. However, as we all know, the transition period isembedded in the withdrawal agreement, and there is uncertainty on this agreement. Therefore, it is impossible to rely on the existence of such a transition period until the very end of the negotiating process. This is why contingency planning must be done as if there were no transition period.

However, this being clear, there is a need for guidance from supervisors and, of course, for political certainty regarding the final deal in order to help firms in their contingency planning. However, political uncertainty will stay with us until the end and sometimes political declarations are just that: political declarations. You need to wait for the legal text to have certainty and I would not build the future of my firm on the basis of political declarations.

Clearly, institutions and agencies in the EU are working on steering Brexit and addressing cliff-edge risks.

I trust the Commission is constantly working on Brexit contingency planning. They have published on 19 July a Communication on the ongoing work for on the preparation for all outcomes of the UK withdrawal.

The EU and Member States may want to be prepared to take unilateral contingency measures to mitigate some of the consequences of a no deal scenario. However, such unilateral measures will never be able to mitigate the significant impact of a "no deal" scenario. It seems legitimate to expect some information on those matters soon.

There is also a role for the ESAs in the planning for Brexit. Strong ESAs will be important in the context of Brexit. ESMA, EBA, and EIOPA are here to maintain supervisory convergence and a common interpretation of EU rules throughout the Brexit process. They have already provided guidance on the application of relevant pieces of legislation. Most notably, ESMA has issued guidelines on the application of MiFiD, UCITS and the Alternative Investment Fund Managers Directive in the context of relocation of firms from the UK.

However, it seems that there are issues with the implementation of those guidelines in practice and that they are not respected as they should be. Guidelines are addressed to national competent authorities and need to be applied by them on a case-by-case basis, which requires a lot of judgement. There is no way for, for instance, ESMA, to check the application of the guidelines and whether application is done in a consistent way across the Union.

The ESAs are also seen on the EU side as important in the Brexit context in order to avoid supervisory race to the bottom among national regulators and to prevent so-called “empty shells”, “letter boxes” or “brass-plates” from being established in the Union and bringing uncontrolled risk from the outside.

I would wish now to spend some time on a very crucial issue, which is this of contract continuity.

It illustrates very well how views on the risks associated to specific sectors might diverge, and also how cliff-edge risks can be reduced by adequate contingency planning.

Over he last two years, there have been repeated calls from the industry for a coordinated public solution, with mentions of a huge volume of contracts at risks.

Yet the analysis undertaken so far by the Commission has shown the following.

In the case of over-the-counter derivatives, many of these contracts expire before the Brexit date, and therefore do not create cliff-edge risks. In addition, derivative contracts concluded between UK and EU market participants should in principle remain valid.
As analysis from market participants, among others from ISDA, has shown that, under the applicable national third country provisions of different Member States, the performance of existing obligations under those contracts could continue. This would mean that those OTC derivative contracts can normally be held to maturity and

execution events such payment or settlement can normally be performed. In other words, there would be no issue of continuity, even in the case of a no-deal scenario, for those OTC derivative contracts. However, the picture is more mixed when it comes to certain life-cycle events such as roll-over, novation and portfolio compression. They imply as a rule the creation of new rights and obligations. In those cases, an authorisation under Union or national law may be required.

In the case of insurance contracts, the vast majority of them are one-off or short-term year contracts such as travel insurance. For these contracts, there are no cliff-edge risks. As regards the rather limited number of cross-border EU-UK insurance contracts that would still be in place after the UK's withdrawal, they would normally remain valid and the performance of existing obligations under the contract could generally continue to take place.

Then, in late August, it was reported in the press that firms had already done a lot to ensure the continuity of insurance contracts. They have transferred policies to subsidiaries in continental Europe or changed the legal status of UK insurance firms. The title of the relevant Financial Times article on that issue was “insurance contracts safe after Brexit”. I do not know if we can really endorse such a statement here and now, but the example of what has been done in this field shows that solutions to address cliff-edge risks exist and that adequate preparation can reduce the threat of no-deal and the disruption of Brexit.

Let me now mention the issues related to the future relationship between the EU and the UK.

Negotiations on the future relationship can and will only start after the withdrawal and once the UK is a third country. However, reflection on the future relationship as regards financial services is already quite advanced.

In discussions with the UK on the future relationship in financial services, it appears that there is now convergence on a set of issues. Namely, there is convergence in the use of equivalence as the main tool, on the principle that each side should maintain full regulatory autonomy and in the common understanding that good cooperation will be necessary.

In particular, one cannot stress enough the importance of continued regulatory and supervisory cooperation between the EU and the UK. Discussion, dialogue, comprehensive memoranda of understanding and the creation of good day-to-day working relationships between EU and UK regulators and EU and UK supervisors will be crucial in the future. This simply reflects the fact that the UK and the EU are two large and interconnected markets, geographically close to each other and that even after Brexit, interconnectedness between the two markets is likely to remain very significant. This situation means that there will be spill over effects and externalities between the two parties: decisions taken by UK firms, UK supervisors and UK regulators will have effects in the EU and vice-versa. Therefore, those spill overs and externalities need to be addressed, and one way of doing so is through regulatory cooperation.

However, regulatory and supervisory cooperation should not mean loss of regulatory autonomy. Both the EU and the UK agree on that in principle. However, there is still, in the discussions between the UK and the EU, a clear difference of views about how regulatory autonomy might be safeguarded in practice and how it can be ensured for one side without endangering the autonomy of the other side. In particular, the proposals of the UK, for instance a more binding equivalence process and making withdrawals of equivalence decisions more constrained, are being perceived by the EU as precisely attempting to limit the regulatory autonomy of the EU. The UK has also been ambiguous in its demand to extend the scope of equivalence, in part hinting at an across the board system which would in fact amount to full mutual recognition and full participation in the EU single market for financial services from the outside, with no EU enforcement.

Discussion on an enhanced form of equivalence, with greater supervisory input from the Union over third country firms which are systemically significant for the Union, is being discussed in the review of EMIR and in the investment firms review, on which the ECON committee has voted this Monday.

The review of the ESAs is also looking at ways of improving supervisory convergence and giving those authorities greater responsibility for monitoring the situation in third countries on which the Commission has taken an equivalence decision.

We need to see how discussions on all those files progress.

I would like now to say a few words on global standards.
With Brexit, some loss of integration between the EU and the UK is unavoidable. However, it will be crucial that both the EU and the UK keep abiding by the international standards, those of the FSB, of the Basel Committee, of CPMI, of IOSCO, of the International Association of Insurance Supervisors. This would minimise regulatory divergences between the EU and UK, which are in the interest of no one. This would more generally avoid market fragmentation on a global scale. We have been investing a lot of efforts, in the aftermath of the global financial crisis, in reducing fragmentation and taking a coordinated approach to the problems that have been revealed back then. Even with Brexit, both the EU and the UK should now strive to keep this global approach and maintain regulatory coherence at the global level.

This being said, global standards are on purpose broad enough to leave scope for divergence. They are also minimum standards and it is often the case that the EU has gone further than them when making legislation. Therefore, they are benchmarks that all jurisdictions should respect but they are not suited to become the sole basis for EU-UK regulatory cooperation in the future.

To conclude, while work on a Withdrawal Agreement and on a framework for a future relationship continues, including by adapting our equivalence framework where relevant, I would encourage once again all market participants gathered today to speed up their own preparedness measures in view of Brexit. As I said, this is the best way to mitigate the disruptions related to the UK withdrawal.

I trust that an industry used to operating in an uncertain environment such as the financial industry is up to this challenge.