POSITION | EUROPEAN POLICY | BREXIT

Financial Services

Challenges caused by Brexit

27 February 2018

Core Recommendations

- Avoid disruptions to existing loans or loan facilities through the loss of passporting rights for financial institutions
- Ensure ongoing servicing of insurance contracts
- Prevent disruptions on financial markets due to an abrupt relocation of clearing activities for existing derivatives
- Implement safeguard measures to ensure an orderly transition regarding the application of external ratings for financial products already on the market and for financial institutions
- Give corporates and financial institutions a reasonable timeframe to adjust to regulatory changes caused by Brexit.

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BDI-Task Force Brexit

The BDI is committed to supporting the Brexit negotiation teams with in-depth expertise in a number of areas of economic policy. In summer 2017, the BDI set up a Brexit task force together with its member organisations, company representatives and partners including the Association of German Banks (BdB), the German Insurance Association (GDV), the Federation of German Wholesale, Foreign Trade and Services (BGA), the Confederation of German Employers' Associations (BDA) and the Association of German Chambers of Commerce and Industry (DIHK).

The BDI Task Force Brexit has established ten project teams to address specific policy areas: (1) Trade in Goods, (2) Transportation and Logistics, (3) Data and ICT, (4) Taxation, (5) Legal consequences of Brexit in core areas of business law, (6) Energy and Climate Policy, (7) Market Access, (8) Workforce Mobility, (9) Banking, Finance and Insurance, (10) Negotiation Process (including Northern Ireland, Research and Development, Defence, Financial Commitments).

The objective of the project teams is to identify the potential risks posed by the exit of the UK from the EU and to propose constructive approaches to countering these risks. The project teams are looking at the regulatory issues in the individual policy areas on the European and the national level. The BDI is also a member of a similar task force at Business Europe, the umbrella organisation for European business. The work of the BDI Task Force Brexit will progress in line with the official negotiations.

This position paper is based on the background information developed by the BDI Task Force Brexit. The views expressed in this position paper are those of the BDI and do not necessarily reflect those of the other members of the Task Force.

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For diversified economies such as Germany and other European countries, free access to financial services is indispensable. London has long been Europe's central hub for many kinds of financial products. Nonetheless, there are several smaller financial hubs on the continent that have the potential to serve clients well in the European Union following Brexit.

As several studies by think tanks and political institutions have shown, the UK's decision to leave the EU (Brexit) will have major implications for financial markets and access to financial services in Europe (see, for example, Sapir, Schoenmaker, Veron 2017; Batsaikhan, Kalcik and Schoenmaker 2017, House of Lords 2016; PWC 2017). In order to address these implications, all financial market participants will have to implement substantial adjustments in many market segments. As the final decision on the overall economic framework for the future relationship between the EU27 and the UK after Brexit is still open, the potential implications are currently hard to gauge.

In this paper, our working group examined the impact of a so-called *hard* Brexit. In this case, the United Kingdom will neither be part of the single market nor part of a trade and investment agreement with a comprehensive financial services chapter. Given the complexity of the issue, it must be assumed that the negotiations over such an agreement will take at least three years and thus will not be finalised before the UK leaves the EU (see e.g. UK Finance 2017 for a detailed analysis).

Any agreement providing for a high degree of mutual access to the markets in financial services will necessarily depend on very close alignment between the financial regulatory and supervisory regimes of the UK and the EU27. Establishing such a closely harmonised system within the remaining time available will, in all likelihood, only be possible if the UK stays in the single market – an option that the British government has ruled out. Market participants must therefore plan on the assumption that no comprehensive agreement will be in place on the day of Brexit (regardless of any transition period).

In view of the strong probability that no agreement over a comprehensive future framework for financial services will have been reached between the EU and the UK before Brexit takes effect, financial institutions and their corporate clients will be forced to make fundamental and far reaching adjustments. Many banks and other financial institutions, as well as clients, have already begun to reorganise their business structure, legal entities, staff and processes to prepare for the anticipated effects of Brexit on financial services. As a result, many financial services currently provided from the UK may be provided from an EU27 location in the future. European supervisory and regulatory authorities are also addressing Brexit and the potential impact on financial markets and financial institutions by setting out their policies on the upcoming challenges for financial institutions.

Extensive consultation in our working group has led to the assessment that post-Brexit, most financial services will continue to be supplied in adequate quality at similar cost. Brexit is nonetheless expected to have a considerable impact on general access to financial services, in particular regarding the scope of services and instruments available.

The question of how to ensure that EU27 corporates will continue to have full and uninterrupted access to the entire range of financial services they require thus still deserves more attention. This issue ultimately boils down to two key questions:

First, what impact will Brexit have on existing transactions and services already rendered, in particular loans or credit facilities extended by UK-based financial institutions to EU27 corporates? This question is often also discussed under the heading of “business continuity” (see also below).

Second, will the EU27 hubs immediately be able to provide the same product range as London currently does and can they immediately absorb the increased demand? It will presumably take time and effort to build up and adjust the required infrastructure, relocate market activities, and transfer the required depth of capital and liquidity.

From our point of view, **the overarching goal must be to ensure that companies can use the required financial services without interruptions and to make sure that all market participants have sufficient time to adjust corporate treasury and finance activities** to a post-Brexit world. While this will be challenging in many instances and may require changes to legal structures, business models and banking relationships, no insurmountable obstacles have been identified so far.

In the following, the BDI’s Task Force on Brexit has evaluated the most critical issues for corporate clients, banks, and insurance providers.

Identified Issues: Assumptions and Measures

In our view, the most critical issues that need to be addressed are the potential effects of the loss of so-called passporting rights as a consequence of Brexit on existing financial transactions, in particular loan agreements and credit lines (business continuity), and the future framework for clearing derivatives.

We also discuss the future treatment of benchmarks and ratings administered in the UK as crucial side aspects of our analysis, as well as addressing specific insurance-related issues.

Finally, we identified data flows and data protection rules as a crucial component for a future UK-EU trade relationship in financial services. However, standards for the free flow of data are an overall economic issue that affects not only financial services.

Access to Financial Services

Assumptions

Without a comprehensive agreement in place that grants sufficient access to the financial markets in the respective other jurisdiction, financial institutions domiciled in the UK will lose access to the EU27 market and vice versa on the present terms.

The loss of passporting rights for banks, insurance companies, investment funds and other financial market participants could affect existing financial transactions, in particular loans and loan facilities. The impact could go beyond restrictions regarding future transactions. It is currently unclear whether the loss of passporting rights would necessarily mean that institutions would be prohibited from continuing to service loans or loan facilities agreed upon and paid out prior to Brexit. The relevant financial institutions could potentially be forced to unwind existing credit facilities. Such measures would be subject to and bound by constraints under applicable contract law.

Should an uninterrupted continuity for existing credit facilities not be sufficiently assured, this could have highly disruptive effects on financial institutions and their corporate clients, including liquidity shortages. Consumer contracts, however, will most probably not be affected in any meaningful way as consumer loans tend to be provided locally.

Even if existing financial transactions were to remain unaffected, corporate clients will nevertheless be forced to make fundamental and immediate adjustments to their current financing activities in order to channel all future funding activities through EU27-based financial institutions. Fundamentally changing or replacing an existing network of business relations with financial institutions, especially in a very short time, will prove to be extremely challenging for corporate clients. Such business relationships have usually developed over a long time, often many years if not decades. Considering the procedures required for accepting new clients and granting credit approvals, it appears unlikely that banks will be able to provide credit facilities to new clients at short notice and in the required amounts.

Replacing existing creditors through new bank relationships can be particularly challenging for corporate entities currently facing financial difficulties.

Measures

The introduction of regulatory grandfathering provisions should be considered, which, at least for an adequate transition period, would **suspend any immediate effects due to the loss of passporting rights on existing financial transactions.** This measure should not to be confused with providing unrestricted market access. The purpose of such grandfathering provisions would only be to assure corporate clients that existing financial transactions, in particular loans and credit facilities entered into pre-Brexit can continue to be serviced. Regulators should inform the European Commission, ministries, and legislative bodies if such grandfathering requires adjustments to the legal framework.

Existing Insurance Contracts

Assumptions

When the UK loses its access to the single market, provisions are needed that allow for a smooth servicing of existing insurance contracts. This is particularly relevant for life insurance contracts and pensions that will extend well beyond Brexit given their long maturities.

In contrast, most insurance contracts concerning property and casualty insurance traditionally have a relatively short life span (underwritten in most cases on an annual basis). Hence, insurers are able to adjust their insurance contracts or, alternatively, clients are able to change their insurer once a renewal of a contract is due. But there will be contracts where claims are reported but not yet settled before Brexit. It is also likely that claims relating to events that occurred before the contract expired will be reported in the future. This is particularly relevant for liability insurance contracts.

With the United Kingdom leaving the European Union, UK-based insurers will lose their EU market access through passporting and EU insurers, in turn, will lose their passporting rights for the UK (i.e., EU-wide market access for insurance firms with a license in one EU member state). Contracts that have been written under passporting rules are legally still binding after Brexit. However, insurers that continue to service these existing contracts would no longer have the required authorisation. Consequently, servicing these contracts would count as “unauthorized insurance business” (GDV 2017). Insurers would not be allowed to receive premiums or to process payments and claims, leading to a high level of risk for policyholders.

Measures

Insurers have already set up contingency plans by transferring portfolios or by establishing branches and/or subsidiaries to adapt their UK/EU cross-border business to the post-Brexit world. However, the transfer of portfolios to another jurisdiction is a complex and lengthy process and may also require the approval of courts/supervisory authorities and/or policyholders. In particular, life insurance and pension contracts relate to assets that cannot be untangled without high costs for customers. The approval of new entities is time consuming, too.

In order to prevent unauthorised insurance activities, European and UK insurance regulators and legislators should thus **authorise insurers to continue serving their clients for the remainder of existing contracts (“grandfathering”)**.

Grandfathering would protect customers from adverse consequences of Brexit and prevent consumer detriment as far as possible. Grandfathering would offer a permanent solution as it ensures that consumers can continue to benefit from the contracts they have lawfully entered into. Moreover, a portfolio transfer is a very costly process for insurers and customers alike. For life insurance and pension contracts a grandfathering agreement could ensure the stability of the retirement provision and the long-term financial security of those customers. The transitional arrangement should also apply for the underlying reinsurance arrangements.

Given the high workload associated with the different licensing processes, it is unlikely that there is enough time until the Brexit date to completely reorganise business. Insurers should at least be given additional time to revise their insurance contracts in case of a hard Brexit so that they can meet their obligations on a cross-border basis. **A realistic implementation period is required to transfer existing contracts to another entity** and to establish subsidiaries or branches equipped with an EU insurance license in order to avoid unauthorised insurance business. As insurance law varies across the European Union, insurance businesses require profound data mining and implementation. These preparatory steps should be reflected in an appropriate time period.

As some businesses have subsidiaries in the United Kingdom that might have contracts with EU27-based insurance companies, the **UK Government is urged to facilitate business continuity and grant the same means to its national regulators.**

Derivatives and Clearing

Assumptions

Derivatives clearing will be particularly affected by Brexit on two distinct but connected levels, namely the regulatory obligations regarding the clearing of derivatives that are subject to a clearing obligation in accordance with the EU regulatory framework for clearing under EMIR (Regulation (EU) No 648/2012) on the one hand, and the capital charges regarding the exposure vis-a-vis clearing houses in accordance with the Capital Requirements Regulation (CRR; Regulation (EU) No 575/2013) on the other.

Current EMIR Framework for Central Counterparties and Clearing Obligation

The current EMIR regime for central counterparties (CCPs) and the clearing of derivatives distinguishes between EU-based CCPs and CCPs based in third countries. EU-based CCPs obtain an authorisation in accordance with Art. 14 EMIR that is granted by the competent authority of the member state where they are established (in coordination with ESMA and the college of supervisors consisting of certain regulatory authorities of other member states). Authorisations are effective for the entire EU. Third-country CCPs can obtain a recognition in accordance with Art. 25 EMIR. Such a recognition is granted by the European Commission in conjunction with ESMA and requires the adoption of an equivalence decision regarding the applicable regulatory regime. The present EMIR regime is to be revised in order to ensure a greater degree of supervisory oversight over systemically important third-country CCPs and will, in this context, provide for the possibility of rejecting a recognition under certain circumstances.

All European market participants subject to a regulatory obligation to clear derivative contracts (mostly financial institutions) must use either an EU-based CCP or a CCP in a recognised third country (Art. 4(3) EMIR). This clearing obligation applies only to certain types of interest rate derivatives and credit default swaps. In addition, only authorized third country CCPs are permitted to offer clearing services to EU based clearing members (Art. 25 (1) EMIR).

Capital Requirements Regulation (CRR)

The existing CRR regime sets out capital requirements for financial institutions regarding their exposure resulting from derivatives clearing. The requirements cover the exposures from both their own and client-held positions that are cleared through a CCP. It also covers the exposure resulting from financial institutions' contributions to CCPs' default funds, providing that the financial institution is a CCP member. The CRR capital requirements regime for derivatives clearing equally distinguishes between third country and EU-based CCPs. In the case of third country-based CCPs, the CCR provides significantly higher capital charges if the third country supervision has not been recognised as being equivalent to EMIR standards.

Upon the UK leaving the EU, UK-based CCPs' authorizations as EU-based clearing houses in accordance with Art. 14 EMIR would no longer apply. The affected UK-based CCPs will immediately be treated as third-country CCPs both for the purposes of the EMIR clearing obligations and the capital requirements regarding cleared derivatives under the CRR.

Unless UK-based CCPs immediately obtain a formal recognition as third-country CCPs in accordance with EMIR (as revised, see above), EU institutions and all other EU market participants subject to EMIR will no longer be permitted to clear products that are subject to the EMIR clearing obligation via UK-based CCPs. Furthermore, the current EU-based financial institutions would no longer be able to remain clearing members. To what extent this also affects transactions that have already been accepted for clearing with a maturity extending beyond the date of Brexit remains unclear.

In addition, all derivative transactions cleared via UK-based CCPs will immediately be subject to the significantly higher capital requirements under the CRR. This would also encompass transactions that are not subject to EMIR's clearing obligation.

As the vast majority of OTC-derivatives (especially interest rate derivatives) are currently cleared through UK-based CCPs, the abrupt change in status of UK-based CCPs could cause serious disruptions and have potentially destabilising effects on EU markets and their participants.

These disruptive and potentially destabilising effects would be vastly more serious and challenging if the change in status were to affect not only new contracts but also legacy contracts. These contracts would have to be transferred to another authorised or recognised CCP – including a transfer and re-posting of collateral – or, alternatively, terminated. Such a transfer or termination would be challenging from a legal and contractual perspective. For instance, there are open questions regarding the legal basis for such a transfer or termination as well as challenges associated with renegotiating all affected contracts. But also from an operational and economic point of view, there needs to be the capacity to absorb all legacy contracts in such a short time. The transfer of such vast numbers of contracts and collateral to other authorised or recognised CCPs will thus inevitably have a very significant market impact. There will also be wider structural and economic challenges in view of the fact that markets will more be fragmented, affecting overall market liquidity.

Measures

It is therefore of paramount importance to find a solution that avoids such a scenario. Any solution will have to address both the aspect of regulatory access to UK-based CCPs as third-country CCPs as well as capital requirements in relation to UK-based CCPs as third-country CCPs. Such a solution will also need to **resolve the question of whether and if so, to what extent, the change in status will**

affect existing cleared contracts (legacy contracts) and their further treatment for the remainder of their lifecycle.

Benchmarks

Assumptions

The European Union recently introduced a regulation setting out a common framework for financial benchmarks, their providers (administrators) and the users (EU Benchmark Regulation; Regulation (EU) 2016/1011). The central purpose of this new regime is to ensure the accuracy and integrity of benchmarks. The regulation came into force on 1 January 2018.

The regulation outlines the standards for providers of financial benchmarks (administrators) in terms of methodology and transparency. In order to meet these standards, benchmark administrators must present detailed information to the European Securities and Markets Authority (ESMA) on a regular basis. When the conditions for financial benchmarks are met, the regulation allows supervised entities (i.e., financial institutions) to use the benchmarks for financial products.

Under the EU Benchmark Regulation, financial institutions and other supervised entities are required to use only benchmarks that have been formally registered. In the case of benchmarks provided by third-country administrators, this would require a formal equivalence decision.

Benchmarks administered in the United Kingdom are an essential part of financial markets' infrastructure. Most notably, a large number of loan agreements and interest rate derivatives are based on LIBOR and thus a UK-administered benchmark.

Measures

UK benchmarks could abruptly lose their status as an EU-registered benchmark under the EU Benchmark Regulation. This would have very far-reaching and serious consequences if a registration as a third-country benchmark on the basis of a determination of their equivalency is not in place.

Again, it should therefore be considered to **provide at least for adequate grandfathering periods**.

Ratings

Assumptions

Ratings are at the core of modern lending and investment activities. Their main function is to serve as a classification in financial institutions' portfolio management and as a selection criterion for investment products. After the financial crisis and the debt crisis in the euro area, the European Union aimed to "reduce the over-reliance on credit ratings" (European Commission 2017c). The EU also aims to prevent incorrect ratings as were observed during the subprime mortgages crisis.

Since 2011, ESMA has supervised and regulated credit rating agencies based in the European Union. Generally, financial institutions may use ratings issued by ESMA-supervised rating agencies for their lending purposes. With the United Kingdom leaving the EU, however, ratings issued by London-based institutions may no longer be used either for credit risk management or as a basis for investment strategies. Moving forward, European financial institutions as well as investment firms must switch to an ESMA-supervised credit rating agency in order to continue operating their services.

However, certain products are already on the market, such as mutual funds with contractually defined investment criteria. Should such a mutual fund refer to a rating from a UK-based agency, there is a risk that the investment product needs to be unwound with a hard Brexit. This in turn can lead to market instability since a mutual fund could end up selling some or all of its assets at once. In addition, ratings are used for investments conducted by institutional investors.

Measures

So far, Brexit's influence on ratings remains uncertain. There are market-based approaches to resolving barriers. First, financial institutions already have experience in sourcing ratings from agencies based in third countries (most notably from the United States). It remains to be seen to what extent ratings are applied that are solely developed in the United Kingdom. Second, banks have often established their own credit rating processes. With respect to capital management in financial institutions, there is reason to believe that external ratings are relatively easy to replace through other, EU-based, vendors or internal rating models.

Most important, however, is to ensure that ratings issued by crucial rating agencies can still be used by financial institutions and companies based in the EU-27. The prerequisites are given as many agencies have offices in several locations throughout the European Union; it facilitates the organizational restructuring within groups to adjust to a post Brexit scenario. Rating agencies may therefore be able to shift critical data and process steps into the EU-27 and thus under ESMA's supervision. In the context of Brexit, **ESMA should be prepared to register and certify credit rating agencies** in accordance with Regulation (EC) No 1060/2009 **with priority** in order to ensure an uninterrupted and compliant risk monitoring through the users of ratings.

Even so, safeguards must be put in place as dependencies still exist. It remains unclear whether and to what extent financial institutions and business vehicles are exposed to potential market disruptions as a result of suddenly "invalid" ratings. Hence, European legislators and regulators should **allow market participants to continue using ratings from UK-based agencies for the time of a transition period**. In case both parties are unable to agree on a transition period, **a timeframe of five years should provide sufficient reassurance** by allowing financial institutions to cover most long-lasting credit engagements through regular review processes.

Data Protection and Free Flow of Data

Assumptions

Financial transactions require the exchange of sensitive and confidential personal data. When European data protection rules no longer apply in the United Kingdom, confidential information on European bank account holders must no longer be stored in the UK.

Furthermore, the securitisation of consumer loans through asset-backed securities requires the exchange of information on debtors between the loan-making bank and the securitising investment firm. Should the bank be based in the EU-27 and the investment firm in the United Kingdom, the bank must not forward such data unless an appropriate data exchange regime is in place between the UK and the EU.

In the insurance sector, too, the transfer of personal data of policyholders is common practice. It takes place, for example, within an insurance group, between insurers and reinsurers or when business functions such as claims management are operated by a service provider.

Measures

While the free flow of data and data protection standards have a significant influence on financial services activities, data exchange rules affect a broad range of cross-sectoral issues. These issues will be addressed in a separate paper.

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