International
Capital
Market
Association

ICMA

22 June 2018

Dear President Juncker and Prime Minister May,

BREXIT: CLIFF-EDGE RISKS IN INTERNATIONAL CAPITAL MARKETS

The International Capital Market Association (ICMA) represents 540 member firms working in the international debt capital markets in both the EU27 and in the UK, and more broadly in 62 countries in total, on both the buy side and the sell side of the market. ICMA and its members are very concerned about the risks of a cliff-edge on Brexit, which would fragment international debt capital markets and damage business in the real economy and financial stability. Assuming that Brexit goes ahead as planned, this letter gives examples of cliff-edge risks, and proposes a way in which they can be resolved. They need to be resolved as soon as possible ahead of Brexit.

Background to cliff-edge risks

2 The UK is proposing to leave the EU Single Market when it leaves the EU. In the international debt capital markets, cliff-edge risks will arise when passporting rights between the EU27 and the UK cease. These cliff-edge risks will arise most immediately if the UK leaves the EU without an agreement on Brexit on 29 March 2019. A transition period was agreed at the European Council on 23 March this year during which passporting rights will continue, subject to a withdrawal agreement between the EU27 and the UK with effect from 29 March 2019. But even if there is an EU27/UK withdrawal agreement, cliff-edge risks will still arise at the end of the transition period at the end of 2020, if there is no EU27/UK trade agreement which addresses them; and, even if there is an EU27/UK trade agreement, there will be cliff-edge risks if the agreement does not preserve existing passporting rights.

Cliff-edge risks in general

3 International capital market firms need to start preparing for the risks of a cliff-edge now, where they have not already done so. When existing passporting rights cease, the UK has proposed to the EU27 mutual recognition of each other's regulatory standards, taking into account that EU27 and UK regulatory standards will be the same at the outset. But this approach has so far been rejected by the EU27, on the grounds that EU27 and UK regulatory standards may diverge in future. In those circumstances, if there is no consensus on a way forward, international capital market firms have two main options.

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4 One option is to make use of EU provisions for regulatory equivalence. This is currently a patchwork: it applies to some parts of the EU regulatory framework, but not others; where it does apply, it is not always complete; it requires a judgment by the European Commission as well as a technical assessment, and it takes time to assess; and the determination of equivalence can be withdrawn at short notice, though this has not happened so far. The assessment of regulatory equivalence is based on measuring outcomes, but outcomes are not straightforward to measure. It is not yet clear whether, during the EU27/UK negotiations, there will be scope to enhance the arrangements for regulatory equivalence for the UK as a third country.

5 Regulatory equivalence is useful for international capital market firms, but it is not likely to be a complete solution. If it is not possible to rely solely on regulatory equivalence, the other option for international capital market firms is to ensure that, before passporting rights cease, they are authorised to provide financial services in both the EU27 and in the UK, even though this is likely to involve higher costs for them (eg in terms of extra capital and liquidity) and for their business customers than at present. Most large international capital market firms either have authorised operations in the EU27 and the UK already or are seeking authorisation to do so, as long lead-times are involved. But those which have not yet done so need to consider this option carefully, given the long lead-times involved and the shortage of time available.

Specific cliff-edge risks

6 In addition to the need for Brexit preparations in general, there are a number of specific cliff-edge risks involving the EU27 and the UK. When passporting ceases, cliff-edge risks include, for example:

- the risk that it may not be possible for EU27 and UK parties to continue to perform some existing cross-border insurance contracts by paying claims to, or receiving premiums from, policyholders in the other jurisdiction;
- the risk that EU27 and UK parties may no longer have the necessary permissions to service over-the-counter (OTC) derivative contracts with parties in the other jurisdiction;
- the risk that central counterparties (CCPs) may no longer be recognised across borders with the result that EU27 and UK CCPs may find that they are in breach of regulation by providing clearing services in the other jurisdiction, requiring abrupt close-out of positions;
- the risk that the holding and sharing by the EU27 and UK of each other's data may be in breach of national law, with the result that barriers to the cross-border flow of personal data disrupt the provision of financial services;

- the risk that liabilities already issued under UK law may be considered in the EU27 like any other liability governed by the law of a third country, with the effect that they no longer count towards the minimum capital requirement for own funds and eligible liabilities (MREL);
- the risk that, under MiFID II/MiFIR, data thresholds set for the EU as whole may no longer be relevant;
- the risk that automatic recognition of resolution actions under the Bank Recovery and Resolution Directive across the EU may no longer apply between the EU27 and the UK; and
- the risk that delegation of fund management across borders, which is a global practice, may be restricted.

7 If these specific cliff-edge risks are not quickly resolved, the resulting fragmentation in the functioning of international capital markets, and associated market uncertainty, will damage growth in the real economy and damage financial stability.

8 Many specific cliff-edge risks cannot be fully resolved by unilateral action by the EU27 or the UK. They can only be fully resolved by agreement between the EU27 and the UK. It is therefore encouraging that, on 27 April this year, the European Central Bank and the Bank of England announced that they are setting up a working group reporting to the European Commission and HM Treasury on risk management in response to Brexit. Regular communication from the European Central Bank and Bank of England jointly in the run-up to Brexit would help reduce market uncertainty. Supervisory cooperation between the EU27 and the UK needs to continue after Brexit, including the securities markets as well as banking.

9 It is not feasible for international capital market firms to address all the potential cross-border contractual issues – including the associated requirements for repapering – that arise when passporting rights cease through private sector negotiation alone, given the shortage of time available. The best way to address cliff-edge risks is through a joint statement by the EU27 and the UK in, or alongside, the withdrawal agreement. This would need to provide for continuity of cross-border financial contracts between the EU27 and the UK by "grandfathering" all such financial contracts outstanding at the point at which passporting ceases. Something similar was done when several EU national currencies were replaced by the euro on 1 January 1999. If it is not possible to use the withdrawal agreement, a separate agreement is needed between the UK and the EU27: the sooner the better; and the sooner there is a joint statement of intent by the EU27 and the UK, the better, given the shortage of time available.

Conclusion

10 At a technical level, officials in both the EU27 and the UK are already acutely aware of the potential damage to the real economy and financial stability if cliff-edge risks in the international capital markets are not resolved. But they cannot be resolved without political will on both sides.

We would welcome an opportunity to discuss these issues in more detail.

Yours sincerely,

Martin Scheck

Martin Scheck
Chief Executive
International Capital Market Association

c.c. Donald Tusk, President, European Council
Michel Barnier, Chief EU Negotiator
Mario Draghi, President, European Central Bank
Philip Hammond, UK Chancellor of the Exchequer
David Davis, UK Secretary of State for Exiting the EU
Mark Carney, Governor, Bank of England

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