The need for early clarity on a Brexit transition

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Association for Financial Markets in Europe
www.afme.eu

Background

More than one year ago the UK public voted for the UK to leave the EU. With the Article 50 process being triggered in March, the two-year Brexit negotiation process is now well underway. AFME has argued consistently that during the negotiation process, market efficiency and financial stability must be safeguarded. The Brexit negotiations are taking place under significant time pressure with the UK's membership of the EU due to end on 29 March 2019. Faced with no clarity on the future relationship between the EU and the UK, market participants are having to take important decisions amid considerable uncertainty.

In light of this, AFME and others have consistently made the case for transitional arrangements following the Article 50 negotiation period. This note is intended to explain in more detail the importance and necessity of transitional arrangements as well as summarise our views on what such arrangements should look like.

While we believe that transitional arrangements are essential, we share the view of the European Council that they *must be clearly defined, limited in time, and subject to effective enforcement mechanisms.* We also recognise the EU27's prioritisation of matters to ensure an orderly withdrawal and the core principles set out in the Council Guidelines including the integrity of the single market. We believe that transitional arrangements are necessary to support these objectives of an orderly withdrawal, ensuring financial stability and the prosperity of both the EU27 and the UK. We urge the negotiators to progress with reaching agreement on the items under discussion in phase one of the negotiations in order to be able to move to discussing transitional arrangements as soon as possible.

Importance of transitional arrangements to avoid cliff edge risks in financial services

There are a few key reasons for asking for transitional arrangements:

- While business and capital market participants are preparing actively for Brexit, they will need more time than the two years contemplated in the Article 50 process to do it in an effective manner. The ongoing negotiations between the EU and the UK involve a number of uncertainties. Businesses are confronted with a range of cliff-edge scenarios that may arise from Brexit as a result of the UK likely leaving the EU without a settled new relationship to enter into on day one. The timeframe required for businesses to put in place post-Brexit arrangements will very likely not be aligned with the timelines of negotiations to agree arrangements for the UK's departure from the EU and the establishment of a new relationship;
- Transitional arrangements are required to avoid cliff-edge scenarios, support economic growth, and maintain market efficiency and financial stability. Absent a transitional period, European businesses and consequently the economy are likely to face significant and highly unnecessary disruption;
- It is therefore essential that clarity on transitional arrangements is provided as early as possible in the process in light of the short Article 50 timeframe and the scale of the changes involved. This will enable businesses to further plan, make decisions and minimise disruption to their financing and risk management activities;
- In the area of financial services, banks are conducting extensive planning and putting in place arrangements to minimise disruption to their businesses and clients[1]. However, additional time is required to adapt to the post-Brexit framework and to minimise disruption for end users of financial services, including ensuring the continuity of existing contracts[2].

The need for early clarity

It is crucial that clarity is provided as soon as possible on a transitional period, and ideally before the end of this year, even if confirming a final legal agreement takes place subsequently. Absent an early agreement on transitional arrangements, businesses will be forced to make sub-optimal decisions and may further delay investment. Banks are actively putting in place arrangements to minimise disruption to their businesses and clients. However, not all Brexit cliff-edges can be resolved through financial firms' planning; a number of arrangements will need to be adjusted to future regulatory conditions which will be apparent when a new EU-UK relationship is established, including in financial services. A transitional period is needed to bridge this time period.

Forcing complex, multinational businesses with long-standing practices to make rushed decisions on the basis of uncertain outcomes increases the risk of higher costs, operational delays, and negative client impact. There

[1] As explained in the PwC report "Planning for Brexit – operational impacts on wholesale banking and capital markets in Europe" link
[2] The importance of this was emphasised in the BCG report "Bridging to Brexit: insights from European SMEs, corporates and investors" link

are also increased operational risks and risks to financial stability. An early agreement on a transitional period would allow for much better preparation to minimise risks and disruptions that could impact on the economy.

Cliff edge risks requiring further consideration

We believe that the need to address cliff edge risks through transitional arrangements should be an objective for both the EU and UK. Further to AFME's previous work, we are conducting further work on cliff edge risks to consider them in greater detail.

A transitional period would avoid or mitigate cliff edge risks that exist. It would give policymakers, regulators, banks and businesses more time to work out solutions that are needed to mitigate any economic fallout from the cliff edge effects. Examples of regulatory cliff edges that would need to be addressed include:

- **CCP recognition:** in the absence of transitional arrangements, EU27 banks could find themselves in breach of regulations for maintaining positions in UK CCPs that would no longer be authorised under EU regulations and would suffer punitive capital increases. The same could apply to UK banks with positions in EU27 CCPs, depending on the UK regulatory regime[3];
- **Existing contracts:** existing cross-border contacts with customers will be affected by the UK's departure from the EU. This calls into question the ability of EU27 businesses to rely on their existing contracts with UK-based institutions or branches of EU27 banks and vice versa;
- **Data transfers:** cliff edge risks exist around the transfer of data between the UK and the EU27. Immediately after leaving the EU, the UK will cease to belong to the EU "safe data" zone and will become a third country. 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.

Benefits of transitional arrangements for businesses, banks and regulators

Introducing transitional arrangements would not only assist banks, but also businesses and regulators:

- **Businesses and investors**: in addition to direct impacts on business, Brexit is likely to impact businesses' funding and risk management services. Users of financial services that are currently provided on a cross border basis between the UK and EU27, in particular markets services used to fund operations and capital expenditure and to manage risk, are expected to be impacted by Brexit[4]. Brexit will impact banks' regulatory approvals and permissions to conduct business and establish contracts with clients – such as investors, SMEs and corporates – in other jurisdictions. This is expected to impact a broad range of capital market services (including derivatives contracts, clearing, cross border loans, cash management and deposit taking as well as Equity Capital Market, Debt Capital Market and Merger & Acquisition services). A transitional period is necessary to give participants time to consider the effects on their financial services activities, consider options and decide which actions are needed to maintain market efficiency and financial stability[5];

- **Banks**: the challenges for banks (both EU and UK-based) in adapting will depend on each bank's existing geographical footprint, diverging national licensing and regulatory regimes, each bank's legal entity structure and the services offered. A transitional period will provide a more realistic timeframe to obtain the required local authorisations and to put in place new organisational structures, including setting up new physical infrastructures and transferring client contractual relationships where required. Additional proposals for structural changes such as the proposed requirement to establish an intermediate parent undertaking under CRD5, add complexity to Brexit planning. The interaction with Brexit plans should be acknowledged when deciding upon the timing of the introduction of such proposals to facilitate smooth implementation. Obtaining the necessary regulatory approvals is an external factor of uncertainty for banks and a transitional period would make sure that license and model approvals will be in place on time;

- **Regulators**: Brexit also creates challenges for regulators in adapting to the new arrangements including licence and model approvals, putting in place new cooperation and information sharing arrangements between EU and UK authorities, adapting to changes in banks' structures, participation in colleges,

[3] See IRSG paper, CCPs post Brexit at https://www.irsg.co.uk/assets/IRSG-Paper-on-CCPs-Post-Brexit.pdf
[4] As explained in the BCG report "Bridging to Brexit: insights from European SMEs, corporates and investors" link
[5] Business organisations have also emphasised the need for a transitional period. At European level, BusinessEurope has urged the negotiators to agree a transitional period that would see the UK remaining in the customs union and single market. In the UK, the CBI has called for the UK to stay in the single market during a transitional period until a new trade agreement between the EU and the UK is in force. In Germany, the DAI has argued that transitional arrangements are indispensable in order to avoid legal uncertainty.

reviewing any changes that may be required to be made to rules etc. A transitional period would therefore provide supervisors and resolution authorities with time to adapt and assist them in maintaining financial stability.

Design of a transitional period

Various options for transitional arrangements have been suggested. This is what we believe is needed:

- **Meaning of a transitional period**: during the transitional period, existing market arrangements would need to be maintained to provide certainty and stability to businesses and market participants as they prepare to adjust their operations to the final permanent relationship. This means that existing legislation, regulation, permissions and authorisations should continue to be effective during the transitional period;
- **Commitment**: the EU27 and UK Government should commit to a period of transition in a legally binding agreement as soon as possible. Pending the conclusion and ratification/endorsement of such agreement, they should at least commit by the end of 2017 on the principle of a transitional period in a formal political joint EU27/UK statement. However, any such political statement will need legal and regulatory underpinning before it can be relied upon;
- **Elements of transitional arrangements:** these transitional arrangements should comprise:
  - a bridging period to avoid short-term disruption until the new relationship between the UK and the EU27 is ratified, should that prove unachievable within the two-year Article 50 period. This period should avoid damaging 'cliff edge' effects; and
  - an adaptation period, following the bridging period, which would enable phased adjustment to the new trade relationship.

The length of any bridging period would depend on the time it will take for the UK and the EU27 to negotiate their new trade relationship and on the nature of the new relationship. The adaptation period is necessary to allow businesses, clients and supervisors to adapt to the new trade relationship between the UK and the EU27.

Additional transitional measures

In addition to the transitional period, the following steps should also be taken to minimise disruption and support transition:

- Cross-border trades and contracts which are executed prior to Brexit, but which continue after the point of Brexit, should be grandfathered;
- Regulators should adopt a flexible and pragmatic approach to the new structures and operating models that firms propose, including accelerating the approvals process and leveraging prior regulator-approved risk models (possibly followed by a longer-term reassessment). Regulatory flexibility during this period of change could be provided by EU27 authorities (including the SSM, ESMA, and national competent authorities and by the UK authorities (including the Bank of England and the FCA), making use of No Action relief when necessary and available;
- Regulators, central banks and national governments should continue to support financial market stability. This may require particular attention during the uncertain period around Brexit, and in particular during the transition, and may involve more regular market communications and targeted support in case of market need (e.g. access to liquidity schemes); and
- Public authorities in both the EU27 and the UK should identify whether the individual measures needed to implement a transitional period in their own jurisdiction require bilateral agreement between the EU27 and the UK, or could be implemented on a unilateral basis. Measures that can be taken on a unilateral basis are not dependent on the outcome of any negotiation, and thus could be taken earlier, thereby providing market participants with additional information and reassurance at an earlier point in time.

Conclusion

Both policymakers and business recognise the importance of transitional arrangements. It is important that the parties negotiating the UK's exit from the EU provide clarity on these arrangements as early as possible. This would assist business and market participants during the adaptation period. It would also help in making sure that market efficiency and financial stability are safeguarded as much as possible.

/ About AFME

The Association for Financial Markets in Europe (AFME) is the voice of Europe's wholesale financial markets. We represent the leading global and European banks and other significant capital market players. We believe that liquid capital markets and a well-functioning banking system are central to any successful modern economy.

This briefing paper is part of AFME's fact-based, pan-European approach to provide market expertise and insight to Europe's policymakers and regulators. Our aim is to work to safeguard financial stability and market efficiency during the Brexit process and subsequently. AFME is registered on the EU Transparency Register, registration number 65110063986-76

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