

# Brexit: Continuity of cross-border financial contracts

## The argument for a public sector solution



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The EU financial services framework will cease to apply after the UK's exit from the EU and any agreed transition period, meaning that financial services providers will be unable to continue to rely on 'passports' and the right of establishment to service cross-border contracts.

This will impact European Economic Area (EEA)<sup>1</sup> clients and counterparties of UK firms in relation to general insurance, long-term insurance, pension schemes, medium and long-dated derivatives contracts and revolving credit facilities, and may also affect general customer terms of business, prime brokerage, custody and other arrangements<sup>2</sup>. This document has been drafted on the basis of a no deal – and therefore no transition – scenario on 29 March 2019.

The Bank of England estimates the impact on the EEA as follows:

1. **£55 billion** of insurance liabilities and **38 million** EEA policyholders could be affected,
2. a quarter of uncleared over-the-counter (OTC) derivatives contracts entered into by parties in both the UK and EEA, with a potential notional value of around **£30 trillion**, of which around **£18 trillion** matures after March 2019, and
3. the notional amount of outstanding cleared OTC derivative contracts that could be affected is around **£69 trillion** (around **£41 trillion** of which matures after March 2019 Q1).

UK firms have been putting in place measures to protect EEA clients and counterparties from the cliff edge impacts of no deal. There are still significant risks to EEA businesses and consumers that cannot be fixed by the private sector alone.

As a result, **there should be an agreed, co-ordinated public solution for both the UK and EU that adequately protects clients and counterparties from disruption to their business, as well as those businesses in the wider economy who rely on such transactions, and ensures financial stability.**

*"It is almost impossible to fix that problem exclusively just by one side of the stakeholders involved" BaFin's president, Felix Hufeld told Bloomberg, adding there has to be "a solution on a political level."*

**EU governments and the Commission should publicly mandate EU regulators to work with UK counterparts to develop solutions to prevent market disruption, fragmentation and potential financial instability.** An EU level solution is the most optimal approach, one which enables both EU and UK regulators to work together to protect EEA businesses and consumers.

*"The EU and UK authorities should work together to ensure legal continuity in insurance and derivative contracts and proper data sharing to avoid cliff-edge effects, which could potentially be highly disruptive."*<sup>3</sup>

With less than six months until the UK becomes a third country, this document summarises the ramifications for EEA clients and counterparties, including consumers and SMEs, if an EU solution is not put in place. It highlights why private, industry led solutions will not be sufficient to minimise disruption and proposes the most appropriate solution given the constrained time-frame. It is based on analysis undertaken by trade associations representing global, EU and UK businesses and clients.

<sup>1</sup> European Economic Area includes the EU Member States plus Norway, Iceland and Liechtenstein

<sup>2</sup> Continuity of cross-border financial contracts post-Brexit, The CityUK, June 2018

<sup>3</sup> IMF United Kingdom: Staff Concluding Statement of the 2018 Article IV Mission, September, 2018

## Background

# What is the issue and what public sector solution is required?

### What is contractual continuity?

Contractual continuity is a term used to describe the risks associated with firms being unable to continue to exercise rights and perform obligations under existing contracts at the point of Brexit, including the performance of certain product life-cycle events as well as the maintenance of passive on-going contractual relationships.

### Why does Brexit threaten contractual continuity?

The threat to contractual continuity arises from the loss of authorisation consequent upon the loss of the single market passport. In general terms, conducting regulated business without a licence is unlawful across the EEA. In certain jurisdictions, breach of the requirements amounts to a criminal offence and may render contracts unenforceable at the option of the client.

Contracts governing the provision of financial services and products often embed a number of regulated activities which will continue to be performed post 29 March 2019. Where these activities trigger local licensing requirements, post-Brexit, a UK firm would need to obtain a local licence or exemption – although these may not be available to third country firms. Additionally, where long-dated contracts are refined over time, for example, to respond to client need, such changes may, in certain circumstances and jurisdictions, also trigger local licencing requirements.

This creates uncertainty for EEA counterparties and clients as it is unclear how the relevant UK firms can continue to effectively service their portfolios of legacy cross-border contracts post-Brexit and ensure that they continue to exercise rights and perform obligations in line with the requirements of those clients and counterparties, as well as the local licensing rules applicable to the firm in the EEA.



### What type of solution is required?

Given the inherent flaws with the private sector solutions described in this document, there should be an agreed, co-ordinated public solution for both the UK and EU that adequately protects clients and counterparties from disruption to their business and ensures financial stability.

In a no deal scenario, UK and EU policy makers and regulators should confirm that they will grandfather (beyond the UK's exit from the EU) affected cross-border contracts in a manner that is reasonable and appropriate for the product or service in question to enable continued provision and/or performance of services and activities under those existing contracts.

It is expected that the appropriate grandfathering mechanism – for example, one that is for a time-limited period or one under which affected contracts are grandfathered until maturity – might differ depending on the type of product or services provided for and there is unlikely to be one solution that will be sufficient for all areas of the industry.

### Does this proposed solution extend passporting or undermine political negotiations as regards access rights?

No. This would be a strictly limited solution focused on existing contracts which aims to minimise market and EEA client and counterparty disruption in relation to contracts that exist at the point of Brexit.



***"For the transfer of derivatives contracts into the European Economic Area, an appropriate transition phase with grandfathering of existing contracts should be foreseen – even if no withdrawal agreement is concluded. In addition, it is necessary to have clarity about supervisory practice in the European Union during this transition period and to create corresponding incentives for non-European market participants to clear in the European Union in order to increase market liquidity."***<sup>4</sup>

<sup>4</sup> Exit negotiations between the European Union and the United Kingdom: Minimise Brexit Risks and Strengthen the European Capital Market, Recommendations of Deutsches Aktieninstitut, September 2018

## The potential impact

### If no public sector solution is forthcoming, who will be impacted by the issue of contractual continuity?

As discussed below, the UK Government is proposing to legislate to ensure contractual continuity is not an issue for EEA firms conducting business in the UK. However if no public sector solution is agreed, the issue of contractual continuity will impact clients and counterparties in the EEA who have been provided financial products and services by UK firms.

### What is the likely impact for those EEA clients and counterparties?

Among other things, EEA counterparties and clients might be unable to<sup>5</sup>:

- make or receive payments under an insurance contract (including pension products)
- prevent paid losses from being treated as income in their country of residence and be taxed accordingly
- effectively manage their risk, cash flow and capital positions by adjusting derivative contracts
- rationalise open positions and capital requirements across their derivative portfolios by 'compressing' multiple trades into smaller numbers of trades
- retain existing contracts, for example, some contracts may include termination provisions which could be triggered as a result of changes brought about by Brexit.

In July 2018 however, the European Commission stated, in their notice on Brexit preparation, that operators in all financial services sectors need to prepare for the loss of passporting if they wish to ensure that there is no disruption to their current business model and that they are in a position to continue servicing their clients.

*"In relation to contracts, at this juncture, there does not appear to be an issue of a general nature linked to contract continuity as in principle, even after withdrawal, the performance of existing obligations can continue".*

It is vital to engage further on these issues to avoid putting EEA businesses and consumers at unnecessary risk of market disruption.



## Why preserving rights requires urgent action<sup>6</sup>

### Some insurance based examples of contracts potentially affected

<b>Pension Contracts</b>	Savings and retirement contracts with an insurance guarantee	30+ years	<p>A UK citizen living in Spain being paid a pension from a UK provider using the Single Market freedoms.</p> <p>A German customer who has bought a with-profit product from a UK insurer.</p>
<b>Directors and Officers</b>	Claims against Directors and Officers for negligence in carrying out their duties	5-10 years	<p>A Belgian multi-national company whose board has insured itself with a UK insurer. Long tail liabilities could include:</p> <ul style="list-style-type: none"> <li>o a class action from investors 7 years down the line from a major acquisition or rights issue;</li> <li>o a claim made if fraud was subsequently discovered and a director sued for personal negligence.</li> </ul>
<b>Employer's Liability</b>	Claims arising from employee injury as a result of their work	10 years	<p>If a health condition develops which is medically linked to an injury sustained for which an employer was liable.</p>
<b>Financial Guarantee</b>	Provides a guarantee to investors that investment will be repaid should the issuer of an asset be unable to fulfil their financial obligations	30+ years	<p>Payments made to investors in the event that the issuer of a bond is unable to make timely payment.</p>

<sup>5</sup> Continuity of cross-border financial contracts post-Brexit, The CityUK, June 2018.

<sup>6</sup> Brexit and Insurance Contracts, Why preserving customers' rights after 2019 requires urgent action, ABI, 2018

In their Financial Stability Report from October 2018, the Bank of England considers what actions are being taken to mitigate the risk of disruption to end-users of financial services and identifies the risk to both UK and EEA counterparties/clients.<sup>7</sup>

## Preserving the continuity of outstanding cross-border contracts

### Insurance contracts

RISK TO UK RISK TO EU



The UK government is legislating to ensure that the 16 million insurance policies that UK households and businesses have with EU insurance companies can continue to be serviced by those EU companies after Brexit. That legislation needs to be passed by Parliament prior to Brexit to be effective.

EU or member state rules may prevent UK insurance companies collecting premiums from, or paying claims to, their 38 million policyholders in the EU. Most UK insurance companies are making good progress in restructuring their business in order to serve their EU customers after Brexit. If all current plans are delivered successfully, the number of EU policyholders at risk will fall to 9 million. However, given the volume of restructuring and the process of court approval of plans, there are material execution risks.



### OTC derivative contracts (uncleared)

RISK TO UK RISK TO EU



In the absence of action, certain 'lifecycle' events could not be performed on cross-border derivative contracts after Brexit. This could compromise the ability of derivative users to manage risks and therefore amplify any stress around the UK's exit from the EU.

The UK government is legislating to ensure that these lifecycle events can continue to be performed after Brexit on derivative contracts that UK clients have with EU banks. That legislation needs to be passed by Parliament prior to Brexit to be effective. Once passed, UK clients, such as non-financial companies and asset managers, will avoid disruption to their derivative contracts.

However, national rules in some EU member states may prevent certain lifecycle events being performed on derivative contracts that EU clients and banks have with UK banks. These affected contracts account for the majority of (uncleared) derivatives between the EU and UK, which have a total notional value of £30 trillion, of which an increasing share (£18 trillion) matures after March 2019. These restrictions will affect the ability of EEA clients and banks, and of UK banks that have the contracts with them, to manage risks in stress.

### OTC derivative contracts (cleared)

RISK TO UK RISK TO EU

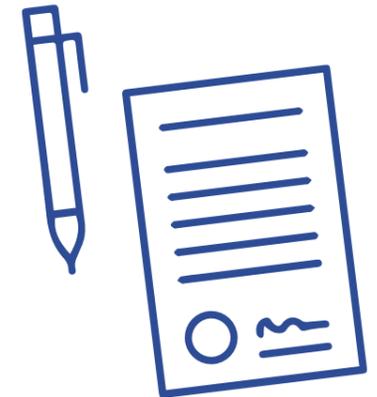


The UK government is legislating to ensure that UK businesses can continue to use clearing services provided by EU-based clearing houses. That legislation needs to be passed by Parliament prior to Brexit to be effective.

Under EU law, after March 2019 EU clearing members will be acting unlawfully if they access clearing services from UK central counterparties (CCPs), and UK CCPs will not be permitted to provide such services, unless they are recognised by the European Securities and Markets Authority.

There is therefore legal uncertainty about whether EU clearing members could continue to meet their ongoing obligations to UK CCPs under existing contracts. Any inability to meet obligations would jeopardise the safe operation of CCPs, particularly in an episode of stress. This would amplify any stress around Brexit and increase financial stability risks. There is also uncertainty under EU law and member state law as to the legal consequences for UK CCPs of continuing to provide services to EU clearing members in relation to existing contracts.

In the absence of action by EU authorities to address these issues, the contracts EU clearing members have with UK CCPs will need to be closed out, or transferred, before March 2019. The ECB estimates EU-based firms clear 90% of their interest rate swaps in the UK. Overall, EU-based firms have OTC derivative contracts with a notional value of £69 trillion at UK CCPs, an increasing share (£41 trillion) of which matures after March 2019. The movement of a large volume of contracts in a short time frame would be costly to, and disrupt the derivatives positions of, EU businesses and could strain capacity in the derivatives market. In addition, fragmentation of central clearing would raise costs for EU businesses. Industry estimates suggest that every single basis point increase in the cost of clearing interest rate swaps alone could cost EU businesses around €22 billion per year.



<sup>7</sup> Financial Stability Report, Bank of England, October 2018

#### Why can't the industry solve this alone?

1. Firms are already taking steps to mitigate the impact on counterparties and clients; however market participants cannot fully address this issue without public sector support by March 2019.
2. This is due to the scale of the task and the need for third party cooperation which will make it extremely challenging, particularly from a timing perspective, and operationally complex to complete in the limited time.
3. A number of trade organisations have published papers looking at the challenges faced by UK and EEA firms and their clients seeking to avoid uncertainty by transferring their legacy cross-derivative contracts to an appropriately licensed EU27 affiliate in advance of Brexit – these papers are listed below. There are several possible mechanisms whether through the operation of statutory transfers or contractual transfers and each of these is considered. In terms of statutory transfer schemes, the papers focus on Part VII schemes, cross-border mergers, European Company Statute and schemes of arrangement, and highlight the operation, complexity and challenges with each particularly now there are less than six months before Brexit. In relation to contractual transfers, the papers highlight that this is not an all-encompassing solution, and that there are significant execution and timing challenges to a large scale novation in favour of an entity in a different Member State.
4. In addition to the timing and execution challenges articulated above:
  - o Certain contracts cannot be transferred (for example, contracts that cannot be separated into UK and European components – such as, pan-European directors' and officers' liability) without public sector intervention; and
  - o Market disruption – given the sheer volume of contracts impacted, the potential for substantial market disruption cannot be underestimated.

#### To the extent private sector solutions could be deployed, is this necessarily the right outcome for EEA clients and counterparties?

Even where UK firms are able to transfer/novate business to new or expanded EU operations ahead of exit day, there will still be ramifications for the EEA counterparties and clients – including businesses across all sectors and the consumers they serve. The timing constraints may mean that EEA clients and counterparties are deprived of choice and may face costs and obligations, including carrying out due diligence as a result of the transfers/novations.

#### Why is this not an issue for EEA firms conducting business with UK clients/ counterparties?

On 20 December 2017, the UK Government confirmed that it would, if necessary, bring forward legislation to enable:

1. a temporary permissions regime – thereby allowing EEA firms and funds to undertake new business within the scope of their permission, enable them to continue performing their contractual rights and obligations, manage existing business and mitigate risks arising from a cliff edge as regards a loss of passporting; and
2. contractual continuity – such legislation would ensure that contractual obligations not caught by the temporary permissions regime could continue to be met.

Following Royal Assent of the EU (Withdrawal) Act 2018, the UK government has begun to lay secondary legislation to ensure such a regime is on the statute book in time for Brexit in case of no deal. The statutory instrument on contract continuity, however, is yet to be published and the UK Government is urged to make details of the UK approach on contract continuity public as soon as possible.

#### Where can further information be obtained?

This paper is based on existing industry positions. Further background and specific examples on the issues discussed in this paper can be found at:

'Brexit and Insurance Contracts', Association of British Insurers (ABI), August 2017

'Impact of Brexit on cross-border financial services contracts', AFME/UK Finance, September 2017

'ISDA Brexit Advice – Summary of Preliminary Analysis of Lifecycle and Other Events', International Swaps and Derivatives Association (ISDA)/Linklaters, October 2017

'The Impact of a No-Deal Brexit and the Cleared Derivatives Industry', FIA, December 2017

'How might wholesale financial services contracts be impacted by Brexit? FAQs for Clients', AFME, February 2018

'Consequences of Brexit on existing contracts', Insurance Europe, March 2018

'Continuity of cross-border financial contracts post-Brexit', The CityUK, June 2018

'Contractual continuity in OTC derivatives – challenges with transfers', ISDA and AFME, July 2018

Financial Stability Report, Bank of England, October 2018

'The impact of Brexit on OTC derivatives: Other 'cliff edge' effects under EU law in a 'no deal' scenario', ISDA, October 2018

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