



Brexit in the international capital markets¹

By Paul Richards

Summary

Since the UK referendum in June 2016, the British Government has proposed to leave the EU Single Market in financial services when it leaves the EU. Instead of a Single Market, the EU27 and the UK will become two separate markets when passporting rights cease. Market firms are in a better position to avoid cliff-edge risks arising from market fragmentation if they are authorised to operate in both the EU27 and the UK. But that still leaves cliff-edge risks *between* EU27 and UK markets when passporting rights cease. Although significant progress has been made by the EU27 and UK authorities to address them, risks remain. A key issue for trade negotiations after Brexit is what role regulatory equivalence will play between EU27 and UK capital markets in future.

The political background

1 The British Government reached agreement with the EU27 at the European Council on 25 November on a Withdrawal Treaty and on a Political Declaration on Future Relations. This agreement is subject to ratification by both the British Parliament and the European Parliament. If the agreement was not ratified by both the British Parliament and the European Parliament and the necessary legislation was not enacted before Article 50² was due to expire on 29 March, the default position was for the UK to leave the EU on 29 March without an agreement (ie a no-deal Brexit), unless Article 50 was extended (by the EU by unanimity) or revoked (by a unilateral decision by the British Government).

2 The agreement between the British Government and the EU27 was rejected by the House of Commons in separate votes on 15 January and 12 March by large majorities. On 13 March, the House of Commons voted against a no-deal Brexit, though the vote was not binding; and on 14 March, the House of Commons voted in favour of delaying Brexit beyond 29 March by extending Article 50. On 20 March, the Prime Minister proposed to the EU27 a “short, limited” extension of Article 50 until 30 June.

3 At its meeting on 21 March, the European Council decided unanimously:

- to extend Article 50 until 22 May, subject to approval of the Withdrawal Agreement by the House of Commons by 29 March, though the Withdrawal Agreement (without the Political Declaration) was subsequently rejected by the House of Commons again on 29 March;
- if the Withdrawal Agreement was not approved by 12 April, the UK should indicate a way forward before 12 April for consideration by the European Council.

4 On 2 April, following a Cabinet meeting, the Prime Minister proposed a cross-party approach to a Brexit deal in an attempt to win the approval of the House of Commons and, on 5 April, she proposed to the EU27 a further extension of Article 50 beyond 12 April until 30 June at the latest. She agreed that the UK should prepare for elections to the European Parliament on 23 May, in case the agreement is not ratified by the House of Commons before then. The European Council met on 10 April to consider the Prime Minister’s request and agreed unanimously on an extension of Article 50 until 31 October, while allowing the UK to leave the EU earlier if the agreement is ratified earlier.³ There will be a review of progress at the European Council in June.

1. For official and other sources of information on Brexit in the international capital markets, see the ICMA [Brexit webpage](#) on the ICMA website.

2. On 29 March 2017, the UK notified the European Council of its intention to withdraw from the EU in accordance with Article 50 of the Treaty of European Union (TEU). According to Article 50(3) TEU, the Treaties cease to apply two years after the notification, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.

3. If the UK is still an EU Member State on 23-26 May, it will be under a legal obligation to hold elections to the European Parliament. If it does not do so, the UK will leave the EU on 1 June without an agreement.

5 Following the European Council meeting on 10 April, this assessment considers the risks arising from Brexit for ICMA member firms involved in the international capital markets in the UK and the EU27. It does not consider the exchange rate, monetary or economic policy implications.

The legal background

6 If and when it is ratified, the EU27/UK Withdrawal Agreement is legally binding. The Political Declaration which accompanies the Withdrawal Agreement is not legally binding. It is intended to lay the groundwork for future negotiations during the transition period after Brexit, but covers financial services only briefly, and at a high level of generality. The transition (or “implementation”) period is due to last from Brexit until the end of 2020, though it could be extended beyond the end of 2020 once for up to one or two further years, if both sides agree.⁴ During the transition period, the UK would effectively be subject to EU rules, including new EU rules, without any say in making them.

The legal consequences of Brexit in the UK⁵

In the UK, the European Union (Withdrawal) Act 2018 was passed in June 2018. It assumes the UK’s exit from the EU on 29 March 2019 without a deal and would need to be amended if a deal is agreed or the Article 50 period is extended. The Withdrawal Act will ensure that most EU-derived laws and regulations will continue to apply in the UK, but as domestic UK law, outside the jurisdiction of the EU.

The Withdrawal Act also gives the British Government powers to make regulations by statutory instrument (SI) to amend “deficiencies” in retained EU law, so that legislation works appropriately once the UK has left the EU. Using powers under the Withdrawal Act, the British Government plans to pass up to 600 SIs to amend retained EU law by the exit date.

Alongside changes to the law, relevant regulators, such as the FCA and PRA, are having to make corresponding changes to their rules and processes.

If a Withdrawal Agreement is reached between the UK and the EU27, the British Government will need to secure the passage of a Withdrawal Agreement Implementation Bill to enable the Withdrawal Agreement to be ratified.

The implications of the UK proposal to leave the EU Single Market

7 Since the UK referendum in June 2016, the British Government has proposed to leave the EU Single Market in financial services when it leaves the EU. Instead of a Single Market, the EU27 and the UK will become two separate markets when passporting rights between the EU27 and the UK cease. The European Commission has stated that, when passporting rights cease, “there will be no Single Market access”. When passporting rights cease, cliff-edge risks will arise as a result of fragmentation between the EU27 and UK markets: on Brexit, if the UK leaves the EU without an agreement; or at the end of the transition period after Brexit, even if there is an agreement. The key difference is that, if there is a transition period after Brexit, that will give market firms more time to prepare. In preparing for Brexit, our focus at ICMA has been on ensuring that cliff-edge risks in international capital markets are addressed and avoided.

The case for market firms to be authorised in both the EU27 and the UK

8 To reduce cliff-edge risks when passporting rights cease, many market firms have chosen to be authorised to provide financial services in both the EU27 and in the UK. The ECB, EBA and ESMA have all drawn attention to the need for market firms to be authorised to operate in the EU27 when passporting rights cease. In the case of the ECB:

- it usually takes six months for a decision once an application is complete;
- banks need to be capable of managing all material risks independently and at the local level;
- sufficient staff need to be located locally, including risk management and front office staff;
- part of the risk on “back-to-back booking models” should be managed and controlled locally.

9 Market firms are in a better position to avoid cliff-edge risks if they are authorised to operate in both the EU27 and the UK. In some cases, this involves significant one-off costs: eg in transferring staff, offices, technology, capital and financial assets from London to one or more locations in the EU27; and extra running costs from operating in two separate markets in the EU27 and the UK rather than in one Single EU Market. These costs reduce the competitiveness of European capital markets in global terms. And for market firms, the migration of

4. It is not yet clear whether the dates in the Withdrawal Agreement will be amended as a result of the delay in Brexit following the extension of Article 50.

5. Source: Linklaters: *Are the UK and EU Ready for Brexit?* 14 February 2019.

businesses, assets and contracts in a short period of time poses operational risks. In general, large sell-side and buy-side firms seem better prepared than smaller firms, and financial institutions seem better prepared than some of their clients.

The need to address cliff-edge risks in international capital markets

10 When passporting rights cease, it appears that market firms will in general be able to carry out contractual obligations already agreed between EU27 and UK entities on cross-border financial contracts.⁶ But when passporting rights cease, specific cliff-edge risks will arise. The question is whether these specific cliff-edge risks can be addressed and avoided.

11 In the UK, a Temporary Permissions Regime will be introduced for a limited period in the event of a no-deal Brexit. This will allow inbound firms and funds to continue operating in the UK on the basis of their current permissions for a limited period while seeking full UK authorisation. On 28 February, the Bank of England announced that, in the event of a no-deal Brexit, it will grant transitional relief for UK regulated firms for a period of 15 months after Brexit. This means that, subject to limited exceptions, UK regulated firms do not generally need to take action now to implement changes in UK law arising from a no-deal Brexit. The Bank of England's approach is in line with the approach taken by the UK FCA.

12 But at EU27 level, there has so far been no equivalent to the Temporary Permissions Regime. Instead, the European Commission has concluded that only a limited number of contingency measures is necessary to safeguard financial stability in the EU27, and only where preparations by market firms are clearly insufficient to address these risks by the withdrawal date.

13 In addition to legal provisions at EU27 level, it is important to take account of legal provisions at national level, where national governments in the EU27 have introduced legislation in an attempt to minimise disruption arising from a no-deal Brexit. A number of EU Member States have put arrangements in place similar but not identical to the arrangements for the UK Temporary Permissions Regime, including Germany, Spain, France, Ireland, Italy, Luxembourg and the Netherlands.⁷

6. Nausicaa Delfas, Executive Director of International, FCA: "While some Member States are taking action, and firms are taking their own action, there are likely to be some remaining areas where the legal risks relating to the ongoing services of existing customers have not been fully mitigated.": speech on *Brexit and Beyond* in London on 21 March 2019.

7. Nausicaa Delfas, Executive Director of International, FCA: speech on *Brexit and Beyond* in London on 21 March 2019.

8. For more detail, see the Bank of England Financial Policy Committee Summary and Record, published on 5 March 2019. See also the Brexit webpage on the ICMA website and the sections in this Quarterly Report on: ESMA guidance in relation to MiFID II/R in the first quarter of 2019; credit rating agencies; and OTC (derivatives) regulatory developments.

Progress in addressing specific cliff-edge risks⁸

The authorities in the EU27 and the UK have recently made significant progress in addressing some of the specific cliff-edge risks which would arise in international capital markets, in the event of a no-deal Brexit, in order to prevent financial instability. It is important to note that the specific cliff-edge risks for which temporary equivalence and recognition would be granted in the event of a no-deal Brexit will run out quickly, unless they can be renewed. If there is an EU27/UK Withdrawal Agreement, there may still be cliff-edge risks at the end of the transition period.

CCPs and CSD

First, cross-border central clearing of derivatives is one area where both the EU27 and the UK agree that financial stability risks may arise.

On 19 December, the European Commission adopted a temporary and conditional equivalence decision for 12 months after a no-deal Brexit to ensure that there will be no disruption in central clearing of derivatives.

On 4 February, ESMA agreed an MOU with the Bank of England for temporary recognition of CCPs currently established in the UK so that they can continue providing services in the EU27, and on 18 February ESMA formally recognised UK CCPs as equivalent. Similar arrangements have been made for the UK CSD for two years, taking account of its role in servicing Irish securities, so as to reduce the risk of disruption to the Irish securities market.

On 25 February, the UK and US authorities made a joint statement on continuity of derivatives trading and clearing activities between the UK and the US after Brexit; and on 5 March, the Bank of England and ECB announced a new swap line as a precaution against financial instability.

Uncleared OTC derivatives

Second, the Bank of England has been concerned that, in the absence of action, certain lifecycle events will not be able to be performed on uncleared OTC derivative contracts across borders between counterparties in the EU27 and the UK, in the event of a no-deal Brexit.

On 19 December, the European Commission adopted delegated regulations allowing some OTC derivative contracts to be transferred to an EU counterparty during a fixed period after a no-deal Brexit.

On 13 March, following proposals from ESMA, EBA and EIOPA, Commission delegated regulations entered into force allowing UK counterparties to be replaced with EU counterparties without triggering the clearing obligation; and facilitating the novation of legacy contracts to EU counterparties, since novation might also trigger the application of bilateral margin requirements.⁹

However, market firms still face some uncertainties in the EU27 at national level, and the time needed for contracts to be transferred is considerable, as clients are frequently slow to agree to transfer.

Supervision and enforcement

Third, ESMA, national securities regulators in the EEA and the FCA announced on 1 February that they have agreed an MOU to allow information exchange for effective supervision and enforcement, and continued access to UK CCPs and the UK CSD, in the event of a no-deal Brexit. ESMA and the FCA have also agreed an MOU on the exchange of information for the supervision of CRAs and TRs; and MOUs have been agreed with EBA and EIOPA too. These MOUs would be due to come into effect immediately after the UK became a third country, in the event of a no-deal Brexit.

Delegation of fund management

Fourth, EU rules allow asset managers to delegate fund management outside the EU27 when a cooperation agreement is in place between the authorities concerned. Provision for the continuation of the delegation model is contained in the MOU between ESMA, national competent authorities in the EU27 and the FCA announced on 1 February.

Other issues

Finally, there are a number of other cliff-edge risks relating to the impact of Brexit on international capital markets that still need to be addressed. Clearly, there should be more time to address them, if there is an agreement between the EU27 and the UK on withdrawal leading to a transition period or a further extension of Article 50. Examples include:

Personal data: Although the MOUs between the EU27 and the UK cover information exchange for supervision and enforcement, there are still outstanding questions about the free flow of personal data from the EU to the UK after a no-deal Brexit, which may restrict the access of EU27 customers to UK financial service providers.

Trading venues: There is currently no provision for the recognition of the equivalence of UK trading venues by the EU27. EU customers may not be able to trade certain securities on UK trading venues, in the event of a no-deal Brexit.

Non-EU exposures: The Bank of England has noted that EU regulations impose higher capital and liquidity requirements on EU banks' and insurance companies' non-EU exposures and also impose some restrictions on holdings of non-EU assets.

Transparency: The MiFID II transparency framework is based on thresholds specified by ESMA. These thresholds, which currently include both the EU27 and the UK, will need to be adjusted after Brexit. This will take time to resolve.

9. See also ESMA: *Update on the UK's Withdrawal from the EU - Preparations for a Possible No-deal Brexit Scenario on 12 April*: 28 March 2019. This notes that references to a no-deal Brexit on 29 March need to be updated to 12 April.

International capital markets in the EU27 after Brexit

14 When passporting rights cease, either on Brexit or at the end of the transition period after Brexit, the EU27 and the UK will have two separate – though interconnected – capital markets. Europe’s biggest capital market will be outside the EU.

15 For the EU27, it will be important to complete Capital Markets Union, if the EU27 wants to diversify funding and investment opportunities across its national borders. It will also be important for the EU27 to clarify the relationship between the euro area and the rest of the EU27. Such a clarification was provisionally agreed by a former British Government with the EU27 in early 2016 but subsequently abandoned following the outcome of the UK referendum in June 2016.

16 Supervisory convergence within the EU27 will be needed to avoid regulatory arbitrage between different national jurisdictions in the EU27 (eg on relocation decisions to the EU27 by market firms in the UK). In ESMA’s view, financial centres in the EU27 should be free to compete with each other in offering speed and efficiency to relocating firms, but in all cases the EU rulebook should be consistently applied and supervised.

17 In anticipation of Brexit, a number of market firms in the UK have been moving EU27 activities from one location (ie London) to a range of different locations within the EU27 (eg Frankfurt, Paris, Amsterdam, Luxembourg and Dublin), all with different national regulators. In ESMA’s view, this increases the need for powers to ensure consistency and convergence between national regulators within the EU27.

Market access between the EU27 and the UK after Brexit

18 If the UK leaves the EU with a Withdrawal Agreement, it is not yet clear what form a future trade agreement between the EU27 and the UK after the end of the transition period will take, as the Political Declaration sets out a range of potential options; and it is not clear whether it will be possible to complete the negotiations within the transition period. (The free trade agreement between the EU and Canada took seven years to negotiate and ratify.) The future prospect will be even more uncertain if the UK leaves the EU *without* an agreement.

19 The Political Declaration by the EU27 and the UK covers financial services only briefly, and at a high level of generality. But the focus is on regulatory equivalence between the EU27 and the UK:

“Noting that both Parties will have equivalence frameworks in place that allow them to declare a third country’s regulatory and supervisory regimes equivalent for relevant purposes, the Parties should start assessing equivalence with respect to

each other under these frameworks as soon as possible after the UK’s withdrawal from the Union, endeavouring to conclude these assessments before the end of June 2020. The Parties will keep their respective equivalence frameworks under review.”¹⁰

20 When passporting rights between the EU27 and the UK cease, the UK will become a third country. The British Government has indicated that it does not intend to be a “rule-taker”. Consequently, when it becomes a third country, the UK’s approach to regulation may *diverge* from the EU27, though the extent to which this can happen in practice, particularly in wholesale markets, is likely to be limited by global agreement under the G20, in which both the EU27 and UK participate. But where regulatory *convergence* between the EU27 and the UK continues, and provision is made for regulatory equivalence between the EU27 and the UK, market firms operating across borders between the EU27 and the UK will be able to make use of this.

Regulatory equivalence between the EU27 and the UK after Brexit

21 EU regulatory equivalence with third countries is currently a patchwork:

- It applies to some parts of the EU regulatory framework, but not others.
- It requires a judgment by the European Commission, and this takes time to assess.
- The determination of equivalence can be withdrawn at short notice.
- The assessment is based on measuring outcomes, which are difficult to assess.
- The determination is made unilaterally by the EU.

22 When passporting rights cease, the EU27 and the UK will start with identical rules and close supervisory cooperation. The UK is planning to develop a new partnership with the EU27, under which it can:

- qualify for all the provisions relating to regulatory equivalence already granted to other third countries; and
- negotiate enhancements during the trade negotiations after Brexit. There is potential provision for negotiating enhancements by June 2020 in the Political Declaration. Amendments to the MOUs between the EU27 and the UK may also be needed.

23 It is also important to note that, where equivalence is granted to provide an EU-wide passport to firms in the UK, ESMA considers that it needs appropriate safeguards giving the EU stronger powers to regulate and monitor third country investment firms in wholesale markets.

10. Political Declaration Setting out the Framework for the Future Relationship Between the EU and the UK, paragraph 38: 25 November 2018.

Brexit: ICMA's role and approach

ICMA's role is to encourage efficient and integrated capital markets, which are necessary to support economic growth.

ICMA's approach has been to focus on the potential impact of Brexit on international capital markets, particularly the need to address and avoid cliff-edge risks which arise when passporting rights between the EU27 and the UK cease.

ICMA is not lobbying for any particular financial centre. ICMA's members are based in London, the EU27 and more broadly.

ICMA has been discussing capital market preparations for Brexit with members through its main ICMA Market Practice and Regulatory Policy Committees and reporting to the ICMA Board.

ICMA is keeping in contact with the authorities in the UK, the EU27 and the euro area.

ICMA is cooperating with other trade associations by sharing information, wherever possible.

ICMA is keeping members up-to-date on Brexit by giving them regular assessments through the ICMA Quarterly Report and conference calls.

ICMA has posted on its website for members an ICMA Brexit FAQ, focusing on ICMA's own documentation.

ICMA is keeping its Brexit webpage up-to-date, both with its own work, and also with electronic links to key documents published by the authorities in the EU27 and the UK, and with links to the webpages of law firms and others.

in two separate markets instead of a Single Market involves costs: both set-up costs and extra running costs.

26 But that still leaves cliff-edge risks *between* the EU27 and the UK when passporting rights cease. In the event of a no-deal Brexit, the UK is proposing to address these risks through a Temporary Permissions Regime for EU27 firms. There is no equivalent in the EU27. Instead, cliff-edge risks between the EU27 and the UK are being addressed case by case in order to reduce market uncertainty and prevent financial instability.

27 Although significant progress has been made on addressing cliff-edge risks, there are still some unresolved issues, and it is not clear whether there are gaps. The assessment of the Bank of England Financial Policy Committee, published on 5 March, is that, in the event of a no-deal Brexit, "some disruption to cross-border services is possible and, in the absence of other actions by EU authorities, some potential risks to financial stability remain".¹¹

28 Even if there is an agreement between the EU27 and the UK, there is as yet no detail about how EU27 and UK capital markets will interconnect in future, once passporting rights cease, as the Political Declaration on future trade relations deals with financial services only briefly and at a high level of generality:

- (i) One option is for the regulation of the two separate markets to diverge. When the UK becomes a third country, it will not want to be a "rule-taker". Brexit will provide the opportunity for divergence to occur once passporting rights cease.
- (ii) But in the period up to June 2020, the Political Declaration will also provide an opportunity for the UK to negotiate regulatory equivalence with the EU27 as a third country. Both sides accept that regulatory equivalence is currently a patchwork. There may be scope to negotiate enhancements.

Conclusions

24 Under current British Government policy to leave the EU Single Market when it leaves the EU, the EU Single Market will become two separate markets when passporting rights cease. If the UK leaves the EU without an agreement, passporting rights will cease on Brexit. If there is an agreement, passporting rights will only cease at the end of the transition period after Brexit. This will give market firms more time to prepare.

25 When passporting rights cease, cliff-edge risks will arise as a result of fragmentation in international capital markets between the EU27 and the UK. Market firms are in a better position to avoid cliff-edge risks if they are authorised to operate in both the EU27 and UK markets, though operating

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11. Bank of England Financial Policy Committee Summary, published on 5 March 2019.