GFMA White Paper: Brexit: Implications for the Global Financial System

Introduction: Brexit – The Global Perspective

Capital markets, and the economies they support, have grown increasingly global in recent decades. There is enormous social and economic value to global financial markets. They enable efficient capital formation and flows as well as risk management. Market based financing also adds diversity to bank lending, providing a more durable framework that can support economic growth locally and internationally through the cycle.

Consequently, GFMA believes that Brexit is an issue that has unique and global spillovers, not just isolated to the UK and EU. Indeed, Financial Stability Board Chair and Bank of England Governor Mark Carney has said[1] "*the global financial system is at a fork in the road……the outcome of the Brexit negotiations could prove highly influential in determining which path the global financial system takes*." GFMA believes it can assist policy-makers by providing a truly global perspective of the issues as they relate to the financial markets[2].

Brexit is an event of such magnitude that it will affect almost all dimensions of the global economy, including financial services, in some way. The Brexit negotiations between the EU27 and the UK will cover a wide range of areas including trade, regulation and future cooperation – all of which will be important from a financial services perspective. However, in this paper, we are focused on the three issues that our global members have identified as most important to their cross-border businesses and the international investment and economic growth they support. Those are:

- Maintaining integrated and efficient capital markets and minimizing regulatory divergence and fragmentation;
- Safe-guarding functioning clearing and financial markets infrastructure; and
- Ensuring there is a phased implementation towards post-Brexit arrangements to allow time for policy-makers, regulators and market participants, including end users, to adapt to the new arrangements and minimise financial stability risks.

[1] 'The high road to a responsible, open financial system' Speech given by Mark Carney, Governor of the Bank of England, Thomson Reuters, 7 April 2017.

[2] The Global Financial Markets Association (GFMA) represents the common interests of the world's leading financial and capital market participants, and speaks for the industry on the most important global market issues. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, visit http://www.gfma.org.

It is symptomatic of the complexity of Brexit that none of these issues is mutually exclusive. For example, establishing an effective phased implementation period will be crucial to safeguarding the smooth functioning of clearing arrangements.

Analysing Brexit through a global lens does not necessarily lead to significantly different policy conclusions compared with adopting a bilateral EU27/UK perspective. Indeed, in many cases the analysis reinforces and strengthens such policy conclusions. But a global perspective does illuminate the significant number of global affected parties arising from Brexit and magnifies the importance of policymakers establishing a positive relationship between the EU and UK and making critical market structure decisions early, in the interests of international financial stability.

GFMA Recommendation: Those negotiating Brexit should seek to minimise risks to the ability of financial firms to serve their clients and the economy.

1. Minimising Market Fragmentation

The UK Prime Minister's announcement that the UK will not seek Single Market membership outside the EU means that, upon the UK's actual exit in 2019, UK and EU27 firms will lose passporting rights to provide financial services throughout the EU and UK respectively. Thus, we can expect Europe's markets to become fragmented, in contrast to the current high degree of integration:

- Exports of financial services from one EU country to another (intra EU exports) reached €96.6bn by 2014. EU financial services exports account for 39 percent of total EU financial services gross value added (GVA) – 22 percent is trade within the EU and 17 percent is trade outside the EU.
- The UK is heavily involved in existing intra-EU trade flows of financial services. For example, in the current pre-Brexit environment, 78 percent of European FX trading, 74 percent of European interest rate derivatives trading and 50 percent of European fund management activities (by assets) takes place in the UK[3]. Lending from UK-based banks to EU corporates amounted to €1.2 trillion as of 2016 Q2, which accounts for around 9 percent of total lending issued to EU residents. Around 30 percent of insurance premiums in the UK have been written by the UK branches or subsidiaries of EU-based insurers.

[3] TheCityUK https://www.thecityuk.com/assets/2016/Reports-PDF/Key-Facts-about-the-uk-as-an-international-financial-centre-2016.pdf

GFMA strongly believes that integrated cross-border markets are crucial to growth and employment. Growth in cross-border trade has enabled greater specialisation, productivity and depth across the EU's wholesale banking and capital markets. This has contributed to reducing the cost of, and improving access to, financial services across the EU, strengthening growth of the global economy. The importance of avoiding market fragmentation has been recognized by G20 leaders repeatedly. For example, in Pittsburgh in 2009, leaders sought to implement financial standards 'consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage'[4]. Brexit potentially amplifies these risks to a globally integrated financial landscape.

The severing of existing market access arrangements would force firms with cross-border activity to reorganize in order to preserve service provision to their clients. This would diminish efficiency including access to capital and ability to layoff risks and raise the cost of providing financial services to firms in the agricultural, manufacturing and services sectors, for example.

Whatever form of Brexit is eventually agreed, policymakers should pursue regulatory consistency for capital markets activity in Europe and globally. Financial services are global, as are many of the non-financial businesses financial markets serve. Any new sources of regulatory divergence would further fragment markets, limit investor choice and reduce the efficiency of markets including cross border capital flows and risk management, increasing costs to customers, clients, and the economy and potentially reducing access to financial markets. Consistent implementation across all jurisdictions of global standards, of which the GFMA is a long-standing supporter, would clearly help to support an orderly Brexit process.

GFMA recommendation: GFMA calls for the UK and EU to reach a Brexit outcome that minimises market disruption in order to protect, as much as possible, global economic growth and the financial services industry's ability to support it. This could be accomplished through a trade agreement or regulatory cooperation agreement. In the meantime, until such an agreement is finalized and while negotiations are ongoing, interim legal arrangements should envisaged so as to alleviate the risk of disruption to the provision of cross-border products and services.

2. Clearing

As the European Commission noted in its May 4 Communication,[5] clearing derivatives transactions is a global financial service. As such, most derivatives clearing is done across borders both within the EU and internationally with CCPs established in other countries. CCPs play a crucial role in reducing systemic risk by facilitating the netting of exposures and

[4] http://www.g20.utoronto.ca/2009/2009communique0925.html
[5] https://ec.Europa.eu/info/sites/info/files/170504-emir-communication_en.pdf

mutualisation of tail risk among many participants. We understand the challenges that Brexit creates for Europe's regulatory and supervisory framework, and financial stability. In this regard, the European Commission recently released a proposal on the supervision of EU CCPs, and the recognition and oversight of non-EU ("third-country") CCPs.[6]

Post-crisis financial reforms led by the FSB have mandated centralized clearing of standardized derivatives contracts to: improve risk management through netting and trade compression; create transparency; and add resiliency to the system through margin and default funds. CCPs continue to grow in systemic importance as clearing services are concentrated in a limited number of CCPs across the world. As of Q4 2016, 85% of total notional of interest rate swaps was cleared[7], with 75% of euro denominated interest rate derivatives cleared in UK. Through global initiatives led by the FSB and CPMI-IOSCO, CCPs have become subject to a robust and evolving regulatory framework and oversight model to ensure adequacy of governance and resources to enhance resiliency and resolvability of critical market infrastructure.

Continued ability of CCPs to provide services cross-border is vital to avoid market disruption

Any loss of cross-border CCP capabilities following Brexit could lead to significant market disruption, impacting both clearing members and end-users that use these markets for hedging and risk management. Without such continuity:

- EU27 counterparties would be in breach of regulatory requirements by maintaining mandatorily clearable positions in UK CCPs, which would no longer be recognized under the European Market Infrastructure Regulation (EMIR).

- UK CCPs would no longer be considered Qualifying CCPs (QCCPs) for the purposes of the Capital Requirements Regulation (CRR). As a result, EU27 credit institutions and investment firms would be subject to punitively high capital requirements for their exposures to UK CCPs.

- UK CCPs would be prohibited from providing clearing services to EU clearing members or EU trading venues.

There are several potential options available to ensure continuity and avoid market disruption. Achieving continuity of recognition requires steps to be taken by both the

[6] The proposed rules can be found here: http://ec.europa.eu/finance/docs/law/170613-emir-proposal_en.pdf, 13 June 2017
[7] ISDA SwapsInfo Fourth Quarter 2016 Review, https://www2.isda.org/attachment/OTE5Nw==/Swaps%20review%20Q4%202016.pdf

European Commission and ESMA well ahead of Brexit in order to allow market participants to continue to satisfy the clearing mandate. While the EU and the UK currently have the same regulatory framework, the European Commission is still required to make an equivalence determination based on an assessment of the UK's framework. This is a pre-requisite for ESMA to recognize UK CCPs and allows them to provide services under EMIR, for example satisfying the clearing mandate. ESMA does not currently have the ability to grant forbearance of such requirements. If it is not possible to grant equivalence and recognition ahead of Brexit, transitional arrangements should be formalised in good time, to allow the market to continue to operate without risk of significant disruption.

Significant operational, legal and governance challenges could ensue for market participants if they are required to move positions to an EU27 CCP, either as a result of a lack of equivalence and recognition, or through a location policy, requiring certain clearing activity to take place in the EU. Market participants would have to gain access to an EU27 CCP with authorization to offer equivalent products. A move would have to be coordinated across all affected market participants to avoid creating imbalances. Clearing members and clients would need to analyze the impacts of any new governing law. Significant time would be required to plan, communicate and implement new arrangements.

Disruption of cross-border access to CCPs would also lead to market fragmentation, potential financial stability risks, and increased costs. If EU27 counterparties were unable to utilize third-country CCPs, they would be restricted to a smaller liquidity pool, without the ability to access liquidity for products cleared in London. In some cases, only one EU27 based CCP would be available to clear OTC mandatory clearable products, creating increased concentration risk to a subset of users at a systemically important CCP. Loss of netting and compression would lead to larger aggregate exposures to CCPs and material increase in margin requirements for both members and end-users. Contributions would also be required to the default fund of the successor EU27 CCP for direct participants. The impact would be particularly pronounced during the transition period. This could reduce end user access, and reduce the key benefits that were fundamental to the requirement of centralized clearing of derivatives in the first place – efficient risk management through broad netting, consolidated collateral pools, and greater transparency.

Market fragmentation could also lead to an increase in the cost of clearing for end-users due to incremental default fund and initial margin requirements. Clearing members, and indirect participants that are credit institutions, would also be subject to incremental capital requirements due to their increased exposures to CCPs. While estimates of the impact vary depending on underlying assumptions, significant costs are associated with market fragmentation. These additional costs would be felt by end-users, including pension funds, asset managers, and clearing members in the UK, EU27 and the wider world economy given the global nature of the derivatives market.

Focus should be on ensuring financial stability and resilience of FMIs, without fragmentation of the market

We recognise that Eurozone authorities should have adequate oversight of significant EUR denominated clearing activity occurring outside of the EU following Brexit, and we are supportive of measures to achieve enhanced supervision of third-country CCPs. Ensuring financial stability and the resilience of FMIs should be the primary focus.

We believe that the goal of ensuring the safety and soundness of CCPs can be achieved through arrangements such as recognition and enhanced oversight, while maintaining integrated financial markets. As an example, derivative products denominated in many different currencies clear at CCPs outside their local markets today, supported by supervisory arrangements and central bank swap lines. As has been noted by the CFTC[8], they do not require USD-denominated products to be cleared in the U.S. A significant volume of cleared USD interest rate swaps are currently cleared outside the U.S. The CFTC has oversight arrangements in place for non-U.S. CCPs that perform substantial U.S. business.

This allows the CFTC to meet its regulatory goals, while allowing market participants to manage risk in an efficient and effective manner.

GFMA Recommendation: Policymakers should agree and implement arrangements that facilitate the continuity of widespread cross-border access to clearing services. This should include an early commitment to avoiding disruption of QCCPS recognition for both UK and EU27 CCPs as a result of the UK leaving the EU, with appropriate transitional agreements. Policymakers should consider enhanced cross-border supervision of systemically-important CCPs, rather than a location policy, to achieve effective oversight of clearing activities without fragmenting markets.

3. Phased Implementation

The nature and scale of change caused by Brexit, coupled with the current high degree of market integration, means that the timeline for executing the necessary changes is very challenging, particularly as market participants are implementing changes in the face of uncertainty about the nature of the future EU/UK relationship.

[8] Remarks of Acting Chairman J. Christopher Giancarlo before International Swaps and Derivatives Association 32nd Annual Meeting, Lisbon, Portugal, http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22; Speech of Commissioner Sharon Y. Bowen at the Eurofi High Level Seminar 2017, http://www.cftc.gov/PressRoom/SpeechesTestimony/opabowen-15

Transformation programs in large organisations are generally complex, lengthy and resource-intensive. Some bank structural change programs delivered to date have taken four years or more. Because banks are systemically important to the global financial system, it is critical that they continue to operate without becoming a source of financial instability, and that they continue to meet the expectations of customers, regulators, and other stakeholders. As noted in PwC's study 'Planning for Brexit: Operational Impacts on Wholesale Banking and Capital Markets in Europe', "*adapting to the post-Brexit landscape potentially requires a wide range of interacting transformation activities….from restructuring legal entities, designing new ways of operating and transacting, gaining regulatory approvals, connecting to new market infrastructure providers, moving staff into new premises and drawing up new contractual arrangements with suppliers and clients*".

Further complexity arises from:

- Banks grappling with a complex array of other regulatory reforms which overlap the Brexit timetable;
- All market participants, including market infrastructures, having to undertake Brexit programs in the same period.

Many affected market participants and supervisors will need more time to prepare effectively for Brexit than the two years provided for by the Article 50 process. The study by PwC of the operational impact on Brexit suggests that a further 3 years will be required for the most impacted firms to adapt following completion of the Article 50 exit negotiations. It will be vital to give an early indication that transitional arrangements will be agreed upon as part of the exit negotiations, so market participants can adapt their execution plans to minimise disruption and execution risk[9]. This applies generally, but also applies, critically, to market infrastructures, including clearing (to allow equivalence and recognition processes be completed, as noted in the section above).

It is essential that clients are assured that their products will not become invalid post-Brexit. In this regard, there is also a need for early agreement or signaling of legally binding grandfathering rights for trades and contracts which were executed prior to Brexit, but mature after Brexit. Appropriate grandfathering rights make the scale of transformation programs substantially smaller than if there are no such rights. This is because new or up-scaled operations can be more focused on new and ongoing business activities rather than dealing with migrating trades and contracts. Ultimately, clients which require ongoing relationships with new legal entities will have to be transitioned to those new entities, but the ability to grandfather existing trades and contracts means both banks and customers do not have to put in place new arrangements for those existing trades and contracts. This would significantly reduce the potential financial stability risk and administrative burden related to the need for re-papering contractual relationships. It would also avoid wasting resources on

[9] See: "Implementing Brexit: Practical challenges for wholesale banking in adapting to the new environment", AFME, April 2017 and "Planning for Brexit - Operational impacts on wholesale banking and capital markets in Europe", Price Waterhouse Coopers for AFME, February 2017.

existing financing arrangements and instead means banks can devote resources to new financing activities.

GFMA Recommendation: Policymakers negotiating Brexit should quickly commit to:

- a bridging period, to avoid short-term disruption until any new trade relationship between the UK and the EU27 is agreed, should that prove unachievable within the two-year Article 50 period; and
- an adaptation period, following the bridging period, which would enable phased adjustment to the new trade relationship.

4. Conclusion

Brexit will present significant and unprecedented challenges to the global financial system and the world economy. EU and UK policymakers need to do their utmost to construct a Brexit and post-Brexit arrangement that maximises future economic potential, for the benefit of their citizens. To achieve this, policymakers should:

- Minimise market fragmentation.
- Ensure derivatives clearing can continue to function efficiently
- Establish appropriate transition arrangements.

GFMA stands ready to work with policymakers to find effective policy solutions that support global markets.