

28 June 2016

Brexit:

***What now for the cleared
derivatives markets?***

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Overview

- FIA's immediate response
- The politics
- The markets
- The legal implications
- Next steps

Questions may be submitted at any time during this presentation in writing via the webinar

Brexit:

FIA's immediate response



FIA's immediate response

24 June:

- Dialogue with members
- Bilateral communication with the Bank of England, the Financial Conduct Authority and CFTC
- Liaison with other trade associations
- In-person meeting with the City of London Corporation policy team and other trade associations
- Published a memorandum “Brexit: What now for the cleared derivatives markets?” available at www.fia.org
- Launched a dedicated Brexit resources section of our website: www.fia.org/UK-EU-Relations
- Launched a dedicated email address for queries: uk-eurelations@fia.org
- Established an internal staff Brexit group

27 June: Follow-up meeting with City of London Corporation

28 June: Webinars for Asia, Europe and US members



Brexit:
The politics



The politics – overview

- The key political question for the UK was summarised by the International New York Times nicely: “*When? How? Really?*” – i.e. **whether, and when, to trigger the Article 50 procedure, and whom will do so**
- The **UK Prime Minister (David Cameron) has resigned** and a new leader should be appointed by 2 September. Cameron states that the triggering of the Article 50 EU withdrawal procedure will be left to the new leader. Current Chancellor George Osborne has ruled himself out of the running
- Jeremy Corbyn, **leader of the UK’s main opposition party (Labour), faces a leadership challenge** – he lost a vote of no confidence on 28 June (172 against, 40 for, 4 abstentions) but currently remains leader
- **A general election in October** looking increasingly likely, to give a mandate to the new ruling party and leaders
- The **Chancellor** and the **Governor of the Bank of England** have sought to calm the markets via public addresses
- The United Kingdom may face break-up: Scotland may hold a second referendum on UK membership and may also seek to withhold its consent to the UK withdrawing from the European Union. Northern Ireland and Scotland are reportedly investigating proposals to have EU federated membership, whilst remaining in the United Kingdom
- European Commissioner **Jonathan Hill has resigned**, effective 15 July – he will be replaced by Commission Vice President Valdis Dombrovskis, former Prime Minister of Latvia. Hill’s Cabinet is anticipated to be disbanded on 16 July
- Both Nicola Sturgeon (leader of the **Scottish National Party**) and Sadiq Kahn (**Mayor of London**) **demand a seat** at the negotiating table

The politics

24 June

- Juncker meets with Commission Vice-Presidents to assess situation
- Belgian Prime Minister keen to ensure Brexit doesn't trigger more referenda and departures from the EU
- Pushback from Germany, France, Italy and others regarding the UK's proposal to delay triggering Article 50
- US President Obama has emphasised America's steadfast commitment with Britain and the transatlantic alliance with Europe
- US Secretary of State John Kerry is coming to London and Brussels

26 June

- Francois Villeroy de Galhau, governor of the Bank of France, told a radio station “**Clearing houses cannot be located in London**”

The politics

27 June

- College of European Commissioners to discuss a preliminary view of the Commission's approach to negotiations
- Merkel, Hollande, Renzi and Tusk meet to devise a joint position on Brexit
- European Commission's Juncker "No cherry picking"
- European Commission's Timmermans "Retaliation and recrimination should be the last thing on our minds"

28 June

- European Parliament extraordinary plenary session - MEPs passed a resolution for:
 - Order of Presidencies to be changed (UK due to take over in July 2017, after Malta – British Foreign and Commonwealth Office is also pushing for the UK to relinquish the presidency; David Cameron is expected to outline his views during a working dinner tonight)
 - Immediate activation of Article 50 and swift/coherent implementation of the withdrawal procedure
 - Cameron to notify the outcome of the referendum during the European Council meeting of 28 and 29 June, launching the Art 50 withdrawal procedure
 - Any new relationship between UK and EU not to be agreed before the conclusion of the withdrawal agreement

The negotiations

- We understand Charles Roxburgh from HM Treasury will likely be organising the UK negotiation team
- Didier Seeuws (former chief of staff to Herman van Rompuy during his tenure as Council President) will lead the EU's negotiating team
- The negotiations will be split into two streams:
 - The first will be managed by the European Commission and will deal with the mechanics of the UK leaving the European Union, through the Article 50 procedure
 - The second will be managed by Didier Seeuws day-to-day and will determine the political nature of the UK's post-Brexit relationship with the EU

Brexit:
The markets



The markets as a whole

- Shares around the globe lost USD 2.08 trillion of value on 24 June (worse than Lehman Brothers in 2008 and Black Monday in 1987)
- Bank share collapse continued on 27 June, with trading suspended in some institutions as losses exceeded 10%. GBP 40bn was wiped off the value of banking shares in 2 days
- Nikkei dropped nearly 8% on 24 June, but closed up 2.4% on 27 June
- Sterling/USD exchange rate fell at double the rate of when the UK left the Exchange Rate Mechanism in 1992 - opened sharply lower on 27 June. Yesterday the exchange rate stood at its lowest level since 1985
- UK 10 year gilt yield hit record lows and the sovereign CDS spread widened
- Moody's put UK's Aa1-rating on "negative outlook", S&P has cut the UK's AAA rating by two notches to AA and warned of further cuts, whilst Fitch has also cut the UK's rating from AA+ to AA
- Announcement of several thousand potential UK job cuts by international banks
- Possible cuts to UK interest rates to zero may occur, to stimulate the UK economy

The cleared derivatives markets

- Everyone appeared **well prepared** on 24 June
- No fundamental concerns raised regarding operational issues, exchange/CCP connectivity, liquidity or financial stability – “it’s a political event, **not a liquidity crisis**”
- A number of CCPs issued **large intra-day margin calls** but, to our knowledge, all calls were met
- **High trading volumes**: some firms saw a day’s worth of electronic trading by 8-9 a.m.
- The fact that **some markets trade around the clock** has helped them absorb things overnight going into 24 June, mitigating some of the potential sharpness of the immediate impact
- Deutsche Boerse and the London Stock Exchange Group issued a joint press statement to reiterate that their **proposed merger is not conditional on the outcome** of the Referendum

Brexit:

The legal implications



Some immediate questions

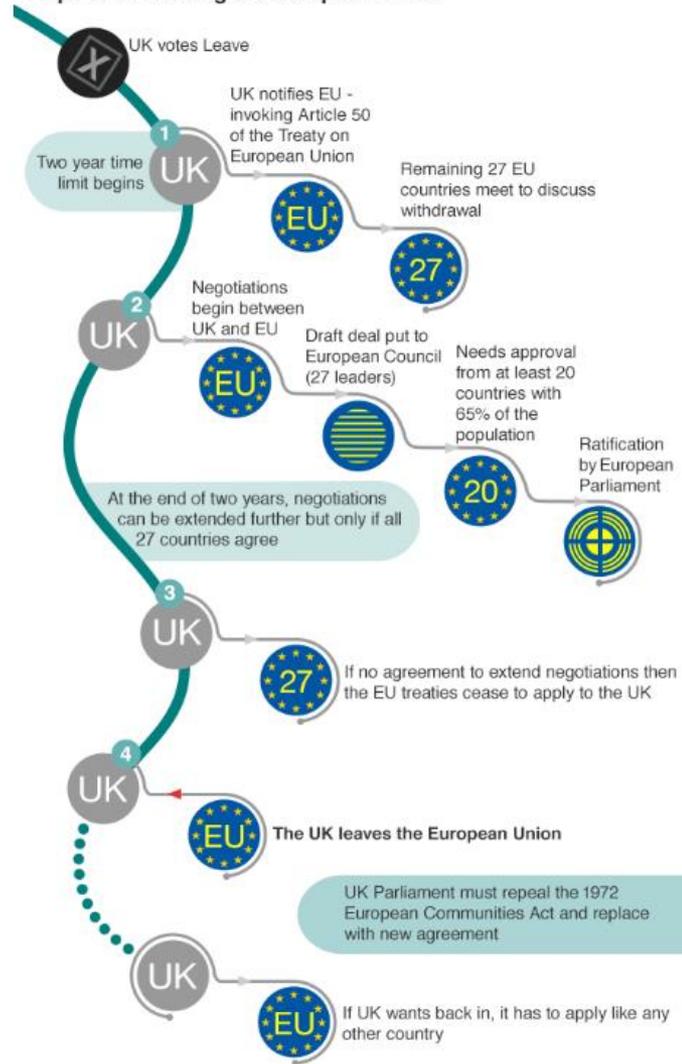
- Will the UK actually pull out of the EU? If so, how, when and who will do it? Are informal discussions possible ahead of the Article 50 notice being delivered?
- What influence does the UK now have in Brussels and ESMA/EBA, if any?
- Will UK firms still be able to avail themselves of “passporting” rights post-Brexit?
- Do members still need to press ahead with their MiFID II implementation programmes? (short answer – yes!)
- Will the ECB insist once more on euro-denominated derivatives being cleared only by CCPs located within the eurozone?
- What does Brexit mean for directly effective/applicable regulations such as EMIR, MiFIR, CRR, MAR, REMIT, SFTR and PRIIPS etc.
- Do UK CCPs and Trade Repositories now need to seek “recognition” under EMIR?

Article 50

- There is no precedent for a Member State leaving the European Union
- Article 50(2) of the Treaty of the European Union (the “TEU”) sets out the leave procedure: the UK government must give the European Council notice of its intention to exit the EU (an “Article 50 notice”)
- No EU treaties or UK legislation specify the timing for the delivery of the notice – it’s a political decision
- The framework for withdrawal:
 - Within two years of the Article 50 notice, the EU must negotiate and conclude an agreement with the UK, setting out the arrangements for its withdrawal and taking account of the framework for its future relationship with the EU
 - The withdrawal agreement must be signed by the European Council, acting by qualified majority, and after obtaining the consent of the European Parliament, acting on a majority vote basis
 - The relevant Treaties would cease to apply to the UK from the date of entry into force of the withdrawal agreement or, failing that, two years after the Article 50 notification, unless the European Council, in agreement with the UK, unanimously decides to extend this period

Article 50

Steps to UK leaving the European Union



Article 50 - FAQs

Can an Article 50 notice be withdrawn?

- There is no provision in the Treaties for withdrawal. However, an agreement to that effect could nonetheless be reached, if there was sufficient political will on all sides
- If no agreement reached, the UK could reapply for EU membership at a later date, but the UK would have to establish its eligibility criteria, which currently includes joining the Eurozone

Can the two year timeframe be extended?

- Yes, but only with unanimous consent of the European Council (excluding the UK), in accordance with Article 50(3) of the TEU

Are there any alternatives available to the UK other than the Article 50 route?

- The UK could conceivably withdraw from the EU in breach of the TEU, perhaps citing the supremacy of Parliament

The UK's on-going relationship with the EU

When will we know the UK's proposed post-Brexit model and what the EU's proposal is?

- This is unclear. The Treaties provide very little guidance about the legal consequences of withdrawing from the EU or what the post-exit world would look like for the UK (and remaining Member States). There is a complex trade-off between market access and sharing of sovereignty

What are the principal models available to the UK?

- The Norway model: European Economic Area membership
- The Swiss model: Bilateral agreements with Members States and limited access to the single market in specifically defined areas
- The Turkish model: A customs union
- The Canadian model: A deep free trade agreement
- The WTO model: The U.K. becomes a member of the World Trade Organisation
- The UK model: a bespoke solution that differs from all previous models

The Norway model – EEA membership

- Assuming the necessary agreement/approvals could be obtained, and the UK becomes a member of the European Free Trade Association (as required under the EEA Agreement), the UK could leave the US but join the EEA as a non-EU Member State member, like Norway
- Closest to the UK's current relationship with the other EU Member States
- UK stays within the single market
- UK still required to implement unpopular EU laws such as those relating to the free movement of people
- Requires significant financial contribution from the UK
- UK would be bound to apply a significant volume (but not all) of EU law in a range of fields, including financial services, employment and consumer protection
- Whilst bound by such laws, the UK has no formal seat at the table with EU law is drawn up
- Where EU law does not apply, the UK would have to enable domestic legislation – notably, the UK could set its own rules in areas such as agriculture and fisheries, transport and energy

The Swiss model – Bilateral relationships

- This model was originally intended as a transition to full EU membership
- Many bilateral agreements with EU Member States
- Limited access to the single market in specifically defined areas: requires more detailed negotiation than the Norway model, as bespoke terms for access to the single market would need to be agreements
- UK may also seek to become an EFTA member, like Switzerland
- UK may have to accept some of the EU freedom of movement rules and to comply with EU rules when trading within the market, again without a formal seat at the table
- Freedom of movement of services may be limited

The Turkish model – Customs Union

- Applies only to trade in goods, not services
- No internal tariffs are applied to trade and there are common external tariffs for trade with third states
- No financial contribution to the EU by UK
- UK not bound by the majority of EU law
- UK would have to agree rules on trade, which may involve the UK adopting EU laws on, e.g., the standards applicable to goods entering the single market

The Canadian model – Free Trade Agreement

- Canadian/EU agreement has been agreed but is not yet in force: took over 7 years to negotiate
- Allows tariff free trade in goods (subject to complex country of origin rules)
- Provides for the removal of certain non-tariff barriers in relation to both goods and services, including financial services
- UK would retain control over tariff arrangements with other non-EU countries

The WTO model

- The greatest change from the status quo
- Application of caps on tariffs applicable to goods traded between the UK and the EU
- Limits on certain non-tariff barriers in relation to goods and services
- Would not apply to services and may require substantial amounts of new legislation to replicate EU legislation that would fall away on a Brexit
- No financial contribution to the EU by UK
- UK not bound by EU laws

UK's relationship with non-EU countries

- The EU has signed up to certain free trade deals with non-EU countries, e.g. South Korea
- Unless agreed in the withdrawal agreement, the UK will no longer be bound by these treaties and will need to renegotiate trade deals with these states
- Remains to be seen whether the UK can negotiate as favourable terms as the EU
- Trade deals will take years to negotiate
- More freedom for the UK to conclude trade deals, as they would no longer be constrained by the need to obtain agreement of other Member States

Impact of Brexit on cleared derivatives markets

The creditworthiness of some counterparties may decline

- May become more expensive to enter into new derivatives transactions
- Collateralisation requirements may increase

Exposures under existing derivatives contracts may fluctuate

- For contracts that reference, or are settled in, GBP or UK assets
- Volatility in financial markets may create or increase exposures under existing derivatives contracts, triggering collateralisation obligations

The value of UK-linked collateral may deteriorate

- A deterioration in GBP and UK assets (e.g. Gilts) will result in increased collateralisation obligations

Impact of Brexit on cleared derivatives documentation

Will Brexit affect my existing derivatives contracts? Will there be an immediate impact on documentation?

- Unlikely: we're not aware of any specific Brexit-related adjustment, termination or other provisions having been routinely included in standard documentation
- Consider impact of other non-standard termination rights

Should I provide for Brexit in my derivatives documentation?

- This may be more usefully assessed when further details of the post-Brexit regime are known
- Bear in mind that legislation regulating the UK's withdrawal may override contractual provisions or, worse still, those contractual provisions may inadvertently override otherwise helpful legislation regulating such withdrawal

Do I need to change my English governing law and jurisdiction clauses?

- Unlikely that a UK withdrawal would substantially impact the enforceability of English governing law clauses and that English law would not continue to be an attractive choice for derivatives markets participants



Impact of Brexit on cleared derivatives documentation

Should I carry out due diligence on my existing derivatives contracts?

Areas to consider may include:

- **Whether existing representations, warranties and covenants can continue to be made and whether any new representations, warranties and covenants are required?** *Unlikely*
- **Whether porting, events of default or other termination rights are likely to be triggered?** *Unlikely that performance under existing contracts will become impossible or illegal so as to trigger related termination provisions under standard cleared derivatives agreements.*
- **Tax implications?** *If there is a change in withholding tax treatment as a result of UK withdrawal, it is possible that the tax provisions may be triggered*
- **Whether there are any territorial terms (for example, references to the “European Union”) or any preferences to pre-existing legislation that may need to be amended**

Regulatory impact on cleared derivatives

- Until the post-Brexit regime has been agreed and is implemented, **existing UK and EU regulations will continue in place for now**
- Over time, the **UK regulatory regime** impacting derivatives is **likely to start to diverge** from the equivalent EU rules: dual-compliance burden for cross-border firms
- **UK will no longer be able to exert as much (if any) influence** on EU financial services regulation
- UK government will be focussed on ensuring that **current protections** for derivatives and collateral arrangements continue in effect and that cross-border trading is not adversely affected

Regulatory impact on cleared derivatives

Continuation of MiFID passports:

The potential withdrawal of the MiFID passport would be a severe blow to an entity's own derivatives business and that of its counterparties. Some have valued the loss to the UK at GBP10bn. The UK is very keen to ensure that passporting rights are unaffected by UK withdrawal.

European Commissioner Jonathan Hill: *"A deal that maintains passporting and single market access rights will be tricky"*

Christian Democrat Union (Germany): *"If the UK wants to use the single market, they must contribute to the EU budget"*

Ensuring no adverse impact on financial collateral, netting and set-off arrangements:

Important to ensure that:

- the UK Financial Collateral Arrangements (No 2) Regulations 2003 continue in effect, to preserve enforceability of financial collateral arrangements
- The relevant implementing measures relating to safeguards for such arrangements under the Bank Recovery and Resolution Directive (BRRD) and the Credit Institutions Winding Up Directive continue in effect

Ensuring no adverse impact regarding the benefit of cross-border recognition provisions under EMIR:

- Will the UK will be considered a "third country" under EU legislation as a result of Brexit?
- Can some sort of grandfathering could be agreed?
- Must the UK embark on its own equivalence discussions with the US and other third countries? Such discussions would be lengthy and complex



Regulatory impact on cleared derivatives

Ensuring no adverse impact regarding financial markets infrastructure:

- UK CCPs will potentially need to seek “recognition” under EMIR, unless their EMIR “authorisations” can be grandfathered as part of the withdrawal agreement
- Will the ECB move to tear up its settlement with the Bank of England on the ECB’s CCP location policy, such that only CCPs located in the eurozone will be permitted to clear euro-denominated derivatives? If so, how do you deal with trades already cleared on non-eurozone CCPs?
- Clarify treatment of the UK-based Trade Repositories: can they continue to be established outside the EU? If so, do they need to seek “recognition” under EMIR, even if they are already “registered”?
- How can the UK trading venues and CCPs continue to avail themselves of the non-discriminatory access provisions in MiFIR relating to access to trading venues, CCPs and benchmarks?

Identifying and resolving the issues:

- What does Brexit mean for directly applicable/effective regulations such EMIR, MiFIR, CRR, MAR, REMIT, SFTR and PRIIPS etc.?



Brexit:
Next steps



Next steps: Questions FIA is asking of its members

- How can we best serve our members?
- What questions do FIA members have?
- What should FIA's policy priorities be with respect to Brexit? We're being asked to provide these to governmental bodies already
- Whom would you like FIA to lobby and to what end?
- Do FIA members have a preferred exit model – the working assumption within the City appears to be a preference for the Norway model?
- Do FIA members agree that the preference is to retain single market access, failing which to be able to rely on third country equivalence/recognition?
- What research should FIA carry out, if any?
- Would you rather we added Brexit as a topic to a number of our existing working groups (e.g. Legal, Ops, Government Relations) or would you rather we set up specific Brexit working groups? If the latter, how should they be structured?



Contact us

FIA's response will be lead out of its London office, but will be working closely with colleagues in Washington, Amsterdam and Singapore.

Please contact us:

- in the first instance by email at uk-eurelations@fia.org; or
- via your usual FIA staff contact, who will refer you to the relevant FIA staff members.

