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afme/ Finance for Europe

UK FINANCE

Impact of Brexit on cross-border financial services contracts

Key points

- **The EU financial services framework will cease to apply after the UK exit from the EU:** The regulatory framework and financial passport that has enabled EU-based customers to access a diverse suite of cross-border financial products and services from UK-based banks will cease to apply after the UK exit from the EU. This potentially creates significant uncertainty for EU-based businesses, including as to the continuity of their cross-border financial contracts which support their funding and risk management. Due to the significant importance of this for UK and EU businesses, AFME and UK Finance have come together to highlight this issue for policymakers.

- **The existing stock of cross-border contracts with customers will be affected:** Prompt action is required to provide the necessary clarity that these contracts will continue after the UK exit from the EU. It is estimated that €1.3 trillion of UK-based bank assets are related to the cross-border provision of financial products and services to a variety of customers ranging from governments and businesses to individuals. These services are supported by a very significant volume of contracts.

- **Contractual uncertainty of cross-border contracts needs to be addressed promptly to avoid damaging impacts:** Both the UK and the EU have a shared interest in ensuring that the issue of contractual uncertainty on the stock of cross-border financial contracts is addressed at an early stage as part of the negotiations: this is to avoid any damaging impacts on business, additional costs for customers and disruptive economic effects for the UK and the EU. In the absence of a blanket solution each contract will need to be individually assessed to determine if elements to be performed constitute a regulated activity no longer authorised under the EU passporting regime and whether the national laws of the Member State where the customer is located nonetheless permit the activity. This uncertainty and the potential need to transfer or restructure contracts could have a significant impact on customers.

- **There is precedent for dealing with contractual uncertainty when legal regimes change:** Uncertainty of this sort relating to the treatment of an existing stock of contracts during a period of transition between two legal regimes is not without precedent. For example, an EU-wide solution was adopted to address uncertainty around the introduction of the euro currency and around the new regulations on OTC derivatives, central counterparties and trade repositories.

- **A range of actions are available to the EU, the UK and individual EU Member States to address cross-border contractual uncertainty:** A range of actions are potentially available to the EU, the UK and individual Member States to manage any damaging impacts from undermining existing contracts or requiring contracting parties to engage in economically unproductive and unnecessary restructuring within a very compressed period of time.
    - A transition period may be put in place as part of broader transitional arrangements that confirms the legal right to contract in this way for a defined period. This will allow banks and their clients in the EU and the UK additional time to transfer or restructure the relevant contract and/or put in place alternative financial arrangements.
    - In conjunction, existing contracts, subject to certain limitations or conditions, should be allowed to continue and run to maturity.
    - The UK and individual EU Member States may also consider grandfathering contracts under their existing national licensing regimes where appropriate.

Overview

€1.3 trillion of UK-based bank assets are related to the cross-border provision of financial products and services to a variety of customers ranging from governments and individuals to businesses of all sizes.

The market place for the cross-border provision of financial services between the UK and the EU is large and active and reflects over three decades of integration and the implementation of the single rulebook. The UK exit from the EU will change this. A new long-term partnership agreement will need to be negotiated and agreed, and transitional measures defined to help mitigate the impact of a revised market framework for businesses that buy and sell between the EU and the UK.

The regulatory framework and financial passport that has enabled EU-based customers to access the diverse suite of cross-border financial products and services from UK-based banks[1] will cease to apply after the UK's exit from the EU. The same holds true for UK-based customers accessing financial products and services from EU-based banks. What, if anything, will replace these current rights to contract for such financial products and services between the EU and the UK remains unclear.

This has important implications for the many customers that hold contracts for the provision of financial services between the two markets where the duration extends beyond the date in 2019 when the UK is expected to exit the EU. It is estimated that €1.3 trillion of UK-based bank assets are related to the cross-border provision of financial products and services to a variety of customers ranging from governments and individuals to businesses of all sizes[2].

These services include lending and capital markets, risk management and foreign currency products and services spanning the entirety of the financial services sector, including banking, insurance and investment management. A significant proportion of this back-book of contracts extend beyond the 2019 exit date, providing important funding and risk management for businesses. Many of these services support EU exporting businesses that are key drivers of the EU and UK's international earnings and strong contributors to economic growth and job creation. European and UK businesses are increasingly concerned about the potential impact on their existing contracts.[3] The UK exit from the EU potentially creates significant uncertainty for these businesses, including with respect to the continuity of the contracts which support their funding, economic activity and risk management[4]. Early action is required to provide the necessary clarity that these contracts will continue following the exit of the UK from the EU.

The contractual uncertainty problem

Uncertainty as to whether elements of continued activity under or any changes to contracts are a regulated activity may have a material impact on the commercial outcomes that these contracts are meant to support.

Typically, a contract for financial products and services will have a number of elements comprising different regulated activities embedded in its performance. Where any of these elements remain to be performed after the date of the UK's exit from the EU, each element will need to be analysed to assess whether it remains permissible or whether it is now restricted or otherwise prohibited. Such assessments will require an analysis to be made of the requirements at an EU regulatory level and also at the national regulatory level of the country in which the customer is located. Because of differences across individual EU Member States it is possible that the outcome of the assessment may differ from country to country and customer to customer[5].

In addition, the commercial or economic environment for a contract that extends for a number of years may evolve or change such that a customer in the normal course of business activity wishes to refine or otherwise 'fine tune' aspects of the contract to respond to the new environment. Where this involves a change to elements of the contract to be performed after the date of the UK's exit this will similarly need to be assessed.

Uncertainty as to whether elements of continued activity under, or any changes to contracts are a regulated activity in the respective EU jurisdictions may have a material impact on the commercial outcomes that these contracts are meant to support. As a result, affected contracts with a UK-based bank may need to be transferred, restructured or potentially terminated. In addition, businesses may need to look for alternative financing providers to ensure that they can meet their commercial objectives and have the

[1] The term 'banks' is used to encompass the broad range of regulated firms providing banking and capital markets services, including credit institutions, investment firms and payment institutions and firms providing electronic money services.

[2, 3] AFME/Boston Consulting Group/Clifford Chance: Bridging to Brexit: insights from European SMEs, Corporates and Investors, July 2017.

[4] European Council: Guidelines following the UK's notification under article 50 TEU, April 2017: "Businesses and other stakeholders will lose the predictability and certainty that come with EU law. It will also have an impact on public authorities. With this in mind, we must proceed according to a phased approach giving priority to an orderly withdrawal."

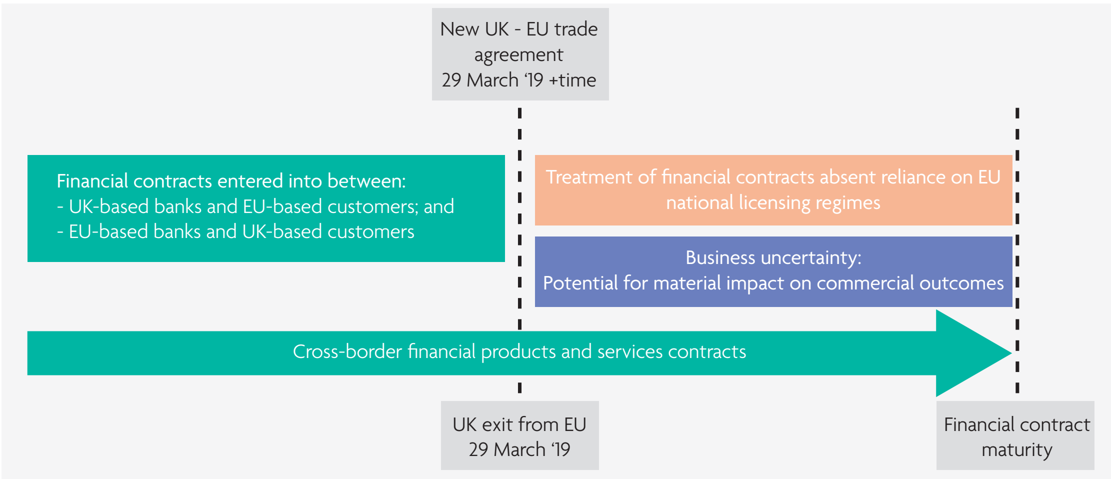
[5] UK Finance/Slaughter & May report: Serving Europe: Navigating the legislative landscape outside the single market: August 2017.

appropriate financial flexibility. If the quantity of requests for alternative service provision is high, then alternative providers may face limitations in their capacity to provide such replacement financial products and services on the same terms and at the same prices, at least in the short to medium term.

For customers, the implications of such restructuring may involve not only significant demands upon management time and resource but may also result in additional one-off reorganisation costs, the crystallisation of tax liabilities and even ongoing expense where it is not possible to restructure the affected contract on a like-for-like basis. They will also need to understand and evaluate commercial changes resulting from any transfer of contracts such as the credit risk of a new counterparty and any impact on their netting position.

The case study below illustrates how potentially disruptive and damaging this uncertainty can be and how it gives rise to potentially significant economic costs that are both unnecessary and that it is possible to mitigate by collaborative and coordinated actions by the EU and UK.

Figure 1: Contractual uncertainty



In the absence of some sort of blanket solution each contract will need to be individually assessed to determine if elements to be performed constitute a regulated activity no longer authorised under the EU passport. Also whether the national laws of the location of the customer nonetheless permit the activity.

For this reason, the treatment of such financial contracts must be addressed as part of the current negotiations between the EU and the UK. Both the UK and the EU have a shared interest in ensuring that this issue is addressed at an early stage as part of the negotiations and avoids any chilling effect for business, additional costs for customers and disruptive economic effects for the UK and the EU. In the absence of some sort of blanket solution each contract will need to be individually assessed to determine if elements to be performed constitute a regulated activity no longer authorised under the EU passport. Also whether the national laws of the location of the customer nonetheless permit the activity.

The EU has rightly confirmed that: "*any good lawfully placed on the single market on the basis of Union law before the withdrawal date [should] continue to be made available on the market or put into service after that date both in the United Kingdom and in the EU27 under the conditions set out in the relevant Union law applicable before the withdrawal date.*"[6] It is important that the same principle be extended to services.

In addition, in its guidelines adopted following the UK's notification of withdrawal the European Council has stated that the first phase of negotiations will aim to: "provide as much clarity and legal certainty as possible to citizens, businesses, stakeholders and international partners on the immediate effects of the United Kingdom's withdrawal from the Union."[7] Providing contractual certainty is an important part of achieving this.

[6] Council of the European Union: Directives for the negotiation of an agreement with the United Kingdom of Great Britain and Northern Ireland setting out the arrangements for its withdrawal from the European Union, May 2017.

[7] See footnote 4

How to address contractual uncertainty

A range of actions are available to the EU and the UK to manage any damaging impacts from undermining existing contracts or requiring contracting parties to engage in economically unproductive and wasteful restructuring.

Uncertainty of this kind relating to the treatment of an existing stock of contracts during a period of transition between two legal regimes is not without precedent. The introduction of the euro currency and new EU regulation on OTC derivatives, central counterparties and trade repositories each required such continuity measures. Common legislative provisions were implemented on these occasions to address the treatment of existing contracts[8,9].

Contractual uncertainty and the resulting cost and time associated with addressing it can be mitigated in a variety of ways. A transition period may be put in place as part of broader transitional arrangements that confirms the legal right to contract in this way for a defined period. This will allow banks and their clients additional time to transfer or restructure the financial contract and / or seek alternative financial arrangements. In addition, and in conjunction with a transition period, existing contracts, subject to certain limitations or conditions, may be allowed to remain in their existing location and run to maturity.

An EU-wide solution would be preferable to minimise uncertainty for businesses across the EU. This could comprise legally binding grandfathering in the withdrawal agreement or European legislation, potentially supported by a coordinated regulatory approach to provide for continuity of existing contracts or 'no-action' relief[10]. Individual EU Member States may also consider grandfathering existing contracts under their national licensing regimes where judged appropriate.

The UK should also provide clarity that existing contracts from EU-based banks to UK customers will be grandfathered, for example through the European Union (Withdrawal) Bill.

A range of actions would help both sides manage any damaging impacts from undermining existing contracts or requiring contracting parties to engage in economically unproductive and wasteful restructuring:

- Both sides should confirm at the earliest opportunity the principle established in the EU negotiating directives that the right to trade goods legally placed on the market at the point of separation must be preserved and should be extended to services and to avoid contractual uncertainty.
- Transitional arrangements should be structured in such a way as to protect existing contracts for the duration of the transitional arrangements.
- A long-term partnership agreement should provide a similar bridge into the new arrangement for contracted services by providing for the continuity of existing contracts.
- EU Member States should consider legislation to ensure contractual continuity for a specified number of years where appropriate or required.
- The UK should use the European Union (Withdrawal) Bill process to provide the same.

Case study: Customer impact - contractual certainty for Europa SA

Europa SA is a leading Mittelstand / SME manufacturing firm, headquartered in an EU27 member state, and with operations across the EMEA region and Asia. Like many similar businesses, it is part of the network of EU exporters to the world that have greatly contributed to European economic growth and job creation.

In early 2016 Europa SA entered into a five-year U.S. dollar denominated revolving credit agreement starting in 2017 with its UK-based bank to fund building a new factory in Asia. Europa SA expects to draw on the credit facility during various stages of building the factory and commissioning the

[8] 'The introduction of the euro shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance under any legal instrument, nor give a party the right unilaterally to alter or terminate such an instrument. This provision is subject to anything which parties may have agreed.' (Article 3, Council Regulation (EC) No 1103/97 of 17 June 1997 on certain provisions relating to the introduction of the euro).

[9] 'An infringement of the rules under this Title shall not affect the validity of an OTC derivative contract or the possibility for the parties to enforce the provisions of an OTC derivative contract. An infringement of the rules under this Title shall not give rise to any right to compensation from a party to an OTC derivative contract.' (Article 12(3), Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories).

[10] See AFME response to the Commission consultation on the review of the ESAs which proposed the introduction of such powers.

production lines to be installed at the factory. Alongside its revolving credit agreement Europa SA entered into interest rate swaps and hedged its foreign exchange risk with forward contracts with the same relationship bank, matching the expected payment flows for the building of the factory and the commissioning of the production lines. Like many other similar mid-sized businesses, Europa SA consolidates its banking relationships among a small number of relationship banks to maximise the service efficiencies and reduce management time required to obtain financing for its international business needs.

Once the UK exits from the EU in March 2019, and in the absence of any transitional arrangements, the financial services activity between Europa SA and its UK-based relationship bank will be governed in relevant part by a combination of EU regulations and the EU national licensing regime in the country in which Europa SA is located. These national licensing regimes differ significantly across EU Member States with some being more restrictive than others in relation to the provision of wholesale banking services.

Although so far as Europa SA is concerned it has only one commercial objective – the financing of the construction of its factory and production lines – as a legal matter Europa SA will have three different financing contracts to be analysed – the revolving credit agreement; the interest rate hedge agreement; and the currency hedge agreement.[11] Each of these contracts has a series of different elements to be performed after March 2019.

Scenario 1: Europa SA's factory is built and its production lines are installed on schedule

In this scenario activities under the contracts are performed as agreed at inception. This already gives rise to certain questions. Is it the case that Europa SA drawing down additional tranches after March 2019 under the existing revolving credit agreement may be a regulated activity? In some EU27 countries the answer will be 'yes'; in others 'no'. In addition, is it the case that if Europa SA is required to post additional collateral as part of its risk management contracts that this may be considered a regulated activity? In most EU Member States the simple posting or release of collateral as part of the normal performance of a derivative contract agreed before the UK departure from the EU would not be treated as a new regulated activity requiring licencing. Nevertheless, the UK-based bank may need to address issues associated with each element of ongoing performance for each contract to ensure that it is not in violation of any regulated activities in the relevant EU jurisdiction.

Scenario 2: Europa SA's factory or production lines are facing delays

As the building process progresses it appears that the factory is built on an archaeological site and local authorities are required to investigate. This is expected to set the planned construction schedule back by six to twelve months. As a result, Europa SA has amended its investment plan and its revolving credit agreement and risk management agreements need to be amended.

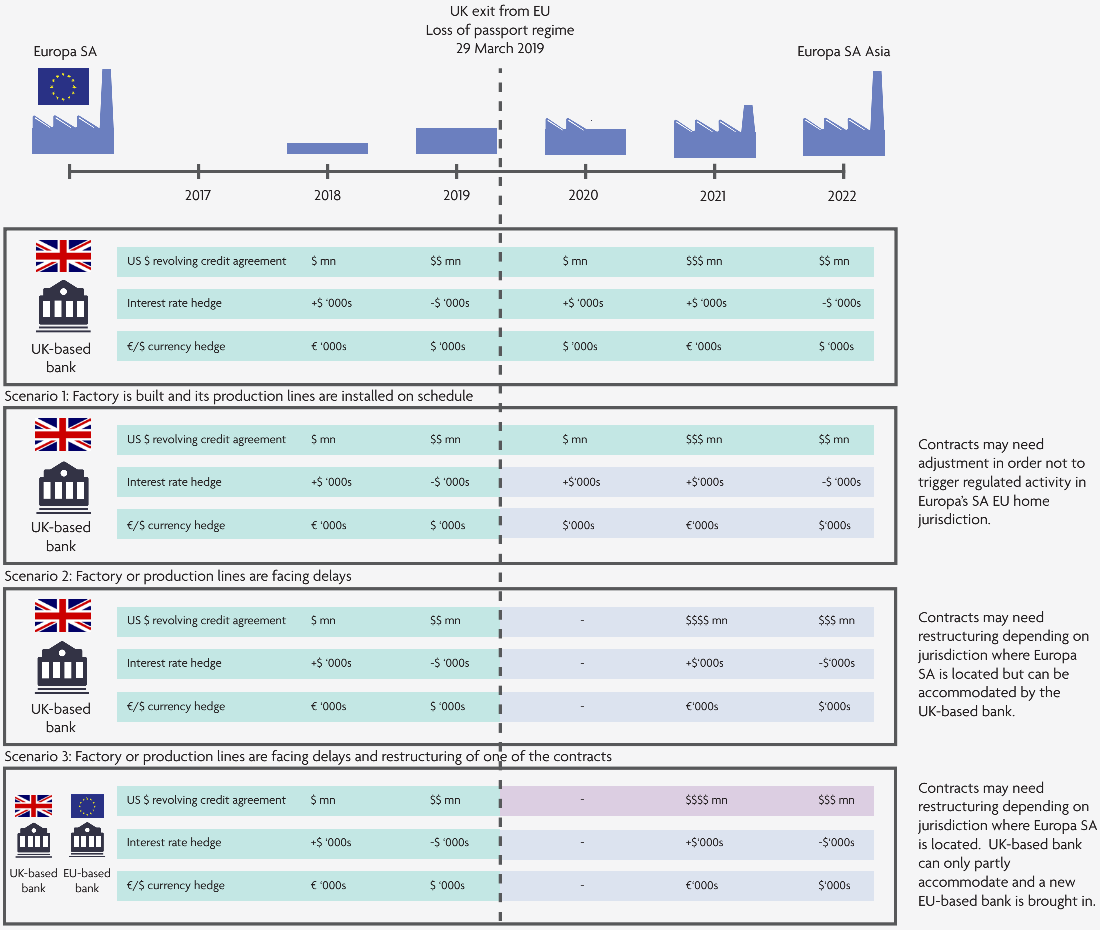
Under the passporting regime reflecting the commercial consequences of the construction delay would have been straightforward, but post the UK exit from the EU, Europa SA and the UK-based bank may need to restructure none, some or all of the contracts depending upon the regulatory position in the country in which Europa SA is located. Some elements of the amendment of the financing plans underpinning the construction are likely to trigger the UK-based bank being considered as engaging in regulated activity in most EU27 countries.

In some countries, only the amendments to the interest rate and currency hedging agreements will be treated as a regulated activity; in others both the amendments to the hedging agreements and to the revolving credit agreement will be regarded as regulated activities. In some countries it is possible to obtain an exemption to conduct such regulated activities with certain types of customers. In other countries, no such exemption possibility exists. If there are regulated activities for which Europa SA no longer has the legal right to contract with a UK-based bank, then it faces a complex and potentially expensive process of restructuring.

[11] See also ISDA Brexit Briefings: http://www2.isda.org/functional-areas/legal-and-documentation/uk-brexit/ for further information on the impact of the UK exit from the EU on contractual points under ISDA documentation.

To properly assess its situation and determine whether remedial action is required to ensure that its commercial objectives are not impacted, Europa SA and its UK-based relationship bank will wish to work together and ascertain what needs to happen under different scenarios with each of the financial contracts it has outstanding and whether any of these need to be restructured, novated or even terminated. In addition, Europa SA will need to consider how to organise the capacity and capabilities of its own finance function after the UK exit from the EU to ensure that it can execute on its financial strategy and can finance its operations and future investments.

Figure 2: Europa SA factory and production line financing



Scenario 3: Europa SA and its UK-based relationship bank conclude that one of the three agreements should be restructured

After working together to determine the risk, Europa SA and its UK-based relationship bank conclude that the regulations of the country in which Europa SA is located are among the most restrictive in the EU27, and that the drawing down of the next tranche of the loan to pay for the next construction instalment for the factory will be a regulated activity for which no exemption is available. To provide Europa SA with its desired commercial outcomes – drawing down the next tranche of the dollar denominated credit agreement to make the factory construction payment on time – the UK relationship bank proposes to restructure the revolving credit agreement to move this to a subsidiary it has established in Luxembourg.

Europa SA analyses the implications of this proposal and realises that it will crystallise a tax liability for Europa SA because its domestic tax regulations treat the restructuring as the repayment of a loan in US dollars with a UK based bank and the establishment of a new loan in the same currency with a Luxembourg based bank. Europa SA accounts to its tax authorities in euros and therefore the termination of the US dollar denominated loan is treated as giving rise to a taxable gain in euros because the euro/US dollar exchange rate has changed between the dates when the loan was first drawn down to the date when it is to be treated as repaid.

Europa SA wishes to avoid incurring such a significant tax cost merely to ensure that it continues to receive the benefit of the financing arrangements that it had put in place in 2017. It seeks an alternative and less costly solution. Europa SA concludes that it will be more economic to leave the existing revolving loan agreement in place with its UK based bank but make no further drawing under this agreement. Instead it approaches an EU bank based in its own country, and asks the EU-based bank to provide a new US dollar loan agreement for the balance of the financing Europa SA requires to complete construction of its factory and production lines. The EU-based bank assesses its interest in the possible new relationship with Europa SA and decides to offer Europa SA the requested loan.

Because current market conditions for new loans have changed since 2017, because the amount of business that EU-based bank believes it will obtain from Europa SA at this early phase in the new banking relationship is limited, and because the existing interest rate swap and currency agreement to hedge the loan agreement are not with the EU-based bank and so cannot be taken into account by the EU-based bank for its own risk management calculations, the EU-based bank offers pricing and other terms for the new US dollar loan that are more expensive and less attractive for Europa SA than its original 2017 agreement. Europa SA considers the alternatives available to it and decides that the combination of maintaining the arrangements with its UK-based relationship bank for existing drawings and the new arrangements with the EU-based bank for its future drawings are 'the lesser evil'.

Absent any blanket solution, whether via a transition arrangement or a legislative change similar to that introduced for the establishment of the euro, Europa SA's and its relationship bank's experience described in this case study will need to be mirrored for many entities and a large number of contracts across the UK and the EU, a hugely inefficient use of resources that would be better applied to support new exports, economic growth and job creation throughout the EU and the UK.

About UK Finance

UK Finance represents nearly 300 of the leading firms providing finance, banking, markets and payments-related services in or from the UK. UK Finance has been created by combining most of the activities of the Asset Based Finance Association, the British Bankers' Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association.

UK Finance has an important role to play helping negotiators understand how the interest of UK and EU customers and the financial services they all depend on can be protected.

Our members are large and small, national and regional, domestic and international, corporate and mutual, retail and wholesale, physical and virtual, banks and non-banks. Our members' customers are individuals, corporates, charities, clubs, associations and government bodies, served domestically and cross-border. These customers access a wide range of financial and advisory products and services, essential to their day-to-day activities. The interests of our members' customers are at the heart of our work.

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.

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. This paper highlights the potential impact of Brexit on existing cross-border financial services contracts. Given the importance of this issue for EU and UK businesses, we have come together with UK Finance to highlight this issue for policymakers.