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## THE FINANCIAL RISKS CONNECTED WITH THE WITHDRAWAL OF THE UNITED KINGDOM FROM THE EUROPEAN UNION

The completion of the Brexit process requires an agreement to be concluded and ratified by 29 March 2019, establishing the terms of the UK's withdrawal from the European Union (see the box 'Developments in the Brexit negotiations' in Chapter 1 of the Bank of Italy's *Annual Report for 2017*). A draft withdrawal agreement was defined on 14 November allowing the UK to participate in the single market until the end of the transition period (31 December 2020). The draft was approved by the Cabinet of the British government yet its ratification by the Parliament is still uncertain. If the agreement were not to be ratified, bilateral EU-UK relations would be broken off (cliff edge). This would, among other things, bring an end to the current regime of mutual recognition of authorizations and the supervisory system in the financial sector (the 'single passport').

For the finance industry, a cliff-edge Brexit carries several risks – to liquidity first and foremost, but there are also legal, operational and compliance risks – which could be significant in areas such as financial contracts (including derivatives), which are cleared through a British central counterparty (CCP). London is by far the most important centre in Europe for clearing derivatives (predominantly OTCs): according to the European Central Bank, about 90 per cent of EU firms' interest rate swaps are settled in the UK. The Bank of England recently estimated that the notional value of outstanding contracts managed by British CCPs amounts to around £69 trillion, a large portion of which (£41 trillion) will mature after 29 March 2019. On 13 November the European Commission announced<sup>1</sup> that, if it proved necessary to avoid any risks to financial stability, it would adopt a temporary and conditional equivalence decision for UK central clearing rules to allow British CCPs to be recognized by the European Securities and Markets Authority (ESMA), and, therefore, to continue their activities in the EU.

Further risks are connected with OTC derivatives contracts stipulated between European counterparties and British operators but not cleared through a CCP. The capacity of financial intermediaries to perform their primary task of margin trading would not be affected since they would simply be carrying out an obligation that arose before Brexit, although they could encounter difficulties in carrying out some activities related to the lifecycle events of these contracts (netting, renewal, and portfolio compression). The loss of the single passport would prevent UK intermediaries from continuing to carry out such activities if the latter were subject to authorizations provided for in the national rules of member states.

If no deal is reached, the almost 2,700 intermediaries headquartered in the UK that today do business in Italy using the single passport (banks, investment firms, asset management companies, payment and e-money institutions, insurance companies), 117 of which operate through branch offices, will only be able to continue operations on the basis of a new authorization granted by the Italian supervisory authorities.

Numerous British insurance companies operate in Italy, mainly in the fields of general civil liability, especially medical liability, and suretyship. If there is a cliff-edge exit, outstanding insurance contracts would still be valid from a civil law point of view, even if no longer subject to supervision in accordance with EU legislation.<sup>2</sup>

<sup>1</sup> European Commission, 'Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019: a Contingency Action Plan', COM(2018) 880 final, 2018.

<sup>2</sup> The impact of closing OTC derivatives contracts is very low for insurance companies: at the end of the first half of this year, their active and passive positions vis-à-vis British counterparties came to 0.02 and 0.06 per cent of total investments.

Numerous initiatives have been taken to deal with the risks deriving from the cliff-edge scenario in the financial services sector, including the establishment of a joint ECB-Bank of England working group.

Last June, the European Banking Authority (EBA) requested the banks in the UK that provide services in the rest of the EU and those established in the EU that interact with counterparties or clients headquartered in the UK to identify the possible risks of a cliff-edge scenario and to make contingency plans.<sup>3</sup> More specifically, the request regards: (a) exposure to counterparties in the UK; (b) dependence on sources of funding in the UK, for example for instruments that can be bailed-in under the minimum requirement for own funds and eligible liabilities (MREL); (c) continuity of contracts, particularly derivatives; and (d) personal data management. The EBA has also requested compliance with obligations towards the customer base and disclosure of timely information to customers whose contracts or services could be affected if no deal is reached. The ECB has published on its website a section containing indications for the banks that will be set up in the euro area after Brexit.<sup>4</sup> The Bank of Italy has asked the banks under its direct supervision for their opinions on the possible direct and indirect effects of a no-deal scenario, explicitly calling their attention to the risk profiles identified by EBA. In relation to liabilities that are eligible under MREL and governed by UK law, the Single Resolution Board (SRB) has announced<sup>5</sup> that it will take a case-by-case approach when looking at the situation of individual banks under its responsibility, possibly granting an extension period for MREL compliance to banks that might not have sufficient eligible instruments after Brexit.

The European Insurance and Occupational Pensions Authority (EIOPA) published four opinions between July 2017 and June 2018<sup>6</sup> with the aim of: (a) ensuring supervisory convergence among authorities in the member states where British companies intend to transfer their contracts in order to continue doing business in Europe; (b) encouraging the insurance market to prepare for this scenario, through contingency plans drawn up by insurance companies and through the definition of the supervisors' role in evaluating these plans; (c) analysing the impact on the solvency position of insurance and reinsurance companies; and (d) ensuring that present and future insurance customers receive sufficient information about the impact of Brexit. The Insurance Supervisory Authority (IVASS) has published on its website a list of FAQs<sup>7</sup> on the subject and a letter addressed to companies that do business in Italy from the UK, inviting them to inform their customers of the possible consequences of Brexit for their contracts and about the measures adopted to guarantee their execution and service continuity.<sup>8</sup>

<sup>3</sup> EBA, *Opinion of the European Banking Authority on preparations for the withdrawal of the United Kingdom from the European Union*, 25 June 2018.

<sup>4</sup> See the ECB's website, *Relocating to the euro area*, last updated on 2 August 2018.

<sup>5</sup> SRB, *Single Resolution Board expectations to ensure resolvability of banks in the context of Brexit*, 15 November 2018.

<sup>6</sup> EIOPA, *Opinion on supervisory convergence in light of the United Kingdom withdrawing from the European Union*, 11 July 2017; EIOPA, *Opinion on service continuity in insurance in light of the withdrawal of the United Kingdom from the European Union*, 21 December 2017; EIOPA, *Opinion on the solvency position of insurance and reinsurance undertakings in light of the withdrawal of the United Kingdom from the European Union*, 18 May 2018; EIOPA, *Opinion on disclosure of information to customers about the impact of the withdrawal of the United Kingdom from the European Union*, 28 June 2018.

<sup>7</sup> IVASS, *Brexit Information for policyholders, Consumer FAQs*, 4 October 2018.

<sup>8</sup> IVASS, *Informativa agli assicurati italiani sull'impatto della Brexit*, 3 October 2018.