

**Box 6**

Assessing the risks to the euro area financial sector from a disruptive hard Brexit

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**An orderly withdrawal of the United Kingdom from the European Union poses a limited overall risk to euro area financial stability. But the uncertainty accompanying a cliff-edge Brexit could have the potential to pose a more significant downside risk to financial stability.**

**Cross-border clearing of derivatives contracts is one area where financial stability risks may arise in a cliff-edge Brexit scenario without sufficient mitigating actions.** If UK central

counterparties (CCPs) become non-recognised third-country entities after March 2019, euro area clearing members of UK CCPs will be exposed to legal risks if they continue to use UK CCPs to clear both new and existing trades. While euro area clearing members of UK CCPs are establishing connectivity with alternative CCPs to clear new transactions in advance of Brexit, a vulnerability remains with their significant legacy positions at UK CCPs. Euro area clearing members as of 31 October 2018 had positions of over €58 trillion in over-the-counter contracts with UK CCPs, of which €43 trillion matures after March 2019. A forced large-scale transfer to alternative CCPs in a short period could be operationally challenging, given the large amount of individual positions that would need to be closed out in one CCP and replaced in another, and might generate material one-off costs. Risks would be exacerbated if the transfer were to take place in a compressed time frame or in volatile market conditions. These potential risks have now been addressed through the assurance provided by the European Commission that, if necessary, it will allow EU firms to continue to clear derivatives contracts with UK-domiciled CCPs, under strict conditionality and with limited duration.<sup>18</sup>

**Some uncertainty also remains over the treatment of the stock of MREL<sup>19</sup> securities issued under UK law, in the event that the UK decides not to recognise the resolution powers of the Single Resolution Board (SRB).** Euro area credit institutions should follow European Banking Authority and SRB guidance that calls on issuers to issue MREL securities under EU27 law or insert contractual clauses in securities issued under UK law.<sup>20,21</sup> Yet, without further mitigants, these measures would not tackle the uncertainty over the treatment of the outstanding stock of MREL securities issued under UK law which does not roll off before the UK becomes a third country. A mitigating factor for MREL shortfall risk is the case-by-case approach that would be taken by the SRB, which may entail extending the affected banks' transitional periods to meet MREL requirements. The UK could also solve the issue by unilaterally recognising the resolution actions of the SRB, and thus continuing to comply with the Key Attributes of Effective Resolution Regimes for Financial Institutions developed by the Financial Stability Board.<sup>22</sup>

**The continuity of servicing uncleared cross-border derivatives contracts is unlikely to pose significant risks to financial stability provided that the private sector takes sufficient action.** For uncleared derivatives contracts between UK and euro area counterparties, the performance of many contractual obligations agreed before March 2019 (most notably payments and settlements) is unaffected by Brexit. The risk of a sudden mass termination of contracts is, therefore, negligible. The performance of certain life-cycle events and the exercise of certain options are, however, subject to authorisation in certain euro area countries. But the private sector can take a range of actions to mitigate risks associated with no longer being able to carry out life-cycle events on the affected contracts. These include: (i) trading-related strategies including bilateral novations; (ii) holding contracts to maturity and using other mechanisms with non-UK counterparties to adjust hedges; (iii) early terminations; (iv) actions based on statutory schemes for the collective transfer of business to the EU27; or (v) pursuing authorisations based on EU national regimes designed to enable the

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<sup>18</sup> See [“Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019: a contingency action plan”](#), 13 November 2018.

<sup>19</sup> MREL, which stands for minimum requirement for own funds and eligible liabilities, is a requirement under the Bank Recovery and Resolution Directive aimed at ensuring that in the event of bank resolution there are sufficient bail-inable instruments for loss absorption and recapitalisation of the bank.

<sup>20</sup> See [“Opinion of the European Banking Authority on preparations for the withdrawal of the United Kingdom from the European Union”](#), 25 June 2018.

<sup>21</sup> See [“Single Resolution Board expectations to ensure resolvability of banks in the context of Brexit”](#), 15 November 2018.

<sup>22</sup> See [“Key Attributes of Effective Resolution Regimes for Financial Institutions”](#), Financial Stability Board, October 2014.

cross-border provision of services from a third country. The European Securities and Markets Authority has proposed regulatory technical standards in order to facilitate the novation of certain non-centrally cleared OTC derivatives contracts to EU counterparties during a specific time-window, in case of a no deal scenario.<sup>23</sup>

**Similarly, financial stability risks are not expected in the area of cross-border insurance contracts, nor as a consequence of changes to the legal regime for cross-border personal data transfers within the financial services sector.** UK insurance undertakings will lose their authorisation to conduct business in the euro area (and vice versa) in a cliff-edge scenario. But UK insurance companies servicing euro area policyholders have a number of options available to them to mitigate any disruption. These include portfolio transfer, establishment of a third-country branch, relocation of a European company (Societas Europaea) or termination of contracts. These options are being actively used by firms. The vast majority of outstanding cross-border insurance contracts are covered by credible contingency plans, with the residual contracts primarily pertaining to non-life insurers.<sup>24</sup> Potential disruptions to personal data flows should also be negligible as financial institutions are advanced in their planning and intend to rely on mechanisms available to them under the data protection legal framework, such as, for example, standard contractual clauses.

**Despite heightening political uncertainty, any notable impact on financial markets has thus far been largely limited to currency markets.** Market prices do not currently reflect the implications of a cliff-edge Brexit, but – should such a scenario materialise – the market adjustment could be more broad-based. In particular, a hard Brexit could trigger a rise in risk aversion, which – in turn – could lead to an increase in risk premia and volatility. Any resulting tightening of financing conditions, including haircuts and margins, and rising funding costs could add to existing pressure on parts of the euro area financial system.

**ECB analysis indicates overall limited risks to the capital position of the euro area banking sector from its direct lending exposures to the UK, from indirect exposures via its lending to euro area exporters, or due to the application of positive risk weights on sovereign exposures.** Direct exposures to the UK, including to UK financial institutions, make up approximately 7% of SSM significant institutions' assets and have declined since the Brexit referendum. As such, direct credit risk effects are likely to be limited at an aggregate level, particularly if a hard Brexit does not trigger significant immediate increases in credit risk. But exposure is concentrated within a small number of banks with significant credit exposures, which could be more vulnerable if the UK experiences a material economic downturn following a hard Brexit. Regarding indirect exposures, losses are not expected to be large enough to pose risks to banks' capital positions. A hard Brexit could also lead to the sudden application of positive or higher risk weights to the UK sovereign exposures of euro area banks and insurance corporations if the UK sovereign were to be downgraded significantly at the same time. But ECB analysis finds that the impact on Common Equity Tier 1 capital ratios for SSM banks from such a scenario is likely to be very limited. And should UK banks be required to apply positive risk weights to euro area sovereign exposures, the effect on the euro area is also expected to be limited.

**Financial institutions are strongly encouraged to step up contingency planning and act upon those plans in a timely manner.** The City of London currently plays an important role in financial

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<sup>23</sup> See “[ESMA proposes a regulatory change to support the Brexit preparations of counterparties to uncleared OTC derivatives](#)”, 8 November 2018.

<sup>24</sup> See “[EIOPA calls for immediate action to ensure service continuity in cross-border insurance](#)”, 5 November 2018.

services for the whole of the EU. Transition to a new equilibrium will imply adjustment costs and may entail risks of frictions in some market segments if the transition is not adequately managed. In the event of a hard Brexit, managing a smooth transition could prove difficult if financial institutions have not sufficiently prepared for such an outcome. But the risk that the euro area real economy would be deprived of access to financial services following the UK's departure from the EU appears limited. Some services are likely to continue to be provided out of the UK, some will be provided by EU27-domiciled entities instead, and/or some of these activities and entities will relocate to within the EU27. As such, the impact of Brexit on financial services in the euro area is likely to be mainly reflected in the cost of external finance rather than in a reduction in available services.