Fixing the Exit Date: A Terrible Gamble

Quick Summary

The proposal to amend the European Union Withdrawal Bill to specify the date and time on which the United Kingdom will leave the European Union – 11.00PM on 29th March 2019[i] - is a terrible gamble.

The gamble that the Prime Minister is taking is that whatever happens – including a breakdown in negotiations and the hardest of hard Brexits – by 11.00PM on 28th March 2019 the United Kingdom and the EU 27 will have taken all steps to avoid any catastrophic breakdown in arrangements in Europe. These include the UK, the EU and potentially individual member states passing any necessary legislation to preserve existing contracts (including their enforceability), to maintain arbitration mechanisms and maintain the legality of providing banking and insurance sectors across borders.

Neither the Bank of England (including the Prudential Regulatory Authority or PRA) nor the ECB know precisely what the value of derivatives held by banks and potentially affected by Brexit is. No stress tests have been conducted and none planned to find out whether the banks are adequately prepared for the hardest of hard Brexits on 29 March 2019. Actually nobody has tested to make sure that all the big banks have done enough to be sure that even a softer Brexit will not cause huge disruption. The Bank of England has stated that there are:

- around £20 TRILLION of gross notional uncleared derivatives across the border held by UK firms they supervise

- they believe that the ECB's estimate of £20 TRILLION going the other way is probably on the low side

- these, as the Bank has explained, are the figures for uncleared derivatives. "These are derivatives between banks and end users that do not have to go through clearing houses. The effort, since the global financial crisis, has been to put more of this activity through clearing houses, because it gives you better risk management, and there is probably about £70 trillion of these contracts sitting in clearing houses and the like. Some will run off before Brexit, but a large majority will stay. I assume there will be some questions on clearing houses later on, but they face a number of issues about permissions and authorisations, and they also face this life-cycle performance issue" (Deputy Governor Sir Jon Cunliffe).

The amendment will remove the present flexibility on the date on which the Treaties stop working. If preparations are not complete by the point the UK leaves the EU then:

About the author

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The views expressed in this paper are the author's and published by the Conservative Group for Europe as a contribution to an ongoing debate

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- A proportion of derivative and other banking contracts will become non-functional. Not all will but enough to cause a real risk of contagion – to quote Sir Jon Cunliffe again "Sub-prime losses of $360 billion turned into $2.7 trillion-worth of losses for the financial system, in part because those losses knocked banks over, and once you start knocking banks over, you get credit drying up, and that knocks small banks over."

- UK insurance companies will be unable to pay on claims from non-UK EEA insureds and vice versa. Up to a quarter of UK car policies could be affected. This means a large number of motor claims will have to be settled by the driver rather than the insurer. Also the consumer friendly dispute resolution systems will no longer have legal underpinning.

Up to now, everyone has assumed that however hard the Brexit everyone will agree to the steps needed to avoid these potentially catastrophic consequences. But one reason why that assumption could be made is that Article 50 allows for the Treaties to kept in force if some of the steps necessary have to be completed. Take away that flexibility and the risks of catastrophe clearly increase.

What is worse firms will have to evaluate their risk exposures on the assumption that the UK will inevitably leave on 29 March 2019 even if the necessary steps to keep the financial system operating have not been completed. That means they will have to provide for this risk. That means there is a risk of a credit crunch and a substantial diminution in the capacity of the insurance markets occurring well before 29 March 2019.

The significance of the writing 29 March 2019 into the EU Withdrawal Bill

Until last Friday, the EU Withdraw Bill did not specify a date for the UK leaving the EU. It provided for an "Exit Day" and for that day to be decided by subsequent, secondary legislation. As a total break will be hugely damaging to everyone, scenario planning assumed that even in the hardest Brexit before Exit Day there would be a limited amount of legislation to maintain existing contracts, keep the planes flying etc. Even hard Brexiteers recognised the possible need for some sort of transition period to allow essential measures to be put in place.

If the Bill is amended to make it come into effect on 29th March 2019 that may no longer be possible. The proposed new clause will make it entirely impossible for there to agreement under Article 50 to keep the Treaties in force for a period after 29 March 2019. As the Bill is currently drafted, the option of using the EEA Agreement as the basis of a transitional arrangement will also be removed.

Leaving to one side the obvious impossibility of completing IT and infrastructure investment to allow frictionless trade either across the Irish border or across the Channel by March 2019, this is running a huge risk of either or both of a banking crisis and huge numbers of vehicles becoming uninsured. Both of these events could take place months before March 2019.

The risk of a banking crisis

Size of derivative holdings

Giving evidence to the House of Lords[ii], Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England and Mr Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority (PRA) drew attention to the problems that could arise with respect to cross border derivative contracts to which UK and EU banks are party. The total gross notional value exceeds £110 trillion.[iii]

Only a small proportion of derivative contracts need to become problematic for there to be serious problems. As Sir Jon Cunliffe pointed out, "Sub-prime losses of $360 billion turned into $2.7 trillion-worth of losses for the financial system, in part because those losses knocked banks over, and once you start knocking banks over, you get credit drying up, and that knocks small banks over."[iv] The banking system is better capitalised than it was in 2007 and some measures have been taken to put in place safeguards. However Basel III is not in place, the recommendations of the Parliamentary Commission on Banking Standards and Sir John Vickers' recommendations have not been implemented in full.

Limited information

The issue of the ability to enforce contracts is one of those that banks and indeed many other financial firms are expected to consider when drawing up what is called a Pilar 3 Disclosure. This is a document that has to be approved by the firm's Board and published. It has to consider a number of areas including operational risks, position risks, credit risks, counterparty risks, all of which are materially increased by Brexit. Nevertheless there is very little assessment of the impact of the referendum on the risks faced by banks. There are only three references to the referendum in the latest Barclays Pillar 3 Disclosure[v].

The PRA and FCA both require firms to conduct stress tests - those for the most significant firms are supervised closely by the PRA. However as Sir Jon Cunliffe told the Lords, "The stress test that we have this year is not a Brexit stress test, but it is pretty severe."[vi] The FCA – and no doubt the PRA – does ask firms what they are doing to prepare for Brexit[vii]. However there does not seem to have been a systematic attempt to collate data on exposure or require banks to produce the information one might think was required by PRA and FRCA rules – perhaps through fear of precipitating a crisis.

The insurance problem

There is also a problem over contracts of insurance – this is of particular relevance to motor insurance. Mr Sam Woods told the Lords: "If the UK exits the EU and you have a customer who, say, has bought a policy from a UK insurance company but is in the EU 27 and wants to claim, it may well then be illegal for the company to pay that claim. That is the problem."[viii] The same will of course apply to UK customers with policies with EU (or EEA) insurers. There will also be a problem in obtaining a resolution of disputes over claims – the new Insurance Distribution Directive requires that Host Countries (those where the insurer is based) should provide user friendly dispute resolution mechanisms; the FCA rules will provide that those promoting policies must explain the way to access these mechanisms. If you have a car insurance policy with an EEA (or Gibraltar) underwriter that expires before 11.00PM on 29 March 2019 you will be able to drive legally but if you have an accident and the claim is not settled and paid by 29 March 2019 you may find that the policy is ineffective and you have personally to pay damages.

It is necessary to make and implements agreements to deal with such problems

Enforceability of laws

The recently retired Lord Chief Justice, LORD THOMAS OF CWMGIEDD, warned of the need for action in this area in his Mansion House speech on 5 July 2017. He was so concerned at lack of response to some pretty basic points that he repeated these points in Cardiff on 24 July 2017:

> "First, on applicable law, certainty is needed. It can be secured through the incorporation of the provisions of Rome I and II into English law in the ways of which I spoke in the Scarman Lecture

> "Second, choice of jurisdiction clauses should be respected. There is the strongest case that this should be supported through the United Kingdom acceding as a Contracting State to The Hague Convention on Choice of Court Agreements.
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> "Third, it is essential for the UK that we work with the EU to ensure that there is a simple and flexible regime for the mutual recognition of enforcement of judgments for the future."[ix]

None of this is particularly difficult or controversial. It is rather similar to the proposition that however hard the Brexit, it makes sense to ensure airlines can continue to fly.

Specific measures needed in Withdrawal Agreement

There is also a need for some steps to secure the continued operation of the banking and insurance sectors. Mr Sam Woods addressed some of the problems specific to derivatives in his evidence to the Lords:

> *What are the potential solutions? In decreasing order of effectiveness/desirability, by far the best fix for these is if something can be included in the withdrawal agreement, or a separations issue agreement of some kind—a bilateral agreement to fix these things in a symmetrical way on both sides. There is precedent for this sort of thing. The most obvious one—Jon might even have been involved in it—was with the introduction of the euro. The same question arose: "Does the introduction of the euro disrupt large numbers of existing contracts?" The answer to that was, "It may do, unless someone does something", so a clause was inserted in the euro regulation that dealt with that problem. That would be by far the best fix; that would give certainty, and would effectively deal with the issue.*
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> *The next step down is whether the UK and the EU 27 could respectively, either in a loose agreement or entirely separately but informally co-ordinated, take unilateral actions to deal with that problem. That, again, might be effective. It strikes me as more likely to be messy and more likely to end up with slight disparities that people find difficult to manage.*
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> *Then, third best—and, in my view, very unlikely to be satisfactorily effective—is self-solving by firms. If you will forgive me such a long answer, in brief the first option is for firms to move those contracts. They can use a part VII court process to do that. They can set up a thing called a societas Europaea and move that across a border. Many firms are planning to do some of those things. Looking across the totality of the derivatives side and insurance side, I do not believe that we can be confident that that can be credibly and completely done for all firms and all clients by April 2019. That is one self-solve. We will definitely see bits of that, but it will be highly incomplete. That is the main option that they have.*
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> *The other way they could do it is to get their clients to agree to re-paper. Again, some of that will happen, because with derivatives, if you have an EU 27 company that is transacting with a UK bank, they may wish to move their existing contracts to the new EU entity that they are contracting for new business for netting benefits. Bits of that will happen, but I just do not believe that all these contracts with all customers can be re-papered in the timeframe that we are talking about.*

It is self-evident that fixing the date of leaving the EU and thus removing the possibility of using the extension of time provision in Article 50 means that if something is not in place on 29 March 2019 but could be put in place in realistic timeframe it will be impossible to deal with the problem by a short extension under Article 50. We should note that Mr Woods' desiderata may need to be ratified by national Parliaments or regulators, a time consuming process.

A question mark over the validity of Mr Woods and Sir Jon Cunliffe's evidence "The issue is not an immediate rupture of the contracts."

When Mr Woods and Sir Jon gave evidence to the Lords, there was no suggestion that there was an absolutely fixed date for the UK's exit from the EU (or perhaps more importantly in this case the EEA). Indeed all the talk was of an extended transition period. The EU Withdrawal Bill was so drafted that Exit Day could be determined later. There was an easy mechanism to avoid massive dislocation if some parts of the new wiring were not complete. If the proposed amendment to the EU Withdrawal Bill is made, the situation will be quite different.

It is particularly concerning that in a number of places it was quite clear that Mr Woods and Sir Jon Cunliffe were anticipating that reasonable women and men would make sure sensible arrangements were put in place. There was a degree of optimism at the time they gave evidence that this would happen. We need to know how much of their assessment of systemic risk was based on hope, and their assessment of the impact of removing the flexibility on timing inherent in Article 50 on systemic risk. Until a Select Committee has heard new evidence based on the new circumstances we cannot rely on the assessment of Mr Woods and Sir Jon Cunliffe that there is no danger of immediate disruption of contracts, based as it was on a Bill that explicitly provided a mechanism to allow time to fix problems.

The risk is of trouble long before 29 March 2019

The insurance sector

The insurance sector could be disrupted from the end of February 2018. Under FCA rules, insurers (including intermediaries) have to give customers (including those renewing an existing policy) information that is relevant. The possibility that a policy might fail to respond if a claim were not settled by 29 March 2019 is obviously relevant. The fact that dispute resolution mechanisms might cease to function after 29 March 2019 is something that certainly as to be disclosed. The amendment of the EU Withdrawal Bill to fix Exit Day on 29 March 2019 will clearly require insurers and intermediaries to give stronger warnings. One consequence could be that insurance is no longer able to be placed outside the UK, and that would certainly mean substantially higher premiums leading to more uninsured drivers.

The banking sector

Risk assessment is crucial in determining the capital requirements of a bank. Obviously there was a risk that the UK would crash out of the EU with no provision made to deal with the problems over derivatives discussed above. However it was a pretty small risk because nobody in their right mind would want to cause a credit crunch or otherwise seriously impair bank balance sheets. There is good reason to suspect that the banks and the regulators were quietly agreed to play the issue down and not look too closely at the actual risk.

The risk has gone up with the announcement that the government wants to put a specific date (29 March 2019) on the face of the EU Withdrawal Bill. The risk will increase if the Bill actually is amended. Conscientious risk officers – a breed that has not forgotten Dr Liam Fox's more than marginally offensive comments last September – are likely to point out that some of the derivative book might severely impaired if the UK leaves the EU without a number of steps being taken and that while these can be taken and everyone will doubtless agree to take them there are difficulties with achieving them by 29 March 2019. Balance sheets could start to be impaired and risk measurements ratcheted up long before 29 March 2019.

One obvious danger is that inter-bank lending will be seen as increasingly risky – which is what happened ten years ago. Inter-bank lending simply stopped. Another is that some banks will be forced to implement resolution plans – in other words engage with their regulators in an orderly wind down. There is huge benefit in avoiding forcing the issue.

Conclusion

Writing 29 March 2019 on the face of the EU Withdrawal Bill threatens severe disruption of the banking and insurance sectors because it removes the single most important tool for facilitating something any sort of Brexit needs – the introduction of measure to avoid legal uncertainty and disruption of contract. That tool is the Article 50 power to extend the period in which the Treaties apply so that some critical step can be taken.

Once a date is written into the Bill, that option will be gone and everyone will have to plan and assess risks not on the basis that the UK will leave the EU as soon after 29 March 2019 that new wiring and structure for essential matters are in place but that UK will leave the on 29 March 2019 even if the banking and insurance sectors cease to operate properly.

That is a huge increase in risk and makes the proposed amendment of the legislation a reckless gamble.

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[i] https://www.facebook.com/notes/theresa-may/i-am-determined-to-give-our-country-the-best-possible-brexit/1950978318252265/?utm_medium=email&utm_source=SCexm&utm_campaign=withdrawal_bill

[ii] Select Committee on the European Union: Financial Affairs Sub-Committee: Financial regulation and supervision following Brexit, Wednesday 1 November 2017. Please note that the transcript is currently uncorrected and neither Members nor witnesses had the opportunity to correct the record prior to its publication on the web. It can be viewed or downloaded from http://www.parliament.uk/business/committees/committees-a-z/lords-select/eu-financial-affairs-subcommittee/inquiries/parliament-2017/financial-regulation-and-supervision-following-brexit/

[iii] Ibid Q66. Sam Woods valued the direct contracts held by UK banks at £20 trillion and said that the ECB had estimated a similar sum for EU banks, although adding that he thought the ECB may have under-estimated. Sir Jon Cunliffe added that the £20 trillion figure given by Sam Woods was for uncleared derivative contracts and that there was probably around £70 trillion "sitting in clearing houses and the like." Hence the figure of over £100 trillion.

[iv] Ibid Q74

[v] https://www.home.barclays/content/dam/barclayspublic/docs/InvestorRelations/AnnualReports/AR2016/B%20Barclays%20PLC%20Pillar%203%20Disclosures.pdf

[vi] Q69

[vii] I have seen such questions in letters to my clients

[viii] Q66

[ix] https://www.judiciary.gov.uk/wp-content/uploads/2017/07/speech-lcj-opening-of-the-business-and-property-courts-for-wales.pdf