bankenverband

Requirements

for the Brexit transition phase and free trade agreement

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Executive summary

Analysis

- The withdrawal agreement, transition phase and framework for the future relationship between the European Union (EU) and the United Kingdom (UK) will only be available as a package – or not all.
- The political situation in the UK remains fragile; conclusion and approval of the withdrawal agreement continue to face considerable uncertainty.
- The aim of concluding a free trade agreement by end of the transition phase on 31 December 2020 is highly ambitious.
- A hard Brexit will not be an unexpected shock. It is highly unlikely to generate any systemic risk and threaten financial stability.
- Brexit will not have any noticeably negative impact on the provision of retail and wholesale financial services; the fragmentation of the markets will, however, adversely affect customers and banks.

Positions

- We support a 21-month transition phase until 31 December 2020.
- During the transition phase, the EU acquis must be applied fully in the UK in the version valid in each case at the time.
- The transition phase must also take effect in the European Economic Area (EEA) and the EU Customs Union (EUCU), and with regard to free trade agreements between the EU and third countries.
- The free trade agreement should cover financial services. It should contain rules on mutual market access and, in particular, on supervisory cooperation.
- A fundamental, long-term review of the equivalence regime is advisable (to enhance reliability and predictability, harmonise procedures and broaden scope).

- The free trade agreement should contain at least general rules on data protection, tax issues, company staff and judicial cooperation.

- If no transition phase is agreed, bilateral or unilateral measures (grandfathering arrangements, supervisory rules) may be necessary.

I. Definitions

"Hard" Brexit

We understand a "hard" Brexit to mean the United Kingdom (UK) leaving the European Union (EU) on 30 March 2019 without any subsequent arrangements in force. The UK would thus be relegated to the status of a third country; trade relations would then be subject to the general WTO rules.

From a banking perspective, it is therefore irrelevant whether a withdrawal agreement pursuant to Article 50 of the Treaty on European Union has been concluded. Yet, with legal certainty in mind, this agreement is of importance for bank employees (and their families) who work in one jurisdiction but are nationals of the other jurisdiction. An outcome without any official agreement at all ("no deal" scenario) would also be covered, however.

Withdrawal agreement

The term "withdrawal agreement" is used in this paper both in the narrow sense, i.e. as a withdrawal agreement pursuant to Article 50 TEU, and in the broad sense, i.e. including an agreement on a transition phase and setting the framework for the future relationship between the EU and the UK.

Transition phase

The EU defines the transition phase as the period from 30 March 2019 to 31 December 2020 in which the entire EU acquis communautaire ("EU acquis") will continue to apply to the UK without the UK being a member of the EU. This also covers all decisions by the European Court of Justice (ECJ), the European Commission and the EU agencies.

The transition phase serves, on the one hand, to give all those concerned more time to adapt to the new legal situation after the UK's withdrawal from the EU, as the effect of its withdrawal on citizens and businesses will effectively be postponed by 21 months. On the other hand, the transition phase serves to allow finalisation and ratification of the basic arrangements for the future relationship between the EU and the UK that need to be made in the withdrawal agreement.

Free trade agreement

The free trade agreement will govern the future trade relations between the EU and the UK. It should incorporate all the requisite rules on trade in goods and services as well as necessary accompanying arrangements. In our view, the EU-UK free trade agreement can thus go much further than the EU-Canada Comprehensive Economic and Trade Agreement (CETA). From a banking perspective, it is irrelevant in this context whether a free trade agreement pursuant to Article 207 of the Treaty on the Functioning of the European Union (TFEU) or an association agreement pursuant to Article 217 TFEU is concerned.

Bridging phase

The bridging phase will end on 31 December 2020 – this is the declared political will of both the EU27 and the UK. The free trade agreement may, however, include rules that only enter into force, or can only be implemented technically, at a later date. It may not even be in force yet at the end of the bridging phase. To prevent enterprises then being relegated initially to pure WTO third-country status and having to make adjustments that would subsequently need to be altered again to reflect the free trade agreement rules, a bridging phase between transition phase and free trade agreement may be necessary.

II. Political assessment

The European Council's decision of 15 December 2017 to acknowledge that sufficient progress had been made in phase 1 of the Brexit talks served, on the one hand, to put back problems (particularly Northern Ireland) that can actually only be resolved within the framework of the future relationship between the EU and the UK and, on the other hand, to achieve political progress in the first place. From our perspective, the state of play in the talks on the Northern Ireland question in particular leaves open many fundamental issues and further details. It is thus by no means certain that a withdrawal agreement can be concluded.

The EU and the UK have reached fundamental agreement on seeking a transition phase. The details are now being negotiated. A transition phase will form part of the withdrawal agreement and thus only come about if a withdrawal agreement is concluded.

The withdrawal agreement should also outline the framework for the future relationship between the EU and the UK. These should then be negotiated and ratified during the transition phase. While it is theoretically conceivable that the withdrawal agreement and the transition phase will be concluded without any deal on the future relationship, the UK sees this as hardly acceptable, so that, in our view, the withdrawal agreement, transition phase and framework for the future relationship will only be available as a package or not at all. So there are effectively two scenarios: the "no deal" scenario and a comprehensive withdrawal agreement addressing the withdrawal-related issues, laying down rules for the transition phase and setting out the arrangements for the future relationship.

The withdrawal agreement and all its components must be ratified in the EU (by the European Council and the European Parliament (EP)). Given that both bodies are closely involved in the talks conducted by the Commission, such ratification is not likely to be a problem. This does not necessarily apply to a free trade agreement that will probably be a mixed agreement and thus also need to be ratified in all EU member states.

In the UK, the approval of both Houses of Parliament will be needed. The political situation in the UK remains fragile, so that neither a cohesive negotiation policy until conclusion of the withdrawal agreement nor parliamentary approval are certain. In particular, there is the threat of negative majorities and irreconcilable "red lines" drawn by "Remain" and "Leave" proponents blocking each other. Conclusion and approval of the withdrawal agreement are thus by no means assured, but continue to face considerable uncertainty.

Regardless of this uncertainty, conclusion and ratification of a free trade agreement by 31 December 2020 are highly ambitious. Without a cohesive negotiation policy and a swift and

conflict-free ratification process, they will not be possible. The risks in this connection lie more on the EU side.

III. Transition phase requirements

We welcome the EU27's intention to provide for a 21-month transition period – until 31 December 2020 – following Brexit. This time should be used to set out the basic arrangements for a free trade agreement in a treaty and to ratify the latter.

During the transition phase, the EU acquis must apply fully in the UK in the version valid in each case at the time (i.e. "dynamically") – including decisions by the ECJ, the Commission and the EU agencies. The UK will therefore effectively remain a member of the EU with rights and obligations, but without any say in decisions by the EU bodies. For the financial services sector, this means that both existing and new business can be handled safely under the current legal framework and that "passporting" in particular will remain possible. The need to adapt to the required new structures will be postponed by 21 months.

Because of the EP elections and the appointment of the new Commission, new legislation is unlikely to enter into force by 31 December 2020. The EU bodies should exercise their powers to adopt and amend legislation with restraint. Conversely, because of the length of ECJ proceedings, the EU has, to all intents and purposes, no effective sanction mechanisms should the UK breach EU rules. The EU should, however, monitor compliance with the rules very closely and lay down effective sanction mechanisms in the withdrawal agreement.

It must be ensured that the transition phase also takes effect in the European Economic Area and the Customs Union, and with regard to free trade agreements between the EU and third countries. Talks to this end with partner countries need to get underway as soon as possible.

If, contrary to expectations, no transition phase is agreed, unintended adverse consequences for citizens and businesses must be avoided. In such a situation, which will, however, probably arise at short notice, bilateral EU-UK or unilateral EU measures (grandfathering arrangements, supervisory rules) may be necessary as a last resort to avert potentially serious harm. The instruments needed for this must then be found and, at the same time, it must be ensured that other WTO countries do not obtain any special market access thanks to most-favoured-national clauses.

Even though there is currently a common EU-UK view on the need for a transition phase, German banks are still preparing for a hard Brexit. Given the extreme political uncertainty, any other approach would be negligent. But this also means that banks are making arrangements geared to a system in which the UK is merely a third country without any special market access and cooperation rules, although a possible withdrawal agreement could provide for easier market access.

The quicker there is legally binding clarity on the details of the transition phase and the free trade agreement, the sooner banks can take this into account in their reorganisation arrangements and the more focussed and more cost-effective adaptation by customers and banks will be.

IV. Free trade agreement requirements

General focus

The Association of German Banks is in favour of as close as possible ties between the EU and the UK. Yet it is clear that the time allowed for negotiating a free trade agreement is very tight and that the EU needs to set priorities when tackling the different areas. Nevertheless, this agreement should cover the financial sector as well and thus go further than other free trade agreements. This is the only way to reflect the close entwinement of national economies in this sector.

The integrity of the European Single Market must be protected and a distinction needs to be made according to whether a country belongs to the EEA with all rights and obligations or whether it obtains access to the Single Market by way of a free trade agreement without making any financial contribution or accepting EU rules at the same time. "Cherry picking", i.e. enjoying the benefits of the Single Market without shouldering the same burdens as its members, should not be allowed. A bilateral free trade agreement should therefore grant far less market access to the UK than to EEA member countries.

Furthermore, the EU should take into account the legal framework set by the WTO's General Agreement on Trade and Services (GATS), according to which – among other things – a comprehensive free trade agreement must be negotiated to avoid having to grant other third countries the same access to the Single Market as the UK.

As the period allowed for negotiating the transition phase, withdrawal and free trade agreements is very short, work on preparing the free trade agreement should start immediately after conclusion (and before ratification) of the withdrawal agreement so as not to lose any time. The free trade agreement should enter into force after expiry of the transition phase (conclusion, including ratification). Should a bridging phase be necessary in individual cases, it must be ensured that the current EU acquis in each area continues to apply until the final rules enter into force.

Cross-border market access

The free trade agreement should allow the cross-border provision of financial services. It could be modelled on CETA. Article 13.7 of CETA states that financial services may be offered and solicited across borders. The provisions also stipulate, however, that, in cases where the customer is actively approached by the financial services provider, the parties may require a licence. This means that the benefit of this CETA rule is somewhat limited. Canadian financial

services providers continue, in principle, to require a licence in the EU to be able to provide services there.

It should be possible for both EU and UK citizens to take advantage of the other party's cross-border financial services across borders. An agreement with the UK should therefore go further than CETA and be designed more reliably and predictably for market participants than is, for example, the case with existing equivalence rules under EU law (see below).

Like CETA, a free trade agreement between the EU and the UK should, however, also provide for the possibility to unilaterally restrict market access or national treatment for financial institutions of the other party by way of "reasonable measures for prudential reasons" ("prudential carve-out"). Such reasons could be protecting investors, depositors or insurance policyholders, maintaining the safety, soundness and responsibility of a financial institution as well as the integrity and stability of the financial system.

With CETA as a model, UK financial services providers would generally be entitled not to be treated less favourably than EU financial institutions, and vice versa. Yet, as explained above, this does not automatically lead to market access. The effect of agreements going further than this has not yet been tested in practice. Should the UK deregulate quickly, a comprehensive agreement would, however, be unlikely.

A CETA-style agreement would therefore have to be seen long-term more as a basis for stronger market reintegration in the future and, as such, would ensure that UK institutions receive equal treatment when they apply for a licence.

Other forms of market access: equivalence regime and agreement

Parallel to this, the current EU equivalence rules in the area of financial services ensure specific market access. The EU's equivalence regime is, however, fragmented and, in its present form, is not suitable for general market integration, particularly because it is not reliably predictable. Yet, in individual cases, equivalence decisions make sense and should be used (e.g. in the area of benchmarks to avoid amendments of agreements that would otherwise be needed if UK bench-marks are no longer allowed in the EU). Each equivalence test should begin quickly and be completed during the transition phase. Given the same regulatory starting level, the test should be relatively easy.

A general overhaul of the equivalence regime is advisable in the long term, however. Its reliability and predictability must be enhanced, procedures simplified and scope broadened.

Should no free trade agreement come about, the German Banking Act (KWG) nevertheless provides for regulatory relief for third-country banks that may be granted where a government agreement assuring reciprocity exists. Such national agreements are already in place with the US, Japan and Australia. However, this relief lags well behind the current status of market integration. The German Banking Act also states that third-country banks may be allowed access to the European market equivalent to current "passporting". This requires an agreement between the third country and the EU, however. There are no such agreements at present. Such an agreement could also be seen as complementing a possible free trade agreement, should the free trade agreement not go further than the CETA provisions on market access.

Supervisory cooperation

After Brexit, many financial services providers will operate in both the EU and the UK. These financial services providers require good and efficient supervision, which presupposes smooth cooperation between supervisors in the EU and the UK. This supervisory cooperation must be deeper and better than with any other supervisor outside the EU.

The free trade agreement should include rules for as close cooperation as possible between supervisors. It should require supervisors to make arrangements for supervisory cooperation and create the legal basis (information-sharing, recognition or consideration of decisions) for this. Single Supervisory Mechanism (SSM) supervisors already meet today with supervisors from non-SSM countries (e.g. the UK) to discuss supervision of individual groups of banks on a case-by-case basis. Such supervisory colleges composed of UK and EU supervisors should remain in place in the future and their work should be made more transparent and predictable. But there should also be a dialogue between UK and EU supervisors on general regulatory standards and supervisory practices. The intensity of the future dialogue should be geared to how close the UK's ties with the EU are in the future.

To meet their MREL obligations, EU27 banks have issued capital instruments and debt securities on a considerable scale under English law. A solution needs to be found to eliminate the uncertainty about whether they may continue to use these.

Data protection

The free trade agreement between the EU and the UK should contain specific rules on the transfer of personal data ("safe harbour" agreement). Alternatively, an equivalence decision

should already be prepared now. Both solutions should be relatively simple in substance, as the EU General Data Protection Regulation ensures that the UK and the EU will have a single data protection regime by 25 May 2018 at the latest.

Taxes

The free trade agreement should contain a mutual commitment to ensuring fair taxation and preventing tax dumping and subsidies.

The free trade agreement should contain rules similar to those under CETA in the area of taxes. Accordingly, the parties to the agreement may treat taxpayers quite differently, depending on whether these are resident in the home country/an EU member state or a third country.

The automatic exchange of financial account information in tax matters, modelled on the OECD's Common Reporting Standards between EU member states, is based on the EU Directive on administrative assistance. After Brexit, the continued exchange of information between the UK and the EU member states must be ensured by way of appropriate arrangements in the free trade agreement.

There should also be an agreement with the UK stating that both the EU Directive on dispute resolution mechanisms in tax matters and the EU Convention on the elimination of double taxation in connection with adjustments of profits of associated enterprises should be integrated into the free trade agreement. This is because, irrespective of Brexit, the economic ties between the EU and the UK will remain in place.

Personnel

The free trade agreement should ensure that enterprises in one jurisdiction can freely deploy qualified/executive staff to another jurisdiction without any bureaucratic workload and that these employees are treated as residents or enjoy the protection of freedom of movement granted to citizens already resident there.

As broad as possible rules on mutual recognition of training and job qualifications should be adopted.

Judicial cooperation and contracts with a UK connection

Following the UK's withdrawal from the EU, the uniform framework for cross-border cooperation and mutual recognition of measures in civil and commercial matters in the EU will cease to apply. To avoid any trouble in enforcing the law and any uncertainty for contracting parties in future cross-border legal and commercial transactions, the existing EU rules on the

- validity and recognition of the choice of law and forum,
- jurisdiction of courts and on competing proceedings,
- recognition of title obtained and its cross-border enforcement, and
- enforcement of claims following counterparty insolvency (possibly splitting proceedings)

should be reflected as far as possible in a free trade agreement.

The UK's withdrawal from the EU will not, as a rule, impinge on the validity of existing contracts with counterparties in the UK or of contracts subject to English law. However, the loss of supervisory licences ("passports") due to Brexit may adversely affect the continued fulfilment of contracts once the UK leaves the EU or trigger rights to terminate (e.g. if possession of a valid supervisory licence was a condition in the contract). But this depends on the circumstances of a given case and the specific contractual arrangements.

V. Financial stability

In its Financial Stability Review in spring 2017, the European Central Bank outlined the importance of UK financial services for the EU. In this context,

- "financial stability" means the ability of the financial system to perform its functions for the real economy also in times of crisis and upheaval and
- "systemic risk" means the unlikely event of significant parts of the financial system defaulting, such default spreading to the entire financial system, culminating in a financial crisis and possibly a depression in the real economy.

In many lines of business, the proportion of financial services providers currently based in the UK is significant (e.g. 15% in loans and finance and 30-40% in investment services). These financial services can, however, be provided in full by EU institutions or the activities performed to date by branches or group enterprises based in the UK can be moved to the EU to ensure an appropriate range of services.

The central counterparties (clearing houses) based in London are particularly important, however. These currently handle the bulk of euro-denominated interest-rate derivative contracts. Relocating this business in the short term, not to mention immediately, would pose considerable legal and technical challenges and entail significant operational and economic risks.

As we see it, market participants are anticipating a hard Brexit. Financial services providers have already been preparing for some time now for a situation in which the UK will be a third country on 30 March 2018. Corporate structures are being modified and contracts are being altered by agreement with customers in regard to place of performance, applicable law, forum and booking venue. This preparation is also being pushed by supervisors. A hard Brexit will not therefore be an unexpected shock. It is thus unlikely to generate any systemic risk and threaten financial stability.

Brexit will inevitably reinforce the fragmentation of the (entire) European financial marketplace. Both (more strongly) separated financial markets in the EU and the UK in the future will be weakened and less efficient, while costs for banks and businesses will increase. This new (partial) inefficiency does not, in itself, constitute any systemic risk, however.

It is unlikely, though it cannot be completely ruled out, that in the course of the Brexit process political decisions and developments may cause expectations to seriously change or confidence in the ability to balance and cover risks to suddenly vanish. Policymakers, supervisors and law-makers have enough options to respond to such a political risk situation that can culminate in a

systemic risk and endanger financial stability, so that we do not see any threat to financial stability in this case either.

In conclusion, it should be stressed that Brexit will not have any negative impact on the provision of retail and wholesale financial services in Germany. Repercussions for large-scale financing or hedging business are, on the other hand, conceivable, as this has taken advantage so far of London's deep liquidity, outstanding risk-bearing capacity and pronounced inter-nationality. The UK's third-country status will make documenting and handling transactions more expensive and more complex and lead to a decline in the number of financial services providers. Banks face the challenge of making their future large-scale financing and hedging business profitable.

Overall, Brexit will be manageable for customers and banks.