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JOINT COMMITTEE REPORT ON
RISKS AND VULNERABILITIES IN THE EU FINANCIAL SYSTEM
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EXECUTIVE SUMMARY AND POLICY ACTIONS

Risks that abruptly increasing yields generate substantive asset price volatility and lead to losses across asset classes remain imminent and high. Financial markets experienced a return of market volatility in the first half of 2018 with corresponding episodes of sharp equity price declines and a sizable widening of sovereign and corporate bond spreads. In addition, rising interest rates and political risks could cause capital outflows in emerging market economies, as developments in Turkey in August have demonstrated. These market developments might reflect to some extent a return to normality, following an extended period of ultra-low interest rates. However, given the trend of monetary policy normalisation with remaining uncertainty over the exact path over time, the potential for further market volatility stemming from investment repositioning of market participants and portfolio reallocations remains a key source of concern. Furthermore, valuation risks might have increased, given heightened geopolitical risk.

Risks related to the repricing of risk premia and possibly increasing interest rates directly affect financial institutions and retail consumers and might also cause contagion. The return of volatility puts additional pressure on bank profitability, not least shown by decreasing net trading income in early 2018. Increasing interest rates may also pose additional challenges to the still high – albeit decreasing – stock of non-performing loans in the EU, which still needs to be addressed. The potential for sudden risk premia reversals also remains a major concern for insurance companies and pension funds, as this could negatively affect the value of their assets. On the other hand, the value of liabilities might decrease, in case such a reversal is combined with an increase in interest rates. Retail investors may also be affected by valuation risks through their portfolio holdings. Finally, contagion between sectors after abruptly increasing yields might, e.g., occur through interconnectedness of the European banking sector with the market-based finance sector, as well as with the insurance sector, or from the still highly leveraged non-financial private sector.

Uncertainties around the terms of the UK's withdrawal from the EU still have the potential to expose the EU27 and the UK to economic and financial instability and to weaken market confidence, particularly if negotiations end in a disorderly fashion. The need to prepare for a withdrawal of the UK from the EU without a withdrawal agreement, including the risk of reduced access to market infrastructures and contract continuity, have become very critical issues.

In light of the above mentioned risks and uncertainties, supervisory vigilance and cooperation across all sectors remains key. **The Joint Committee advises the following policy actions by the European Supervisory Authorities (ESAs), national competent authorities, financial institutions and market participants moving forward:**

1. **Against the backdrop of rising interest rates and the potential for sudden risk premia reversals, it remains crucial to conduct and develop further stress test exercises across all sectors.** These risks are therefore embedded in the scenarios for both the EIOPA 2018 insurance stress test and the EBA 2018 EU-wide bank stress test exercise. In addition, ESMA is progressing on the conceptual development of its approach to stress testing in the asset management industry and is developing guidelines for stress testing carried out by money market funds as well as guidelines for asset managers on liquidity stress testing.
2. **Supervisory authorities need to pay continued attention to the risk appetite of financial institutions.** In particular, banks should accelerate addressing their stocks of NPLs and adapt business models to sustainably improve profitability. In addition, it is important that financial institutions carefully manage their interest rate risk. Similarly, (retail) investors should carefully consider the risk attached to moving into higher yielding, leveraged products, while public authorities should monitor changing investor preferences and, when appropriate, warn against risky products.
3. **Macro- and micro prudential authorities should contribute to further address possible contagion risks,** and they should continue their efforts in the monitoring of lending standards. Authorities concerned should moreover continue their efforts in monitoring and improving asset quality.
4. **It is crucial that EU financial institutions and their counterparties, as well as investors and retail consumers plan appropriate mitigating actions in a timely manner, to prepare for the UK's withdrawal from the EU. Preparations should address relevant risks that inconclusive agreements on withdrawal terms would pose.** Financial institutions should inform their competent authorities about the actions they are taking and be clear about implementation timelines concerned. Competent authorities concerned should monitor contingency plans that financial institutions should have in place in case of inconclusive agreements on withdrawal terms, and encourage the speedy implementation, where required, of adequate contingencies.

1 INTRODUCTION

The Spring 2018 Joint Committee Report on Risk and Vulnerabilities considered (i) the risks related to valuations and repricing of risk premia, (ii) risks around the UK's withdrawal from the EU (iii) operational and ICT risks and (iv) climate change risks as key risks to the EU financial system.

In the first semester of 2018, financial market conditions were overall benign, with continued support from monetary policy. However, asset price volatility slightly increased from historic lows throughout 2017. GDP growth in the EU27 was 2.6% in 2017 and is forecasted to slightly slow down to 2.3% in 2018 and 2.1% in 2019¹. Downside risks to economic growth have increased in the first half of 2018, amplified by increased geopolitical risks, uncertainties around the terms of the UK's departure from the EU, tendencies towards protectionism, and slow implementation of structural reforms. Political and economic tensions may moreover trigger abruptly increasing yields, which possibly lead to financial market stress.

Against this background of heightened uncertainties, risks related to the adequate valuation of asset prices and repricing of risks premia, as well as contagion risks if such risks materialise, remain imminent. Concerns about the terms of the departure of the UK from the EU also remain high, in particular if negotiations end inconclusively. Hence, these risks are still considered as key risks to the EU financial system in the Autumn 2018 Joint Committee Report on Risk and Vulnerabilities. Furthermore, the ESAs continue to pay supervisory attention to operational, ICT risks and climate change risks.

2 RISK RELATED TO VALUATIONS, REPRICING OF RISK PREMIA AND INCREASING INTEREST RATES

Risks that abruptly increasing yields could lead to losses across asset classes and generate substantive asset price volatility were already identified in previous iterations of this report. These risks remain imminent and might even have increased, given heightened geopolitical risk, and could be aggravated in conjunction with rising interest rates. This chapter describes the drivers of valuation risk and potential implications for financial institutions and retail consumers. Finally, it highlights the importance of stress testing to evaluate the impact of valuations risks on financial institutions.

Market developments and valuation risks

Geopolitical risk has been increasing significantly over the last years. This is – amongst further issues - caused by uncertainties around Brexit, followed by concerns of a possible trade war and uncertainty regarding possible changes in free trade agreements. High geopolitical risk may cause a decline in real activity, lower stock returns, and movements in capital flows away from emerging economies and towards advanced economies. Therefore, geopolitical risks can cause an increase in volatility and adversely affects investor sentiment.

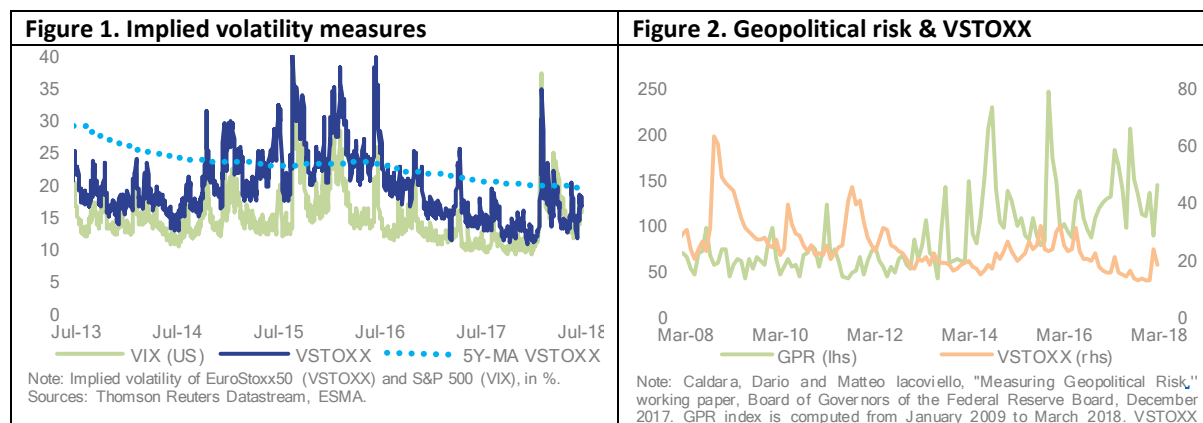
The rising geopolitical risk is possibly not yet fully incorporated in equity prices, since market volatility seems to diverge from geopolitical trends starting in 2016² (Figure 2). Nevertheless, equity markets have experienced two episodes of sharp decline since the beginning of the 2018. The first one saw a broad-based decline of 8% in EU equity prices over seven trading days, while the second episode resulted in a fall of almost 5% during the last week of May. As a result, measures of short-term implied volatility have spiked (Figure 1). Even though the

¹ EU Commission Summer 2018 interim economic forecast, 12 July 2018

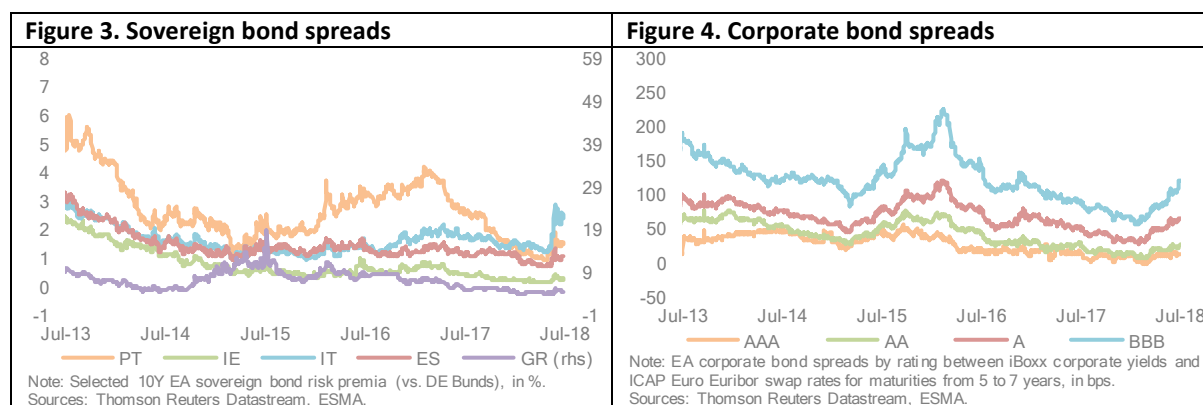
https://ec.europa.eu/commission/news/commission-publishes-summer-2018-interim-economic-forecast-2018-jul-12_en

² Financial Times, North Korea: A rising threat, 9 August 2017

triggers were very different, the proximity in time of these two events also suggest that market participants may have become much more sensitive to news developments.



Moreover, sovereign bond and corporate bond spreads experienced a sizeable widening (Figure 3 and Figure 4). Ten-year sovereign yields rose 20 to 100 basis points in the course of May, mainly in Italy - following the political developments in the country - and in Greece, Portugal and Spain. Two-year maturities also experienced very significant volatility. The turmoil in sovereign bond markets reinforced a negative trend in corporate bond prices, particularly for lower-rated securities. Spread increases were more pronounced for subordinated debt and for financial sector issuers with increased risk perceptions, as well as for low-rated bonds. This could be considered as a sign of shifting risk perceptions related to risk premia reversals. Meanwhile, the yield on euro-denominated high-yield bonds continued to rise, reaching a two-year high of 3.4% in May, up from 2.1% last November 2017. This is in line with developments in the US high-yield bond market segment.



These market developments may reflect to some extent a return to normality, following an extended period of ultra-low interest rates. With the low interest rate environment weighing on profitability of financial sector institutions, EU authorities had repeatedly warned against the potential long-term impact of search-for-yield behaviour and the risk of investor complacency. Reduced spread compression and improved investment opportunities should help relieve some of the pressure experienced by financial intermediaries. The unwinding

of unsustainable strategies was apparent from the steep decline in leveraged short positions on VIX futures³, and large investor redemptions from riskier funds globally. High-yield bond funds experienced six consecutive weeks of outflows in between April and June, while a stronger US dollar severely impacted emerging-market fund flows (-USD 8 billion between May and June).

As monetary policy normalisation continues in the US and has been announced in Europe, the potential for further market volatility from market participants repositioning and portfolio reallocation remains a key source of concern. Going forward, a key question is the future reaction of bond markets to the scheduled end of the ECB Asset Purchase Programmes. By removing the floor from bond prices, the end of the programme potentially increases the scope for heightened bond market volatility. However, the ECB also announced that it would be reinvesting the proceeds of the maturing bonds it holds, implying that the central bank's balance sheet might remain close to its current size of EUR 4.5 trillion. In the end, managing the normalisation of monetary policy is going to be a delicate balancing act. A prolonged period of low interest rates may contribute to create financial stability risks, as investors take on more risks. On the other hand, abrupt changes of monetary policy can cause turbulences in financial markets.⁴

In addition, rising interest rates and political risks could cause capital outflows in emerging market economies, with potential repercussions on EU markets. Thus, in early August 2018, political tensions between Turkey and the U.S. accelerated the deterioration of Turkey's external position, with a 25% drop in the Turkish Lira exchange rate to the Euro in one week, and a higher than 40% depreciation since the beginning of the year. Even if exposures of EU financial institutions to Turkey are comparatively limited and confined to selected market participants, the growing economic vulnerability of Turkey as a large emerging market on the perimeter of the European Union needs to be taken seriously by all EU market participants affected, in particular in case political tensions around Turkey continue to mount and the impact on businesses in the country aggravates. Relevant EU market participants should review all exposures to the country, maintain adequate risk hedging, and be prepared for potential spill-overs into other countries in the region and beyond.

Financial stability risks may also be triggered through other channels than geopolitical risks and the normalization of monetary policy, for example if the ongoing global work on the reform of interest rate benchmarks does not proceed at the intended pace (see Box 1).

BOX 1

The Financial Stability Board has recommended in 2014 that interbank offered rates (IBORs) move away from their quote based methodologies to avoid the risk of manipulations in the future. A move to transaction-based methodologies has proven unsuccessful for Euribor and Libor, although both benchmarks are currently being reformed to be more robust. Some of these rates, or single tenors and currencies, may no longer be available in the short to medium term, as underlying interbank markets have dried out. In the EU, the requirements of the benchmarks regulation will be fully applicable as of January 2020. At least one interest rate benchmark may not be compliant before this date and may consequently no longer be used in new financial instruments or contracts. Therefore, the process of defining and implementing reforms of interest rate benchmarks might provide challenges for all parties concerned.

³ The VIX is an index measuring the implied volatility of US equity prices based on S&P 500 options prices. Leveraged short positions on futures are short positions held by leveraged fund managers (such as hedge funds and various types of money managers) on futures contracts, which are reported to the US Commodity Futures Trading Commission. Short positions on VIX futures are equivalent to betting on lower future equity market volatility.

⁴ IMF Global Financial Stability Report, October 2018

<https://www.imf.org/en/Publications/GFSR/Issues/2017/09/27/global-financial-stability-report-october-2017#Summary>

Industry preparedness to expiring benchmarks appears to be low. While industry working groups have been founded to identify alternatives to the existing IBORs, contracts on a scale significant for financial stability may be frustrated if these respective groups will not conclude their work before the cessation of single interest rate benchmarks. Where fall-back provisions exist, users may additionally be exposed to an increase in interest rates. Public authorities should continue to support the reforms initiated in the private sector working groups, and industry should step up their efforts to prepare for the risk of existing benchmarks expiring in the short to medium term.

Effect on financial institutions and retail consumers

The episode of heightened market volatility and a potentially sudden widening of risk premia puts additional pressure on banks' profitability, which already is below long-term levels necessary to support the sustainability of the current business model. Net trading income - a key element of improved bank profitability in 2017 – was not least negatively affected by market volatility in early 2018 and may prove an unsustainable source to improve profitability. Some banks might nevertheless attain additional trading income in an environment of higher volatility. In addition, net interest income continued to decrease since 2015 and is weighing on EU banks' income. The net interest margin (net interest income to interest bearing assets) decreased to 1.44% in Q1 2018, from 1.48% in Q1 2016 (Figure 5). Banks' operating expenses were moreover higher than net interest income in 2017, while traditional lending activity did not generate sufficient income to cover running costs. Looking forward, the share of banks indicating in the June 2018 EBA Risk Assessment Questionnaire (RAQ) to expect an overall increase in profitability in the next 6 – 12 months has decreased from 27% in June 2017 to 13% in June 2018. Consequently, the sustainability of the current banking business model remains a challenge. This is also reflected in the average Return on Equity for EU banks, which, at 6.8% in Q1 2018, is below the estimated cost of equity of ca. 8 - 10%.

Figure 5. EU banks: Net interest income to interest bearing assets - numerator and denominator trends

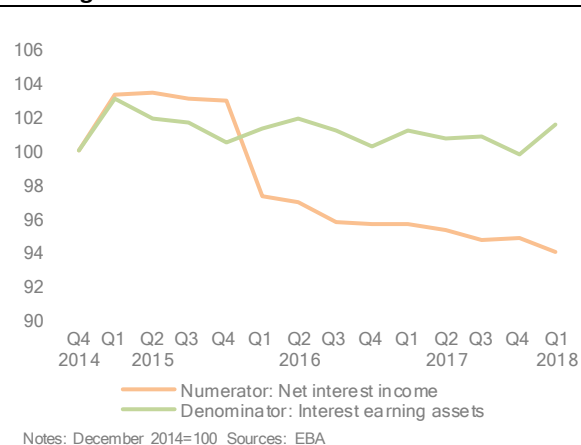
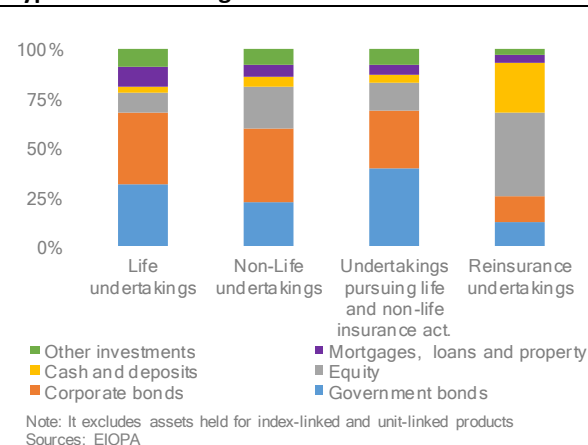


Figure 6. Insurers' investment split in Q4 2017 by type of undertaking



Rising yields and the prospect of rising interest rates may have contributed to some expectations of improving interest income among banks going forward. Moderately increased medium- and long-term interest rates offer an outlook of improved net interest margins (NIM). The share of banks expecting a steepening yield curve to positively impact their bank's earnings in the next 6 – 12 months has increased to 65% in the June 2018 EBA RAQ, from 60% in the December 2017 EBA RAQ. However, net interest income is not the primarily target area for banks to improve profitability, but rather net fee and commission income and operating expenses reductions.

Increasing interest rates may moreover pose additional challenges to further address the still high, albeit decreasing, stock of non-performing loans (NPLs) in the EU banking system. The NPL ratio in the EU decreased from 6.5% in 2014 to 3.9% in Q1 2018, while, on EU average, around half of NPLs are over one year past due. The prospect of rising interest rates risks to affect asset quality, and to facilitate the inflow of new NPLs. Lending risk, e.g. related to real estate financing, might increase in both retail and corporate portfolios, and it will be important that banks carefully manage their interest rate risk.

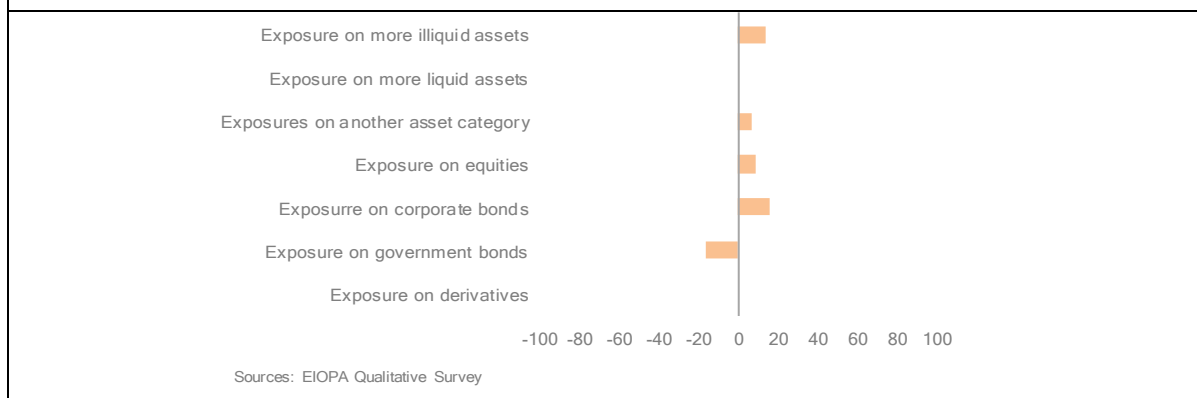
Direct exposures of EEA banks to Turkey are relative limited on average, but not negligible for some selected institutions. Banks have decreased exposures to Turkey compared to 2016. Total direct exposures were at EUR 252bn in Q1 2018, which represents ca. 0.8% of total exposure amounts of EEA banks. Total emerging market exposure of EEA banks stands at about EUR 1.8tn as of Q1 2018, and decreased from EUR 2.2tn in 2014.⁵ Direct asset exposures of European insurers to the Turkish economy are also very limited (EUR 10bn or 0.1% of total assets for groups and EUR 2.1bn or 0.02% for solo undertakings based on Q1 2018 Solvency II data). Exposures across countries are very limited as well. Direct asset exposures of the overall EEA insurance undertakings to emerging market economies is very small (less than 1% of total assets in Q1 2018). Potential spill overs from developments in Turkey to other emerging markets cannot be ruled out and warrant close monitoring.

Valuation risk and the potential for sudden risk premia reversals also remain a major concern for the insurance and pension fund sectors. Figure 6 shows the investment split for different types of insurance undertakings in Q4 2017. Overall, life insurers' are primarily invested in fixed-income assets, with corporate bonds (36%) and government bonds (32%) making up the bulk of the investment portfolio. Non-life insurers' share of fixed income assets is lower compared to life insurers, whereas the share of equities is more than double. A rise in yields would directly affect asset prices in the fixed income market, having a major impact on insurance and pension markets' investment portfolios. However, the economic uncertainty stemming from an abrupt change in the level of yields could also affect other financial market segments such as equities. If the abovementioned scenario is complemented by an increase of the risk free rate, this would, however, lead to lower technical provisions on the liability side, especially for long-term obligations of life insurers and pension funds. This could (partially) compensate for the losses suffered on the asset side in the event of sudden yield reversals, depending on maturity mismatches and interest hedging of individual undertakings. The final impact would also depend on the potential increase in lapses and surrenders.

Even though interest rates may rise in the near future, the current environment of continued low interest rates might incentivise financial institutions and investors to keep looking for investments yielding higher returns. The spring 2018 report highlighted a planned tendency of insurance companies to invest more into less liquid asset classes, such as infrastructure, mortgages, loans and real estate over the coming years. The results of the EIOPA Spring 2018 Qualitative Survey revealed that most supervisors expect a further decrease of the share of government bonds held by insurers over the coming 12 months, whereas holdings of corporate bonds, equities and illiquid assets are expected to increase (Figure 7).

⁵ Original exposures, i.e. before any credit risk mitigation measures, which e.g. include eligible guarantees, and pre credit conversion factors (CCF) etc. Data based on supervisory reporting data. IMF definition of emerging markets applied.

Figure 7. Supervisory assessment of expected change on insurers investment exposures in the coming 12 months



Valuation risks may also affect retail investors. Retail investor portfolio returns fell in the first quarter of 2018. The components of the portfolio indicator representing direct and indirect equity investments registered quarterly returns of -3.4% and -3.7% respectively. Annualised returns for the indicator as a whole were around zero, significantly below the five-year average of 0.3%. However, substantial growth rates across most asset classes of Euro area household financial assets were seen throughout 2017.

Against the backdrop of the potential for sudden risk premia reversals, possibly combined with rising interest rates, the development and regular use of stress evaluation across all sectors remains crucial. Therefore, the aforementioned risks are embedded in the market scenarios for both the Insurance and Banking 2018 stress tests (see Box 2). In addition, banks should accelerate addressing their stocks of NPLs. Furthermore, it is important that financial institutions carefully manage their interest rate risk.

Supervisory authorities need to pay continued attention to the risk appetite of financial institutions. In particular, close supervisory monitoring is warranted to address potential liquidity risks should financial conditions tighten, especially in times of sudden price reversals and increased volatility.

BOX 2

The ESAs are conducting comprehensive stress test exercises in 2018, which reflect key risks highlighted in this report: the repricing of risk premia and rising interest rates.

The 2018 EIOPA insurance stress test covers the largest European 42 (re)insurance groups selected in terms of size, EEA market coverage from a financial stability perspective and business lines (life and non-life), reaching a total EEA market coverage close to 78% based on total consolidated group assets in the Solvency II reporting. The stress test includes two market scenarios: a yield-curve up shock and a low yield shock.⁶ These scenarios are combined with insurance specific shocks. The risks related to repricing of risk premia and increasing interest rates are dealt with in the first scenario, which assumes an abrupt and sizeable repricing of risk premia in global financial markets leading to a tightening of financial conditions. Additional stresses on lapses and claims provisions are also included in this scenario. The second scenario assesses the risks of a prolongation of the current low yields. Market shocks are combined with additional longevity stress originating in increased life expectancy which would affect best estimate calculations by life insurers.

The EBA is currently conducting its 2018 EU-wide stress test on a sample of 48 EEA banks, covering ca. 70% of total banking sector assets in the EU, and Norway. The adverse scenario assumes the materialisation of four systemic risks, which are currently deemed as representing the most material threats to the stability of the EU banking sector. These risks are not least reflected in this report: (i) an abrupt and sizeable repricing of risk premia in global financial markets, (ii) adverse feedback loop between weak bank profitability and low nominal growth resulting from a decline in economic activity in the EU, (iii) public and private debt sustainability concerns amid potential repricing of risk premia and increased political fragmentation, and (iv) liquidity risks in the non-bank financial sector with potential spill-overs to the broader financial system. The adverse scenario in the EBA EU-wide stress test reflects that tightening financial conditions in Europe and beyond would lead to a sharp fall of EU stock prices in 2018, compared to the baseline scenario. Long-term interest rates in the EU would also increase.

On the asset management side, ESMA is progressing on the conceptual development of its approach to stress testing in the asset management industry, including model-based stress simulations. Moreover, ESMA is developing guidelines for stress testing carried out by money market funds as well as guidelines for asset managers on liquidity stress testing in all funds.

3 CONTAGION RISKS IF VALUATION RISKS MATERIALISE

The repricing of risk premia and possibly increasing interest rates do not only impact financial institutions directly, but might also cause contagion. This chapter analyses possible transmission channels, such as the interconnectedness of the European banking system with the market-based finance sector, the interconnectedness between the banking sector and insurance sector and contagion from the leveraged non-financial private sector to financial institutions. Finally, this chapter highlights the importance of micro and macro prudential tools to address these contagion risks.

The European banking system is significantly interconnected with the market-based financing system, for example through funding channels⁷. It is estimated that interconnectedness in the form of wholesale funding provided to banks by entities within the market-based financing system measure has increased by 2% in 2017 to ca. EUR 2.2 trillion (Figure 8). In addition, there has been a notable shift towards non-money market investment funds and other financial institutions in repo funding. Resulting vulnerabilities could, for instance, arise from sudden and large redemptions among investors of money market funds (MMFs) and other investment funds, potentially leading to sales of bank debt securities and increasing cost of funding for the banking sector. EU legislation specifically covering MMFs has been introduced recently⁸, which should help to reduce the likelihood of potential stress in the MMF sector and contagion risk for the banking sector.

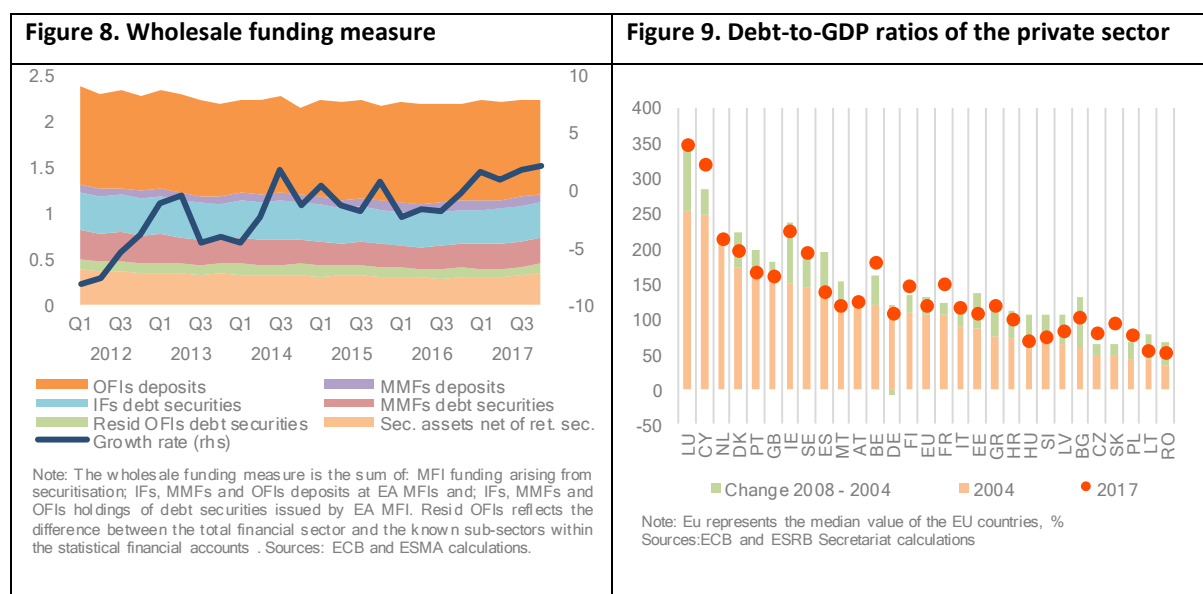
The banking and insurance sector are also significantly interconnected. The insurance sector is exposed towards the banking sector to more than EUR 1.24 trillion, although significant disparities can be seen among countries. EU/EEA insurers' exposures towards banks as a percentage of their total investment assets (excluding unit-linked and index-linked business)⁹ range from 6.43% in Croatia to 40.09% in Estonia, with the EU average exposure of 16.26% in Q4 2017.

⁷ Abad, J.; D'Errico, M.; Killeen, N.; Luz, V.; Peltonen, T.; Portes, R.; and T. Urbano, "Mapping the interconnectedness between EU banks and shadow banking entities", ESRB Working Paper No. 40, March 2017

⁸ Money Market Funds Regulation (EU) 2017/1131

⁹ Exposures include investments in corporate bonds, cash and deposits, mortgages and loans, collective investments, structured notes, other investments, equity, collateralised securities, property.

Another source of interconnectedness is between insurers and collective investment undertakings (CIUs). Insurers invest about 19% of their total investment assets in the non-unit linked portfolio through CIUs. Insurers who concentrate their portfolios in a few funds could pose risks to the financial stability of markets due to potential common investment behavior, particularly in cases of stress. The top 1% of CIUs hold approximately 52% of total investments of insurers through funds, while the top 10% of CIUs account for approximately 90% of total investments through CIUs.



Highly indebted households, government and non-financial firms are another possible contagion channel. Excessive credit growth and leverage of the non-financial private sector have been at the origin of many past financial crisis. In particular, evidence from the global financial crisis shows that NPL ratios tended to be higher in those EU countries which experienced large increases in the debt-to-GDP ratios of households and non-financial corporations.

Risks of short-term fiscal stress have receded, while indebtedness of households and non-financial companies are still at high levels, associated with debt overhang. While the positive economic outlook and favourable sovereign financing conditions mitigate sovereign risks, fiscal fragilities remain at the country level, as identified both by the European Central Bank and the European Commission. As banks, insurance companies and institutional investors are major holders of government bonds, a worsening of fiscal positions might spill over to the balance sheets of these institutions. In addition, medium-term risks to debt sustainability remain. Private sector indebtedness of households and non-financial companies stands high in many EU countries and, in most cases, is still above the pre-crisis level (Figure 9). Moreover, the evolution of debt payment obligations in relation to income signal that their debt servicing capacity has not significantly improved despite prevailing low interest rates.

Geopolitical shocks or rising interest rates over the next years are decisive factors that could a trigger the materialisation of the risks related to a highly indebted economy, especially if combined with worsening macro-economic conditions. A sudden rise in interest rates directly increases the funding costs of the public and private sectors, making the refinancing of large outstanding amounts of debt more challenging. A lower economic growth and higher unemployment also negatively impact the debt servicing capacity. This could cause an increase in the number of non-performing loans and reduce confidence, which could negatively affect the solvency position of financial institutions.

Several actions on the macro and micro prudential side can contribute to address such vulnerabilities, even if indirectly and with a limited scope. Macro prudential authorities should continue their efforts in the monitoring of lending standards to detect any possible excessive relaxation, which could lead to an increase of non-performing loans in the future. On the other hand, micro prudential authorities should continue their efforts of monitoring and improving asset quality. Similarly, borrower-based measures (like Loan-To-Value or Debt-Service-To-Income) could be effective tools, in case authorities are concerned about excessive indebtedness in particular segments of the private sector. Finally, beyond the prudential realm, the enhancement of insolvency frameworks and resolution tools for households and non-financial companies would also contribute to mitigate the adverse consequences of the excessive accumulation of debt in the private sector.

4 RISKS RELATED TO THE UK'S DECISION TO WITHDRAW FROM THE EU

The spring 2018 report already indicated that uncertainties around the terms of the UK's withdrawal from the EU have the potential to expose the EU27 and the UK to economic instability and to weaken market confidence, in particular if negotiations end in a disorderly fashion and without a ratified Withdrawal Agreement by the withdrawal date. Such a "no-deal Brexit" would be a worst case scenario. This chapter discusses relevant risks of such a scenario and highlights risk-mitigating actions that EU financial institutions and market participants should take.

A possible consequence of the UK's withdrawal from the EU is the relocation of financial services activities. Common EU efforts to ensure a consistent EU supervisory approach to potential relocations of financial institutions are necessary to protect the integrity of the Single Market. The spring 2018 report already highlighted several opinions the ESAs have published with principles on authorisation, supervision and enforcement issues related to UK financial firms seeking relocation to the EU27 in order to preserve their passports which allows them to operate Union-wide. In addition to these opinions, ESMA emphasised the importance of submitting requests for authorisation to the National Competent Authorities in a timely fashion, for regulated entities wishing to relocate in the context of the United Kingdom withdrawing from the European Union. On March 30 2019, firms that wish to preserve their Union-wide passports must have a fully authorised legal entity located in the EU27 to continue providing services in the EU27. In the ESMA publication, entities are reminded that the time required to analyse an authorisation request depends primarily on the quality of the application file. Hence, entities are encouraged to be complete and accurate in their filing for authorisation.

Besides relocation risks, a hard Brexit would impact the provision of financial services and the rights and obligations under existing contract. For example, it may become impossible for UK financial institutions and market participants, which have not relocated their business to the EU to preserve their Union-wide passports, to continue to perform certain operations in individual EU27 jurisdictions post-Brexit. In the case of e.g. non-centrally cleared derivatives the private sector should accordingly envisage all possible scenarios and assess all relevant related risks, plan a response and react to potential outcomes. In the short term, the UK's withdrawal from the EU may also affect access of EU27 households and corporates to financial services provided in the UK and could negatively affect market confidence. This also has potential implications on market liquidity and risk premia, and the risk of further adverse feedback loops.

The need to prepare for the risk of reduced access to market infrastructure and the impact of a hard Brexit on rights and obligations under existing contracts and has become a very critical issue. To mitigate many of the risks inherent in Brexit, and in particular in a no-deal Brexit scenario, it is crucial that institutions operating between the EU27 and the UK swiftly undertake adequate preparations. While a political agreement on a

transition period has been reached and is welcomed, it will not be given legal effect until there is a ratified Withdrawal Agreement in place. This is by no means guaranteed, and in any event, will only come at the end of the withdrawal process pursuant to Article 50 of the Treaty on the EU.

The monitoring of ESAs and resolution authorities of the level of financial institutions' contingency planning indicates that firms need to speed up their preparations for a potential “hard Brexit”. Contingency planning appears not sufficiently advanced in a number of areas. The EBA published an Opinion¹⁰ in June 2018 highlighting risks posed by lack of preparation by financial institutions for the departure of the UK from the EU. It calls on competent authorities to ensure that financial institutions take practical steps now, to prepare for the possibility of a “hard Brexit” and no transition period. The Opinion calls on financial institutions to ensure to have the correct regulatory permissions, and associated management capacity in place ahead of time. Contingency planning should consider timely responses to all potential challenges. They should identify risks around access to financial market infrastructures and funding markets and mitigate those. Financial institutions should also assess and take necessary actions to address any impacts on rights and obligations of their existing contracts, in particular derivative contracts. It also reminds on the duty for firms to communicate clearly to their customers where they might be impacted by the departure of the UK without a ratified Withdrawal Agreement.

In addition, EIOPA has issued an Opinion on the solvency position¹¹ of insurers and reinsurers. The Opinion calls upon national supervisory authorities to ensure that all risks to the solvency position of insurers arising from the UK becoming a third country are properly addressed. Technical provisions, own funds and capital requirements of insurance and reinsurance undertakings in Member States other than the UK can change when the UK becomes a third country due to changed regulatory requirements. Moreover, EIOPA issued a new Opinion on the disclosure to customers.¹² Without taking contingency measures, customers of cross-border contracts between the UK and the EU27 may face risks when it comes to the provision of services by insurance undertakings. The Opinion highlights that it is important that customers and beneficiaries are made aware of the implications for both existing and for new contracts before the withdrawal date in due time, by providing clear and non-misleading information on the contingency measures taken or planned.

In line with the abovementioned ESA opinions, it is crucial that EU financial institutions and their counterparties, as well as investors and retail consumers prepare appropriate mitigating actions in a timely manner, to prepare for the UK's withdrawal from the EU. Financial institutions should inform their competent authorities about the actions they are taking and be clear about the implementation timelines concerned. Competent authorities concerned should monitor contingency plans that financial institutions should have in place, and encourage the implementation, where required, of adequate contingencies.

¹⁰ EBA Opinion on preparations for the withdrawal of the United Kingdom from the European Union, June 2018 <http://www.eba.europa.eu/documents/10180/2137845/EBA+Opinion+on+BREXIT+preparations+%28EBA-Op-2018-05%29.pdf>

¹¹ EIOPA Opinion on the solvency position of insurance and reinsurance undertakings in light of the withdrawal of the United Kingdom from the European Union, May 2018 https://eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-18-2018_opinion_on_solvency_and_BREXIT.pdf

¹² EIOPA Opinion on disclosure of information to customers about the impact of the withdrawal of the United Kingdom from the European Union, June 2018 <https://eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-18-119-Opinion%20on%20Disclosure.pdf>