Brexit's Challenges and Opportunities for Foreign

Financial Firms in Germany

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Brexit and the Continuity of Contracts

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(views expressed in this paper are personal views and not opinions of the European Banking Authority)

In the event of a hard Brexit, the UK would become a third country for all purposes.

And legacy contracts may be discontinued, if the performance of the relevant obligations amounts to unauthorised provision of regulated financial services.

The idea of ensuring contract continuity, which has been proposed by the industry as a solution to the Brexit-induced disruption, has offered a terminological framework for dealing with the issue.

At the same time, however, it has paradoxically pre-empted a more fundamental investigation of the topic.

To put it simply, instead of exploring how post-Brexit business relations could be built on firm legal foundations, the rhetoric of contract continuity has deflected attention to what is potentially the wrong question, namely, how to keep all legacy contracts unchanged and enforceable for the years to come, as if Brexit had never occurred.

Adapting business relations to Brexit's new legal reality is undeniably a resource-intensive exercise – and possibly one with winners and losers, too.

Thus, substituting the question of how all existing contracts would remain in force despite Brexit, for the real question, which is how business relationships would need to be structured in the future, is mentally and psychologically convenient because it brings the debate back to familiar ground.

To put it in the terms of behavioral psychology, it is what Kahneman calls an availability heuristic, a mental shortcut referring us back to a fairly recent memory, namely, to the Euro Regulation that the Council adopted back in 1997 in the wake of the introduction of the single currency.

But is Brexit an event comparable to the introduction of the euro? Can it be addressed in similar manner?

A few observations are in order in this respect.

Until today, the implied conditions of every contract concluded between a UK party and an EU27 counterparty (including a contract governed by English law) was

first, that the provisions of Union law apply in a number of key areas (such as the areas of consumer and data protection),

second, that the financial services provider is subject to prudential regulation and supervision in accordance with the standards of Union law

and third, that the UK is a Member State and as such participates in the EU-wide area of recognition and enforcement of judicial and administrative procedures.

None of these considerations will hold true after a hard Brexit.

Moreover, in the future, English law may evolve independently and separately from Union law. Accordingly, the EU27 client (or, for that matter, the EU27 provider of financial services) will be exposed to a legal regime, which may change in an unpredictable and unilateral manner.

This is not conducive to legal certainty.

Nor does it provide assurance that conflicts between the governing law of the contract (this now being the law of a third country) and the mandatory provisions of the laws of the clients' country will be avoided or reconciled.

For these reasons, to commit EU27 clients or providers to legacy contracts may not be optimal.

But from a practical perspective too, how could individual contracts be "grandfathered" in such a way that their performance remains unaffected after the provider has lost its passport?

In the case of the introduction of the euro, had a contract managed to escape frustration, unilateral amendment or termination induced by the selfsame change of the currency, then its performance could proceed without obstacles; in respect to its cash part, in euros.

Brexit is far more complicated than this.

The term "contract continuity" was ambiguous by design.

It offered a supposedly clear and simple answer ("continuity") to an ill-defined question: Which contract?

Let's take the example of a derivative contract. Continuity refers to what exactly?

To the pending trade as such, namely, to the particular option, forward or swap?

Or to the underlying relation with the customer, which is based on at least two framework contracts, one under MiFID and another under some Master Agreement like ISDA?

Which one should or can be continued after Brexit?

In a recent paper, Barnabas Reynolds and Thomas Donagan accurately delineate the scope of continuity, when acknowledging that the discussion can only concern the pending trade itself and nothing more than that.

As they correctly put it, what can be seen as "property right" protected under the Charter, is only the "*right under a specific financial instrument agreed prior to Brexit".*

Conversely, "a*mending the terms of, or novating, pre-existing contractual arrangements or concluding a post-Brexit transactions under an existing ISDA Master Agreement, brokerage agreements or market infrastructure rules would typically be regarded as constituting a 'dealing' activity under MiFID II"*, and would therefore not be protected as a property right.

And rightfully so: what I will buy only tomorrow, cannot be my property of today…

So, when it comes to framework contracts, it appears that these will at least have to be transferred, to ensure that the supplier and the customer sit both on the same side of the Channel.

One should note in this context that the alternative argument insinuated by Reynolds and Donovan –namely, that framework contracts can remain in force, serve as evidence that the client has not been approached after Brexit and generate new trades on the basis of reverse solicitation– is not very convincing.

As for the trade itself, the preponderance of opinion appears to be that only those lifecycle events that do not amount to a new contract, could have a chance to survive Brexit. Even under a rather bold legal construction, according to which contractual relations are property and as such benefit from human-rights protection, it is very unlikely that novations, unwinds, portfolio compressions, roll overs or other similar lifecycle events could be seen as acquired property rights, whose protection trumps the micro- and macro-prudential considerations underpinning the passport system of financial services in the single market.

For residual performances, on the other hand, like payments, settlement or exercise of pre-existing options, recourse to human rights might not be necessary in the first place.

More generally, it would be for the judge to determine the fate of these trades: which pre-existing rights survive, how conflicting objectives, or public as against private interests, should be balanced, etc.

Industry is aware of that.

This is why proposals for a “public solution”, as it is called, go far beyond than just adding a few more clauses in the contract and then hoping that the judge will concur with your preferred theory of property rights or reverse solicitation.

Let's take a closer look at what is being proposed.

The industry essentially proposes “contract” to be defined as any unilateral act, instrument granting a security interest and other instrument with legal effect and any of their amendments. And it further proposes that “single market right” should be defined as any right existing under Union law before Brexit. On the basis of these definitions, the proposal goes on to establish that any service provider may continue to provide services to existing counterparties or perform activities within the territory of the Union or, conversely, within the territory of the UK, as the case may be, as if these single market rights continued to exist in order to service existing relations, including by entering into new (permitted) contracts.

Essentially, what would be grandfathered in this manner would be nothing less than the passport itself.

But grandfathering the passport in relation to all existing business relations is, in reality, suboptimal for the parties (consumers and providers alike) both in the UK and in the EU, as these will then have to live with contracts that do not fit into the new legal reality and which may well defeat their original expectations.

The “same” contract in a different legal environment cannot guarantee either continuity or legal certainty.

And then again, this grandfathering of existing “single market rights” is clearly suboptimal from a prudential and regulatory perspective.

It compromises key choices that the Union legislator has already made.

Take, for example, the right of access to markets and infrastructures: MiFID2 reserves this right for Union firms only, while third-country firms can have access if they benefit from the Commission equivalence regime or if national law permits it.

Against this background, how can access be grandfathered?

Another example: Assume that we grandfather all OTC contracts. Wouldn't this interfere with the choice of the Union legislator, as expressed in MiFID2, to encourage order execution through regulated markets as compared to execution over the counter?

And from a more philosophical point of view:

Grandfathering passports would have the effect of freezing in time the moment before (even shortly before and in preparation of) Brexit: existing business relations can thereafter continue, as if nothing ever changed.

But what if the legislation subsequently changes either in Europe or in the UK? How will these grandfathered rights be adapted?

Doesn't this amount to a severe limitation of the field of applicability of legislative and regulatory initiatives, both at the Union and at the national levels?

And isn't it the case that these grandfathered rights confer to their beneficiaries (which are evidently already existing market players) an undue advantage (since it shields them from the change of regime) in a manner that tilts the competitive field?

In my view, the evident solution for service and funding continuity, which are the real objectives here, is what the market calls "repapering", which essentially means the replacement in the long-term contractual relationship of the UK provider with its EU27 affiliate, and vice versa, and the re-funding of capital and MREL instruments in a way that their subordination, bail-inability and operation in resolution and insolvency under Union law is legally ensured.

Repapering, of course, requires some effort on the part of the industry. And where it should be done, the work should really start immediately.

Thank you very much.