FINANSINSPEKTIONEN

Consequences of Brexit for the Swedish Financial Market

21 June 2018

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Foreword

Through an amendment to its appropriation directions for 2018, Finansinspektionen (FI) was tasked with investigating and explaining the consequences of the decision by the United Kingdom to leave the EU (Brexit). This assignment includes charting the consequences of Brexit for the Swedish financial market, identifying specific Swedish challenges and estimating the impact of this on FI's operations. The aim is to strengthen the Swedish Government's ability to deal with the questions and requirements that may arise in the financial market as a result of Brexit.

In the process of producing this report, FI has analysed significant economic and legal aspects of Brexit. This is done on the basis of the assumption that the UK will become a third country among others (a hard Brexit). That is not the only possible outcome, but it is not meaningful for FI to speculate on other possible results of the negotiations.

This is an interim report. A final report will be submitted when the consequences of Brexit can be determined in greater detail.

Stockholm, 21 June 2018

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Director General

Summary

Brexit will become a reality when the UK leaves the EU on 29 March 2019. This will change conditions for cross-border trade in financial services to and from the UK. FI describes in this report its analysis of a number of significant economic and legal aspects related to Brexit. In order to streamline its analysis, FI assumes a scenario in which the UK leaves the EU without the future relationship between the two being clearly defined and the UK becomes a third country among others (a hard Brexit).

When the UK leaves the EU, British financial firms will become third country companies. They may continue to conduct business in Sweden through subsidiaries or branches that are domiciled either in Sweden or another country within the EEA. Due to the narrow EU regulations regarding equivalence, British firms will only be able to conduct very limited business directly from the UK. The extent to which Swedish firms can conduct business in the UK will be dependent on British rules, but there are strong indications that it will be possible to do so through subsidiaries or branches.

The supply of financial services is expected to largely remain the same for Swedish households and businesses since British firms have announced that they will apply for authorisation within the EU to be able to continue to conduct business. There are also opportunities to find equivalent alternatives. The British firms also have only a small number of retail customers in Sweden. FI makes the assessment that Brexit will not affect consumer protection. One possible exception pertains to issues related to contract continuity, where contracts with consumers may be affected, primarily in the insurance sector.

For FI, it is important that consumers' interests are given priority. This means in particular that companies are required to ensure that no consumers are adversely affected and even that uncertainty about contract continuity is removed. Ultimately, it is the responsibility of legislators and supervisory authorities to protect the interests of consumers.

The general question is whether agreements entered into before the UK leaves the EU will be affected by the fact that the British firm is no longer permitted to conduct business. The European Commission is among those that take the position that firms are already under obligation to ensure prior to Brexit that the counterparty does not suffer negative consequences, while some market participants are calling for legislative measures at the EU level. These issues are being discussed by the European supervisory authorities, and FI is participating in this discussion.

In its analysis, FI notes that the clearing organisation London Clearing House Ltd (LCH) is very important for interest rate derivatives trading, which in turn is important for the Swedish financial market. More than 90 per cent of interest rate derivatives trading in SEK is cleared there. In a hard Brexit scenario, LCH will be a third country company and the conditions for clearing will change. Banks will no longer be able to use LCH for clearing of new OTC derivatives with clearing obligation. There is also uncertainty here regarding the

requirements on contracts that have already been entered into. There may be inconveniences and added costs for Swedish banks. How large these will be depends on the alternative solutions for clearing that will be offered. There are also alternative solutions that the firms themselves can use. FI will monitor and participate in the discussion and work to find solutions that meet the interests of a well-functioning financial market.

There is a risk that the preparations for a hard Brexit are generally insufficient. This risk is not specifically Swedish but rather applies to Europe in general. The current political uncertainty surrounding the Brexit agreement and an agreement on future relations, in combination with a possibly exaggerated expectation that the Commission will adopt equivalence decisions regarding British firms, is creating risks of market disturbances at the international level in the event of a hard Brexit. Such disturbances could impair the Swedish financial market's ability to function properly. However, given that it is a known risk factor, firms should be able to handle and counteract the consequences of any market disturbances. Ultimately, appropriate policy measures can also be implemented, primarily at the EU level. Both firms and authorities can and should maintain customary preparedness to handle financial shocks. FI therefore assesses the risks of financial instability as a result of Brexit to be limited.

FI has not identified any particular need to change the law other than what has already been presented in the proposal that the settlement systems in third countries in some respects be considered equivalent to those in the EEA.

There are no signs that FI will receive a stream of new authorisation applications from British firms that want to relocate to the EU. If derivatives clearing is moved to the EU, the volume that goes to Nasdaq Clearing may increase, which would increase the importance of this firm for the Swedish financial system. This would probably call for more supervisory activities, but it is currently not possible to estimate the scope.

The Assignment – Investigate the Consequences of Brexit for the Swedish Financial Market

Finansinspektionen is tasked with investigating and explaining the consequences for Swedish participants in the financial market as a result of the United Kingdom's decision to leave the EU (Brexit). The aim is to strengthen the Swedish Government's ability to face the questions and requirements that may arise as a result of Brexit. The assignment includes the following:

1. Charting the impact of Brexit on various market sectors in Sweden, e.g. the banking, insurance and securities markets. This shall encompass both legal and operational consequences for participants in the financial market and an assessment of the impact on the functioning of the financial markets, financial stability and consumer protection.

2. Identifying any challenges, questions or consequences that are specific to Sweden, including any requirements for new or amended regulations.

3. Estimating the impact of Brexit on FI's operations.

In addition, FI shall assist the Government Offices in the negotiation of a potential free trade agreement between the EU and the UK that applies to financial services.

An interim report on this assignment shall be published no later than 22 June 2018, and a final report pertaining to points 1 to 3 once the consequences of Brexit can be elucidated.

Significance of the UK – Current Situation

London is a global financial centre and is thus also of importance to Swedish companies. One of the most important services offered there is central counterparty clearing. British financial firms also offer financial services in Sweden, for example funds, financial advice and mergers and acquisitions.

The EU's internal market gives financial firms the right to operate throughout the entire European Economic Area (EEA). A firm that is domiciled in a certain country (home state) and wants to conduct operations in another country within the EEA (host state) can choose between establishing a subsidiary in that country or setting up a branch there. The firm can also choose to run cross-border operations, i.e. directly from the home state. This has been made possible by the EU and the other EEA countries having adopted a regulatory framework that is, in principle, harmonised and having agreed to respect the notion that financial supervision is conducted primarily, albeit with specific exceptions, by the home state's supervisory authority, even with regard to operations in the host country.

The free movement of services and capital has contributed to developing the range of services offered in the financial sector. London is the predominant financial centre in Europe. For example, London accounts for approximately one third of the trade in shares within the EU. London also dominates the trade in exchange-traded derivatives. In this way, the UK acts as a base for important firms and operations that span the entire EEA. This is also true for Sweden and Swedish financial firms. Accordingly, the relationship with the UK is of importance to these firms' customers and to the Swedish economy as a whole.[1]

BRITISH FINANCIAL FIRMS THAT OFFER SERVICES IN SWEDEN

British financial firms have established subsidiaries or branches in Sweden. There is also a large number of firms that conduct activities cross-border directly from the UK. Firms that are domiciled in a third country and want to operate within the EEA have, in many cases, established a subsidiary in the UK and use this as a hub for cross-border operations in other EEA countries or establish branches in these countries.

British banks' operations in Sweden

The British banks that operate in Sweden, including those owned by parent companies in countries outside the EEA, generally concentrate on institutional and large corporate clients. Their focus is on specialist advice, mergers and acquisitions and capital market instruments. They thereby contribute to making the Swedish financial market more competitive and home to a wider range of services. There are currently ten branches of British banks in Sweden.

1 The importance of the UK for Sweden as a trading partner is described in detail in the National Board of Trade's investigation "After Brexit – Recommendations for Swedish priorities in upcoming negotiations" (Ref. 2017/01831-29).

British insurance companies in Sweden

Some British insurance companies also conduct business in Sweden. This is done through branches or cross-border operations. In 2016, there were 15 branches of British insurance companies and 30 companies that conducted cross-border operations. They account for a small portion of the Swedish insurance market. Their principal business is non-life insurance.

British investment firms, fund management companies, AIF managers, insurance intermediaries, payment institutions and e-money institutions

There are 23 branches of British investment firms, fund management companies, AIF managers, insurance intermediaries, payment institutions and e-money institutions in Sweden. They offer services including fund distribution, investment advice and portfolio management, primarily to larger companies and Swedish banks. Only a few branches have consumer clients, but there are two larger investment firm branches that offer electronic trading to consumers.

Close to 4 000 firms in the above categories have registered with FI in order to conduct cross-border operations from the UK to Sweden. In spring 2018, FI contacted just over 2 500 of these firms. Just under 200 responded that they operate in the Swedish market in practice. It is therefore common for firms to notify EEA countries without subsequently utilising the opportunity to offer services.

THE RANGE OF SERVICES IN THE SECURITIES MARKET

The financial infrastructure firms such as central counterparties, central securities depositories, trading venues and clearing organisations play an important role in the securities market. There are British companies in this area that are of major importance to the Swedish financial market.

The fact is that the clearing of derivative instruments and currency transactions used by Swedish firms is largely carried out by firms based in the UK. The two largest are London Clearing House Ltd (LCH) for interest rate derivatives trading and Continuous Linked Settlement System (CLS) for currency trading. More than 90 per cent of interest rate derivatives trading in SEK is cleared by LCH. FI defines interest rate derivatives trading as systemically important; see box below.

Approximately 45 per cent of Swedish firms' outstanding derivatives contracts (regardless of asset class and currency) is cleared by LCH. For firms that are subject to capital and clearing requirements under EMIR[2], the proportion is 60 per cent. The significance is greatest in EUR, NOK and SEK. However, Swedish companies only represent a small portion of LCH's total business volume; approximately three per cent.

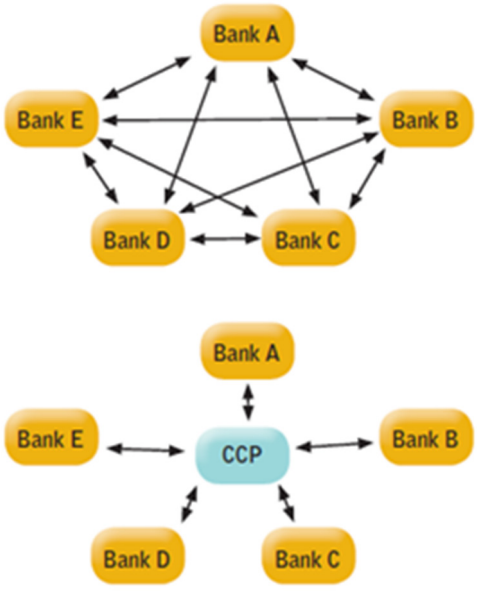
2 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

Central counterparty clearing – an important part of the financial system

A central counterparty's primary task is to take over counterparty risks by acting as a counterparty to both the seller and the buyer in a financial transaction. After the most recent financial crisis, central counterparties have gained a key role, in part due to new regulations under which a larger number of market participants must clear several types of transactions through a central counterparty (clearing obligation). Given the concentration of counterparty risk that thus arises at a central counterparty, they have come to be regarded as systemically important. Consequently, stricter requirements for this type of business have been introduced in recent years, primarily through EMIR.

Clearing of derivatives in SEK can take place in both Swedish and foreign systems. In Sweden, Nasdaq Clearing is currently the only central counterparty for derivatives trading and it is therefore subject to FI's supervision. London Clearing House Ltd (LCH), which is domiciled in the UK, is another central counterparty that offers clearing of derivatives in all major currencies.

Figure 1. Counterparty risks are concentrated in one firm, a central counterparty



Note: Central counterparty (CCP)

The new rules on central counterparty clearing under EMIR have been gradually adopted within the EU. Stricter capital requirements for uncleared derivatives have also been introduced. The aim is to create further incentives for central counterparty clearing. The requirement for central counterparty clearing under EMIR only applies to standardised OTC derivatives.

In addition, Swedish firms are also members of regulated markets, multilateral trading facilities and other financial infrastructure firms, such as central securities depositories and central counterparties, that are domiciled in the UK. Correspondingly, British companies are

active in the Swedish securities market. The Swedish trading venues have more than 100 members that are based in the UK. The bulk of trade in the Swedish stock market is carried out by members based in the UK. They thereby contribute to the liquidity of the stock market.

The Swedish clearing organisation Nasdaq Clearing, which clears derivatives, has around 15 members based in the UK. The central securities depository Euroclear Sweden has a few members based in the UK. The largest of these is LCH Clearnet Ltd, the British central counterparty. In total, British members account for around ten per cent of the value that is settled in the Swedish stock market through Euroclear.

SWEDISH FINANCIAL FIRMS' OPERATIONS IN THE UK

Swedish banks and insurance companies operate in the UK to some extent. Other types of Swedish financial firms conduct a limited amount of business there.

The banking sector

Swedish banks conduct business in the UK in various forms. One Swedish credit market company has a subsidiary in the UK and four banks operate there through branches. At the beginning of this year, the four major banks had total assets of SEK 531 bn in the UK. This equates to almost 4.5 per cent of their total assets. In addition, 19 Swedish banks have notified that they conduct cross-border operations in the UK.

Swedish banks' retail banking customers in the UK normally have no connection to the Nordic region. In the business segment, the relationship is the opposite; clients often have a connection to the banks' home markets in the Nordic region.

The insurance sector

Swedish insurance companies' operations in the UK are limited. At the beginning of this year, there were 16 Swedish insurance companies operating there in the form of a subsidiary, through a branch or as a cross-border operation.[3] Ten of these are "captives".[4]

The Swedish insurance companies in the UK offer non-life insurance. The insurance contracts are normally shorter than one year. Examples of insurance policies are pet insurance that is taken out by private individuals and credit insurance of companies' pension commitments, which is taken out by companies. Some of the insurance policies also contain liability elements that are of an extended nature and may remain in place for a long time after the primary policy has expired.

Ten captives insure Swedish companies' operations in the UK. The insurance is tailored to the company in question and may make it possible to take out a policy that is not available on the general insurance market. However, a captive is primarily used as a means by which to reduce the insurance costs within the group. These services

3 According to the insurance companies' annual reports.

4 The term captives is used to denote insurance companies that only insure risks within the group to which they belong. The insured person and the policy holder are the same legal entity.

may be important to the individual company but are of no significance to the Swedish financial market and its functioning.

How Will Brexit Alter Conditions?

When the UK leaves the EU, British financial firms will become third country companies. They may continue to conduct business in Sweden through subsidiaries or branches that are domiciled within the EEA. The extent to which Swedish firms are able to operate in the UK will become dependent on the rules in that country. One issue that is generating some uncertainty and concern among financial firms is whether agreements that were entered into prior to Brexit will be affected by the fact that the British firm is no longer able to conduct cross-border operations.

When the UK leaves the EU on 29 March 2019, the conditions for cross-border trade in financial services in and out of the country will change. The UK will become a third country either on 30 March 2019 or at a later date decided in negotiations between the remaining EU member states (referred to below as "EU27") and the UK. There is a preliminary agreement between the parties about the internal market persisting in principle until the end of 2020, but this must ultimately be confirmed within the framework of the overall agreement on the terms of the UK's exit from the EU.

The consequences that will arise as a result of Brexit are largely dependent on what the future relationship between the EU and the UK looks like. It is currently unclear what these negotiations will result in. In order to streamline the analysis in the report, FI assumes a scenario in which the UK leaves the EU without the future relationship between them being regulated (a hard Brexit).

THE UK BECOMES A THIRD COUNTRY

The various EU/EEA countries have national rules on what access to that country's market firms from a third country are permitted. EU law normally only contains rules to the effect that third country companies may not be treated more favourably than firms from EEA countries. It is otherwise up to the EU country to freely decide rules for this, naturally respecting the international commitments that country has made, primarily within the framework of the World Trade Organization's (WTO) General Agreement on Trade in Services (GATS) and its annex on financial services.

After the UK leaves the EU, the general Swedish rules on third country companies will determine what opportunities a British firm has to conduct business either in Sweden or that targets the Swedish market. Unless EU27 and the UK agree otherwise, British financial firms will be treated in the same way as firms from other third countries.

On the whole, there is nothing to prevent British companies or British owners from establishing themselves in Sweden or acquiring a Swedish subsidiary in order to operate here, provided the company has the necessary authorisation. The only thing that can be considered burdensome in comparison to the equivalent for firms within the EEA is a requirement in the Swedish Companies Act (2005:551) stipulating that at least half of the directors on the board and the managing

director must be resident within the EEA. A British company can otherwise establish a subsidiary in any other EEA country in order to ensure that the EU rules on cross-border operations within the EEA become applicable to its operations in Sweden.

Nor is there anything, in most cases, other than the requirement for authorisation, to prevent a British firm from establishing a branch (and when it comes to insurance companies, a general agent) in Sweden. The business has to be run in accordance with basic rules and the Swedish supervisory authority will supervise the branch and place certain demands on it. One exception to the option for firms in third countries to establish a branch here applies to the management of Swedish UCITS funds and of alternative investment funds. Payment service institutions cannot establish a branch in Sweden either.

It is not uncommon for households and companies in Sweden to own units of British UCITS funds. However, a fund in a third country is not deemed to be a UCITS fund in accordance with the applicable EU rules but will instead be considered an alternative investment fund. There is nothing to prevent Swedish people from investing in alternative investment funds in third countries, but funds of this type will no longer be able to participate in the premium pension system, which may have consequences for Swedish pension savers.

These operations cannot be conducted cross-border from the UK as the Swedish rules do not, in most cases, provide this opportunity to firms from countries outside the EEA. As mentioned above, however, there is the option of establishing a subsidiary in another EEA country, which means that this restriction possibly has less of a practical significance, at least for British firms that initially have larger operations within the EEA.

What is equivalence?

Some EU legislative acts contain provisions concerning equivalence. Such rules enable the European Commission to decide that rules and supervision in a third country shall be considered equivalent to the standard within the EU. A decision of this type can be made unilaterally by the Commission and can be withdrawn unilaterally. Decisions on equivalence can give market access to third country companies. However, only certain legislative acts contain equivalence rules, which is why they cannot provide a general opportunity to conduct business. A number of equivalence rules also have completely different purposes than that of providing market access. All in all, this means that the equivalence rules, as they are currently formulated, are far removed from being a replacement for the UK's participation in the internal market.

THIRD COUNTRY RULES IN EMIR AND THE CLEARING OBLIGATION

The EU regulation on OTC derivatives, central counterparties and trade repositories (EMIR) contains rules including the obligation to clear OTC derivatives that have been declared suitable for clearing via a central counterparty, the requirement to report derivatives contracts to transaction registers and on the authorisation of central counterparties and registration of transactions.

An authorisation as a central counterparty anywhere within the EU applies throughout the entire EU under Article 14(2) of EMIR. Consequently, no separate notification procedure is required for cross-border operations. A central counterparty established in a third country may only provide clearing services to clearing members or trading venues that are established in the EU if this central counterparty is recognised by ESMA (Article 25(1) of EMIR). Certain conditions must be met in order for ESMA to recognise a central counterparty in a third country. These include the Commission having stipulated that the legislation in the country in which the central counterparty is domiciled sets requirements equivalent to those found in EMIR. In addition, it is necessary that ESMA has established a cooperation agreement with the competent authority in the country in question (see Articles 25(2)(a) and (c) as well as 25(6) and 25(7) of EMIR).[5]

A requirement to clear certain OTC derivatives contracts that are indicated by ESMA was introduced through EMIR. There is currently a requirement to clear standardised interest rate derivatives in certain currencies including SEK.[6] The clearing requirement means that counterparties for such OTC derivatives contracts must clear the contract with a central counterparty authorised within the EU or with a recognised central counterparty from a third country. The clearing requirement applies to financial counterparties (investment firms, credit institutions etc.) and, depending on the size of their outstanding positions, to non-financial counterparties (companies that are not financial counterparties). The requirement to clear the aforementioned derivative contracts has not yet entered into force for non-financial firms and smaller financial firms. This will take place in 2019.

Table: Clearing of OTC contracts by recognised and unrecognised central counterparties

After Brexit	OTC contracts	Central counterparty in EU27 or recognised third country	Unrecognised central counterparty in third country
Clearing obligation	New	Yes	No
No clearing obligation	New	Yes	Yes
Clearing obligation	Existing	Yes	Uncertain
No clearing obligation	Existing	Yes	Yes
Capital requirement relief for financial firms		Yes	No

5 Please note that, as a result of Brexit, the Commission has submitted proposals with the aim of introducing new provisions into EMIR pertaining to central counterparties in third countries. The proposed regulations give ESMA expanded supervisory powers over certain central counterparties in third countries. Furthermore, some central counterparties in third countries will only be able to offer services within the EU if they establish themselves in a member state.

6 https://www.esma.europa.eu/system/files_force/library/public_register_for_the_clearing_obligation_under_emir.pdf

Note: The table shows which OTC contracts will be affected by Brexit and how the capital requirement affects financial firms.

The rules are summarised in the table above. A higher capital requirement will be applied to exposure that derives from investments in derivatives held in unrecognised central counterparties by credit institutions and investment firms established in the EU and their subsidiaries. The capital requirements for credit institutions and investment firms are higher for exposure from outstanding derivatives with unrecognised central counterparties than for exposure from outstanding derivatives with recognised central counterparties.[7]

After its exit from the EU, the UK is also a third country under EMIR. This means that clearing organisations based in the UK will no longer automatically be able to provide clearing services within the EEA. Furthermore, derivatives that trade on a British regulated market will no longer fulfil the definition of exchange-traded derivatives in MiFIR[8]. Instead, derivatives that are currently traded on a regulated market in the UK will be considered OTC derivatives. Consequently, they will become subject to the requirements under EMIR that are applicable to OTC derivatives, including the requirements for transaction reporting, risk-mitigation techniques and, where applicable, central counterparty clearing. As stated previously LCH is the predominant clearing firm in the EU. Once the UK has left the EU, new derivatives contracts that are subject to the clearing obligation may be cleared by LCH only if the company establishes itself within the EEA in some form or is recognised by ESMA as a central counterparty in a third country.

CONTRACT CONTINUITY

One much discussed question is how Brexit will affect contracts British firms have entered into with counterparties in Sweden (and other countries in EU27), to the extent that the UK's status as an EU country has been of significance to those firms' right to operate in this country. In some cases, the question is irrelevant as the contract will expire prior to the exit date. However, in other situations the contract will continue to run after this date. This may be the case for insurance contracts (in particular life insurance) or pension agreements, for example. The corresponding question is raised, in particular with regard to clearing contracts.

By and large, it is certain that the contracting parties have not (at least if the contracts have been entered into prior to the British referendum) predicted that the UK would end up leaving the EU, which is why the matter of the contract's validity or settlement has scarcely been covered in the contract.

In published notices[9] targeted at concerned parties, the Commission has addressed the question of whether Brexit may have an impact on British firms' potential to continue fulfilling certain obligations and

7 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012

8 Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012

9 https://ec.europa.eu/info/brexit/brexit-preparedness_en?field_core_tags_tid_i18n=22857

conducting activities relating to contracts entered into prior to the exit date. It could be the case that the firm is, for example, prevented not only from extending the contract or coming to an agreement on amended contractual terms, but also from fulfilling other contractual obligations.

In this context, the question may be asked as to whether one of the contracting parties, supported by national rules or legal principles on force majeure or similar unforeseen, changed circumstances would be able to claim that the contract in and of itself is invalid and that the party in question is therefore not liable to fulfil their contractual obligations.

Insurance contracts

In light of the questions raised about the validity of contracts and the possibility of fulfilling their contractual obligations regarding the insurance sector, the Commission cites the rule in Article 41(4) of the Solvency II Directive.[10] The insurance company shall take reasonable steps to ensure continuity and regularity in the performance of its activities. According to the Commission, the consequence of this will be that British companies are obliged to take steps prior to the exit date in order to ensure they are also able to honour agreements after this date.

In a published statement, EIOPA states that in principle insurance contracts will continue to apply post-Brexit[11]. However, a British insurance company could, according to EIOPA, be prevented from fulfilling their contractual obligations as it no longer has the right to operate. This would be the case if the insurance contract has been entered into within the framework of cross-border operations, a business form which will no longer be permissible in the majority of cases post-Brexit.

In light of how important it is that insurance contracts are able to be fulfilled and that claims can be paid out, EIOPA has produced a list of preparatory measures that can be implemented in order to ensure that contracts can be fulfilled. For example, an insurer can transfer the insurance portfolio to a subsidiary within EU27 or establish a branch in the policy holder's country (the equivalent should apply to insurers within EU27 that have policy holders in the UK).

This involves an interaction between regulations under civil and commercial law. Various opinions have been voiced during the ongoing discussion about the effects within these two areas of law. Ultimately the matters subject to civil law can only be settled by a court (unless legislative action is taken). With respect to the regulations that fall under commercial law, it is primarily the supervisory authorities that, in light of factors such as the final positions that may be taken by the European supervisory authorities, will determine whether a current authorisation is required to operate in the country in question in order for a contract to be fulfilled.

10 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of insurance and reinsurance.

11 https://eiopa.europa.eu/Publications/Opinions/2017-12-21%20EIOPA-BoS-17-389_Opinion_on_service_continuity.pdf

FI would like to stress that the issue of contract continuity and the consequences of different interpretations are still being analysed and discussed in various contexts. For FI, it is imperative that the interests of policy holders, especially those of consumers, are given top priority. This means that insurance companies must, in the first instance, be required to ensure that no policy holders are adversely affected and even that there is no uncertainty about contract continuity. Ultimately, it is the responsibility of legislators and competent authorities to protect the interest of policy holders. The equivalent applies in general to valid contracts in other sectors.

Contracts in the field of derivatives

Another key question is what impact the UK's exit from the EU will have on the extensive trade in OTC derivatives between parties in the UK and EU27. This is also an area where discussion is taking place about what events can be regarded, on the one hand, as purely the execution of contractual obligations and, on the other, as new transactions. In the latter case, the transaction must be carried out in accordance with the applicable regulatory framework, which may exclude British counterparties.

The International Swaps and Derivatives Association's (ISDA) assessment in the matter of transactions carried out in accordance with the ISDA Master Agreement is that payments, deliveries, settlement, utilisation of options and transfers of securities fall under the first category set out above. Accordingly, it would also be possible for British companies to implement these after the UK has left the EU and is considered a third country.

According to ISDA, however, there is much to suggest that other actions would be regarded as new transactions. This can involve significant changes to the contractual terms, the parties' agreeing to conclude a transaction and replace it with a new one, transfers to a third party, the parties' settling the contract early and the consolidation of several contracts between the same parties into a new one for the same total net amount. For new transactions such as these, the MiFID II regulatory framework [12] and certain rules in EMIR would apply. All in all, this means that these transactions could not be carried out with a British counterparty.

Alternative solutions for the market

The firms that use British clearing companies need to decide how the clearing they are obliged to carry out in certain cases can be implemented after Brexit. The same applies to the voluntary clearing they have participated in on commercial grounds. This means that firms will probably turn to clearing companies other than the British companies they have been using until now, to the extent that these can no longer be used. To the extent that there are currently no commercially reasonable alternatives, it is conceivable that these will emerge. As has previously been established, it is certainly not being

12 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU and Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

ruled out that using alternative or new clearing companies will lead to higher costs.

The British central counterparties may choose to ensure that they can continue providing clearing services to firms within the EEA. In that case, there are three different options. The first is for the British central counterparty to ensure that it will be considered a central counterparty within the EEA. The clearing organisation can, for example, merge with a company within EU27, establish a subsidiary, transform an existing branch into a subsidiary or establish a branch in an EU27 country (in which case, however, this only has the opportunity to conduct cross-border operations to other countries within the EEA if these accept this under their national regulations). The second option is for the British central counterparty to transfer its contracts to a central counterparty within EU27. This is dependent on there being individual agreements, with one question being whether parties within EU27 accept the new central counterparty the British clearing company wants to transfer the contract to. A third option is for British counterparties to be recognised by ESMA as central counterparties or for them to use a branch in another third country that is already recognised.

Concern and uncertainty among market participants

The questions regarding the impact Brexit will have on valid contracts have given rise to a lively discussion on the legal and financial consequences for the contractual parties. As has been stated, it is the opinion of the Commission and several of the European supervisory authorities that it is the financial firms in question that, in accordance with the applicable rules on duty of care, are primarily responsible for ensuring that their counterparties do not suffer undesirable financial consequences. Objections to this are often raised, stating that it is difficult for firms to take effective action sufficiently early and even, in some cases, that this is perhaps impossible without suffering undue consequences. One example is whether a transfer of derivative contracts to a subsidiary within the EEA is regarded as the type of amendment to a contract that can trigger a clearing obligation, trading obligation and increased capital requirements. In particular, it is pointed out that the prevailing uncertainty regarding what the relationship between EU27 and the UK will ultimately look like after Brexit means that preparatory measures, which may be very costly, would be pointless in certain situations. In turn, this could result in firms spending large amounts unnecessarily in preparation for the wrong scenario. In light of this, there are hopes and expectations among market participants that the problems will instead be solved through legislative measures at the EU level.

APPLICABLE LAW AND JURISDICTION – ENGLISH LAW

It is common for contracts, in particular those pertaining to financial relationships, between parties in different countries to state that English law shall apply to the contract. The UK's exit from the EU does not automatically mean that English law would not be applicable. However, the UK will no longer be encompassed by the EU regulation

(the Rome I Regulation[13]) that governs how to determine which country's legislation shall apply in a certain situation. This may affect contractual relationships between parties.

Nor will the EU regulations on which country's courts have jurisdiction and on enforcement procedures (Brussels I Regulation[14]) apply to the UK. This means that the almost automatic acceptance of British courts' rulings will no longer apply within EU27. Instead, the question of whether a British court's ruling can be enforced in a country within EU27 will be examined in accordance with general international civil law rules, which may reduce the certainty and predictability of contractual relationships.

SWEDISH FIRMS' OPERATIONS IN THE UK

After the UK's exit from the EU, Swedish firms will no longer be able to operate there under the rules applicable to the internal market. Instead, the UK will decide whether and in which case how (in accordance with the UK's applicable WTO commitments) Swedish companies will be allowed to operate in the country. The UK has announced that it intends to give EEA companies the opportunity to continue operating during a transitional period, regardless of whether an agreement on future relations is in place. However, the UK has also indicated to certain companies that they are expected to run their operations from subsidiaries established there, rather than from branches or via cross-border operations.

13 Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations.

14 Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters

Impact on the Financial Markets' Functioning, Financial Stability and Consumer Protection.

FI's assessment is that Brexit will have small effects on the Swedish financial markets. However, the lack of clarity regarding how and where the clearing of interest rate derivatives will take place after Brexit is creating uncertainty. FI will also continue to monitor certain matters concerning contract validity.

UNCERTAINTY REGARDING THE CLEARING OF INTEREST RATE DERIVATIVES

As has been mentioned previously in this report, Swedish firms make extensive use of central counterparties in the UK for clearing interest rate derivatives. Some derivatives must be cleared by a CCP. Financial firms also have an incentive to clear other derivatives transactions through a recognised central counterparty as this means that the capital requirement is reduced for the exposure the derivative entails.[15]

After Brexit, British clearing organisations such as London Clearing House Ltd (LCH) will be considered central counterparties in a third country. As long as LCH is not a central counterparty recognised by ESMA (which in turn depends on the Commission declaring British legislation to be equivalent to that of the EU) derivative contracts with a clearing obligation will need to be cleared by another central counterparty.

There are currently three central counterparties within the EEA and central counterparties in third countries that ESMA has recognised and are therefore able to offer clearing of the products the companies are obliged to clear in the Nordic currencies. LCH is one of these. In the event of a hard Brexit, Swedish firms will need to turn to one of the other central counterparties in order to comply with the clearing obligation that applies to standardised interest rate derivatives, for both existing and future derivatives contracts. One effect of this will probably be higher costs, including in the form of membership fees and contributions to loss funds, at least if this business is to be divided between several clearing organisations. There is also a risk that the collateral the firm must provide may be used less efficiently because the collateral needs to be provided to several central counterparties.

Banks' capital requirements and capital needs will increase to the extent that they choose, on commercial or other grounds, to continue clearing the instruments that are not subject to the requirement to clear within the EEA through LCH as this exposure will be to a non-qualifying central counterparty.

15 See Articles 300–311 and 497 in the Capital Requirements Regulation. Article 497 has not yet entered into force and the Commission has put forward a proposal to bring forward the date of its entry into force to 15 December 2018.

In summary, the altered conditions for clearing interest rate derivatives may be problematic for Swedish banks. How problematic it is will depend on what alternative clearing solutions are available.

As mentioned above, there is some uncertainty as to how outstanding derivatives contracts are affected by the fact that they can no longer (as long as they have not been recognised by ESMA) be cleared by British clearing organisations. The contracting parties themselves can try to manage the uncertainty by reviewing their contracts well in advance of Brexit.

It is conceivable that, instead of taking action to deal with the situation, firms will wait for legislators to solve the problem. One risk that is not specific to Sweden, but applies to Europe in general, is that preparations for a hard Brexit are generally insufficient and that derivatives clearing will become hard to access. In that case, there is a risk of disruptions, which could also affect Swedish firms, banks especially. FI, like the European supervisory authorities, is paying great attention to these matters.

LIQUIDITY, MARKET FUNDING AND SOLVENCY REQUIREMENTS

London is the financial centre of Europe, and Swedish firms have traditionally used it for their capital market transactions. Swedish non-financial firms have, in recent years, increased their market funding and the banks also issue on the international capital market. In many cases, London has been used as a platform to reach foreign investors and the prospectuses have been drawn up in accordance with English law. FI has received requests from parties who are considering transferring bond programmes listed in the UK to Sweden and switching from English law to Swedish law at the same time.

There are British participants in the Swedish financial market that contribute by providing liquidity, and one consequence of Brexit may be that they withdraw from the Swedish market. However, on the basis of its contact with many of these British firms, including those owned by parent companies in countries outside the EEA, FI's assessment is that many will continue to operate within EU27.

The capital requirement for insurance companies encompassed by the EU's Solvency II regulations may be altered by the UK's exit from the EU. Solvency II makes a distinction between exposures within and outside of the EU; EIOPA has described the possible effects in a statement.[16] The analysis points to the impact being marginal for most insurance companies, but the effects may be significant for some. Insurance companies must therefore analyse the impact on the basis of their individual circumstances.

RANGE OF SERVICES FOR SWEDISH HOUSEHOLDS AND BUSINESSES

FI's assessment is that the range of financial services and products offered by British companies to Swedish consumers will not change significantly.

16 https://eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-18-2018_opinion_on_solvency_and_Brexit.pdf

The British insurance companies are planning in various ways to continue operating in Sweden after Brexit. Some insurance companies are looking to establishing subsidiaries in an EEA country in order to subsequently transfer their portfolio to the new company. Others will be establishing a European company prior to Brexit and will move that company's domicile to an EEA country.

British firms such as banks, investment firms, fund management companies, AIF managers, insurance intermediaries, payment institutions and e-money institutions active in Sweden intend to continue providing their services. This primarily takes place via cross-border operations from another EU country. However, in some cases they will be establishing branches or Swedish subsidiaries, in particular if the firm has more extensive operations. The British firms only have a small number of non-professional customers in Sweden, which is why FI deems the impact on the range available to Swedish consumers to be insignificant. The same applies to the effect on consumer protection. For FI, it is important that consumers' interests are given priority. This means in particular that companies are required to ensure that no consumers are adversely affected and even that uncertainty about contract continuity is removed. Ultimately, it is the responsibility of legislators and supervisory authorities to protect the interests of consumers.

SWEDISH FIRMS' POTENTIAL TO OPERATE IN THE UK

Swedish financial firms that want to continue operating in the UK need, as mentioned previously, to apply for some form of authorisation from the British authorities.

The Swedish banks active in the UK have begun the process of applying for new authorisation. The British supervisory authorities have stated that they are assessing in what form and under what conditions operations shall be conducted given the business model, size, complexity and protection for depositors. Somewhat simplified, it can be said that a firm is able to operate through a branch if this fulfils the criteria drawn up by the British supervisory authority the Prudential Regulation Authority (PRA). A bank branch does not fulfil these criteria and a bank must therefore establish a subsidiary. All concerned Swedish banks have applied for authorisation and have come relatively far in this process, which is why these Swedish firms can be expected to receive their new authorisations prior to 29 March 2019.

For Swedish companies that want to be able to continue conducting insurance business in the UK, the options are either to transfer the portfolio to a British subsidiary with authorisation or to establish a branch. In general, the Swedish insurance companies affected have limited operations in the UK. Three companies state that they plan to apply to establish a branch.

The British supervisory authorities have also contacted one Swedish central counterparty about a potential new authorisation in the UK.

SUPERVISION AND DIALOGUE

FI has been in contact with several of the British financial firms that offer financial services in Sweden. The majority of these have, as is

evident above, responded that they intend to continue operating within the EU by applying for authorisation somewhere in the EU.

FI has studied the contingency plans and continuity plans of the larger Swedish banks and insurance companies. FI is also monitoring developments concerning the firms that are affected by new applications and authorisations. FI also has an ongoing dialogue with the relevant British authorities.

From the discussions that have been held with the Swedish trade associations about consumer protection, it is evident that preparations are under way, but FI's assessment is that there is a need for firms to provide more information to their customers. It has also become evident that many of the financial firms themselves are analysing and charting the consequences of Brexit. One conclusion is that there will not be that much of an impact on many operations. However, some changes are costly.

Within the European supervisory authorities, FI is also participating in the work to chart firms' preparations and in the work to harmonise the authorisation process. The question of what future cooperation agreements with British counterparts should look like is also being analysed within the supervisory authorities.

Conclusions

FI has charted the relationship between the UK and Sweden within the field of financial services. There is not deemed to be a significant impact on the range of financial services offered by British financial firms to Swedish households and business in the Swedish market. There are a number of Swedish financial firms that intend to apply for authorisation to continue operating in the UK and where the application process is deemed to be concluded prior to Brexit.

The Swedish securities market's ability to function may be affected by a hard Brexit. The consequences of the UK becoming a third country will likely be manageable as there are alternative solutions available within the EEA in many cases. And to the extent that there are no current solutions, commercial forces will create new options.

The area in which the greatest impact on Sweden may occur concerns access to clearing services for derivatives. In addition, there is uncertainty as to what applies for long contracts that run beyond Brexit; what is termed contract continuity. The latter issue is particularly important when one of the contracting parties is a consumer. These issues are not specific to Sweden, rather they should and can be solved at the EU level if it proves impossible for market participants to overcome the problems. FI is monitoring developments and will update the Ministry of Finance when necessary.

There is a risk that the preparations for a hard Brexit are generally insufficient. This risk is not specifically Swedish but rather applies to Europe in general. The current political uncertainty surrounding the Brexit agreement and an agreement on future relations and an expectation of a decision on equivalence that does not arrive is building up risks for market disturbances at the EU level in the event of a hard Brexit. Such disturbances could impair the Swedish financial market's ability to function properly. However, considering that this is a known risk factor, companies should be able to handle and counteract the consequences of any market disturbances. Ultimately, appropriate policy measures can also be implemented, primarily at the EU level. Both firms and authorities can and should maintain customary preparedness to handle financial shocks.

FI has not identified any challenges that are specific to the Swedish financial market. At this time, FI has not identified any requirements for legislative amendments other than what has already been set out in the proposal that the settlement systems in third countries could in some respects be considered equivalent to those in the EEA.[17]

Our assessment is that FI's operations will not be significantly affected as most British firms will apply for authorisation in other EU countries. An increased demand for clearing services with the Swedish central counterparty may entail an increased requirement for supervision when its significance to the Swedish financial system increases.

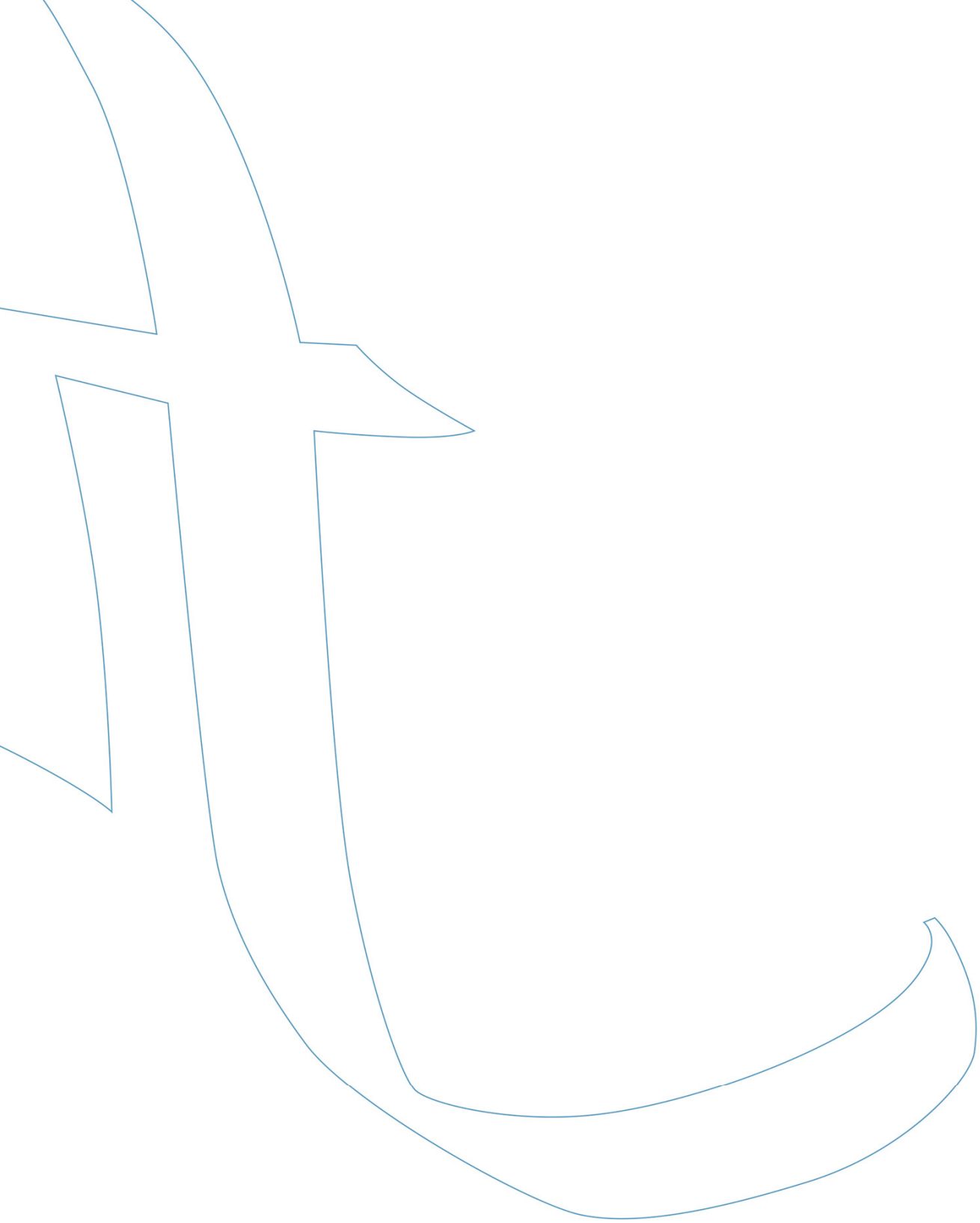
17 The Ministry of Finance's memo Avvecklingssystem som inte omfattas av EU:s regelverk (Settlement systems not encompassed by EU's regulatory framework) (ref. Fi 2018/00758/V).

GLOSSARY

AIF manager	Alternative investment fund manager
Settlement system	System for clearing and settlement of obligations to pay or deliver financial instruments
Brussels I Regulation	Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters
Captive	An insurance company that only insures risks within the group to which it belongs.
Central counterparty (CCP)	An entity that takes on counterparty risks by entering into financial transactions as the buyer for every seller and the seller for every purchaser
Clearing	Establishment of positions, including calculation of net debt, and guaranteeing that financial instruments and/or cash are available to cover the exposure these positions give rise to.
EBA	European Banking Authority
EEA	European Economic Area
E-money institution	An institution for electronic money; a firm that is authorised to issue electronic money
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories
ESMA	European Securities and Markets Authority
EU27	The European Union with 27 member states, i.e. after the UK's exit
MiFID II regulations	EU regulations on markets for financial instruments, which consist of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014

	on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU as well as Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 as well as delegated acts.
OTC derivatives	Derivatives contracts that are traded outside a trading venue
Prudential Regulation Authority (PRA)	British supervisory authority for banks, building societies, credit unions, insurance companies and investment firms
Benchmarks	A value used as reference in a financial agreement to determine, for example, amounts to be paid.
Rome I Regulation	Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations
Solvency II regulations	The common EU regulations for insurance companies, which consist of: Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) The European Commission's implementing regulations (implementing technical standards) Guidelines from the European Insurance and Occupational Pensions Authority (EIOPA)
Capital Requirements Regulation	Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit

	institutions and investment firms and amending Regulation (EU) No 648/2012
UCITS fund	Undertakings for Collective Investment in Transferable Securities. Mutual funds that are encompassed by the UCITS V Directive.



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