Box 1

Assessing the risks to the euro area financial sector from a no-deal Brexit – update following the extension of the UK's membership of the EU

The extension of the UK's membership of the EU agreed by the European Council on 10 April avoided a no-deal Brexit scenario over the FSR review period. But the risk of a no-deal scenario occurring at the end of the extension period cannot be excluded. The additional time should be used by both financial and non-financial sectors to continue to prepare for all possible contingencies, including a disorderly Brexit. Furthermore, banks should use the period in which the UK remains in the EU to make progress towards their target operating models within the timelines previously agreed with their supervisors.

A no-deal Brexit poses manageable risks to overall euro area financial stability and authorities have prepared for this scenario.[6] Action has been taken where necessary (for example, in the area of market infrastructures), and the private sector has made progress in certain areas to address Brexit-related risks. Nevertheless, there remain tail macro-financial risks whereby a no-deal Brexit interacts with other global shocks, in an environment where risks to the euro area growth outlook are tilted to the downside. If such a scenario occurs, the impact would likely be concentrated on particular countries, such as those with significant ties to the UK. This could be further amplified by any lack of preparedness among clients in the financial sector and certain key sectors of the real economy. It is also important to acknowledge that the extent of non-linear effects which might occur in such a scenario cannot be fully predicted.

The materialisation of a no-deal scenario may entail substantial financial market volatility and an increase in risk premia. Market intelligence suggests that financial market prices reflect only a low probability of a no-deal scenario, although uncertainty among market participants remains elevated in light of on-going political developments. So a no-deal outcome could lead to substantial market turbulence. On 5 March, the Bank of England and the ECB announced the activation of the currency swap arrangement for the possible provision of euro to UK banks. As part of the same agreement, the Eurosystem would also stand ready to lend pounds sterling to euro area banks. The activation marks a prudent and precautionary step by authorities to provide additional flexibility in their provision of liquidity insurance, supporting the functioning of markets that serve households and businesses.

Combined with an impact via trade channels, potential financial market shocks related to a no-deal scenario pose a material downside risk to euro area GDP growth. Beyond having an impact on euro area growth, a no-deal Brexit is also likely to precipitate an even more significant macroeconomic shock in the UK.[7] In terms of the implications of this potential macroeconomic shock for the euro area banking system, it should be noted that direct exposures to the UK only accounted for about 7% of SSM significant institutions' assets at the end of 2018. Of this, loans represent less

[6] For a wider discussion of some of the financial stability risks of a no-deal scenario, especially in relation to derivatives markets, see the box entitled "Assessing the risks to the euro area financial sector from a disruptive hard Brexit", *Financial Stability Review*, ECB, November 2018.

[7] See "EU withdrawal scenarios and monetary and financial stability", Bank of England, November 2018.

than 5% of total assets, with much of the remainder made up of derivatives contracts held with UK counterparties. At the same time, these macro-financial tail risks would likely have concentrated effects on particular countries and banks.

In relation to derivatives markets, cliff-edge risks in the area of cross-border centrally cleared derivatives have been addressed through the temporary equivalence decision of the European Commission for UK central counterparties until 30 March 2020. Issues related to uncleared derivatives are also unlikely to pose a systemic risk. In a no-deal scenario, euro area institutions will continue to be able to hedge risks through uncleared derivatives markets using non-UK counterparties – indeed, business with UK counterparties comprises less than a third of outstanding contracts held by euro area institutions. The private sector has also made some progress in addressing risks associated with the existing stock of contracts. Should market participants wish to adjust the remaining stock of contracts, there are a range of options available to them to do so. The private sector should make use of the risk mitigants available to them over the coming months to ensure that they are fully prepared for a no-deal scenario.

Financial stability risks are not expected in the area of cross-border insurance contracts. In particular, UK insurance companies servicing EEA30 policyholders have several options to mitigate any disruption and these options are being actively used by firms. As a result, the vast majority of outstanding cross-border insurance contracts are covered by credible contingency plans, with the residual contracts primarily pertaining to non-life insurers.[8]

In terms of relocation planning, the majority of authorisation procedures related to the establishment of new banks or the expansion of existing banks in the euro area have been completed. The remaining ongoing authorisation procedures are expected to be finalised before the end of October 2019. So no major disruptions in the servicing of EU clients are expected. Banks are now in the process of implementing their Brexit plans, including the transfer of capital, assets and client activities. Going forward, the ECB expects banks to build up their capabilities in the EU27 and to reach the agreed target operating models within the previously agreed timelines.

Overall, the risk that the euro area real economy would be deprived of access to financial services following the UK's departure from the EU appears limited. But macro-financial tail risks may have implications for parts of the euro area financial system. The extension period should be used by both financial and non-financial sectors to continue to prepare for all possible contingencies, including a disorderly Brexit.