

Andreas Dombret: What does Brexit mean for European banks?

Keynote speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at a conference of the Association of German Banks and the Center for Financial Studies, Goethe University Frankfurt, Frankfurt am Main, 13 July 2016.

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Introduction

Ladies and gentlemen

One of the words which were mentioned most during the last few days was “confusion”, followed by “uncertainty”. Both terms express what many people felt after the British vote to leave the European Union – which was not consistent with what experts had expected just before the event. The Brexit could certainly mark a turning point for Europe.

As Jürgen Habermas, the German philosopher, put it in the German weekly newspaper “Die ZEIT”: “I didn’t expect populism to beat capitalism in its country of origin. In view of the banking sector’s existential importance for the UK and the media and political power of the City of London, it seemed unlikely that questions surrounding identity would triumph over other interests.”¹

We were all in the financial sector somewhat confused on the morning of 24 June and probably still are, given the many unanswered questions we are now facing. The full consequences of Brexit will only become evident as time progresses – because formal relations between the United Kingdom and the EU will be decided by a negotiation process that has not yet begun. So far, a British motion to leave the European Union according to Article 50 of the Treaty of the European Union has not been made.

Only after this process has been settled will we be able to better assess the full consequences of this vote – both in economic and political terms. But people are seeking orientation and want to discuss the matter. Therefore, panel discussions such as the one being held here today are of immense value, and I wish to thank both the Association of German Banks as well as the Center for Financial Studies for their initiative.

Let me use this opportunity today to comment both on the potential economic and political consequences of the United Kingdom’s referendum decision.

Banks face immediate economic consequences

While the Brexit decision has caught most Europeans off-guard, its immediate financial consequences have materialised as predicted.

All in all, the reaction of financial markets to the Brexit news was by and large consistent with expectations. The news evidently came as a surprise, but there was no panic: The British pound came under downward pressure, as did bank shares and real estate funds with investments in the City of London or in the rest of the UK. In addition, country rating adaptations did not come out of the blue. The Euro Stoxx 50 displayed heightened volatility as the referendum day approached, but remained range-bound between market tensions earlier this year and in August of last year. Stock prices dropped sharply on the day after the referendum; however, the situation had already calmed down by the afternoon.

A closer look reveals that shares of many financial institutions have dropped strongly since the referendum, and valuations still remain significantly lower than shares of non-financial

¹ Die ZEIT, 7 July 2016, No 29, p. 37.

sectors – not just in the UK but also in the rest of the euro area. This is a sign that other, more deeply rooted structural problems prevail in the European banking sector. I will touch upon one of these issues later on in my speech.

However, most banks had taken the possibility of a Brexit sufficiently seriously and therefore made careful preparations. Supervisors had asked them to assess the risks associated with their holdings of stocks, bonds and foreign currency in good time. As such, banks were forced to make contingency plans. Thanks to stricter capital and liquidity regulations, banks are in considerably better shape today than at the outset of the global financial crisis in 2007.

In this context, I wish to pay tribute to the professional approach of the Bank of England before and after the referendum – which demonstrated excellent preparation as well as execution on its part. The ECB and other central banks, too, declared that they would stand ready to supply liquidity should the need arise. However, up to now, no provision of additional liquidity has been necessary.

All of the actions taken have certainly helped to ward off stronger financial market reactions. But this doesn't necessarily imply that the financial markets have already found their new equilibrium. Nobody can rule out further movements in prices or shifts of funds from one asset class to another. Nevertheless, one can be cautiously optimistic that – regarding the financial markets – a panic reaction to Brexit is rather unlikely at present.

Indisputably, it is to a large extent the United Kingdom that will have to bear the consequences of the referendum. Consumer confidence declined rapidly. Already in May, the Bank of England expected UK GDP growth to slow down to 2 percent in 2016 ² as a result of heightened uncertainty – new forecasts in the wake of the referendum are of course bound to paint a gloomier picture. For the EU as a whole, European ministers of finance have reduced their growth expectations by 0.2 to 0.5 percent for 2017.

In the economic growth forecasts presented by the Eurosystem, a Brexit was one of the downside risks to the projections. The impact on medium-term economic growth will depend strongly on expectations concerning the long-term economic consequences of the referendum, which in turn will hinge on the outcome of the exit negotiations. The chain of causality runs from the single market to productivity: The more restricted access to the single market becomes, the more trade will be inhibited and the more productivity will be curbed – both in the UK and the EU.

In any case, while the impact of Brexit on growth will be negative, fears of a fall in growth in the euro area by, say, 0.6 percentage point in 2017, as predicted by Consensus Economics, seem exaggerated.

Political vagueness within the reach of vision

What does the referendum result imply for the future of the pan-European financial system? In some ways, I would expect clear consequences.

Here, I refer, in particular, to the pulling power of London as a platform for European bond, derivative and forex trading. Banking supervisors take a critical view of the fact that euro activities are mainly based in London and therefore outside the euro area. This criticism has, of course, intensified since the referendum. The same can be said for clearing business and central securities depository services, at least for euro-denominated business. Supervisory authorities would need to be a lot more tolerant if this business were allowed to be conducted not just outside the euro area but outside the EU altogether. Truth be told, that's a level of tolerance I can neither imagine nor support.

² <http://www.bankofengland.co.uk/publications/Documents/speeches/2016/speech915.pdf>.

Against this backdrop, the announced merger plans of Deutsche Börse and the London Stock Exchange need to be re-evaluated. The outcome might seem bizarre at first glance, but the referendum has given positive impetus to, and even bolstered, the economic rationale behind such a merger. Once the UK has left the European Union, bridges between both economies will be more important than ever before. The announced merger of LSE and Deutsche Börse has the potential to become such a bridge.

Clearly, the Leave vote poses new challenges for the corporate governance of the merger: The parties concerned need to find a governance structure which balances all reasonable interests – even at the expense of synergies. Furthermore, I am convinced that, in the medium term, euro clearing cannot take place to the existing extent in London – Frankfurt would be the more appropriate alternative. The Referendum Commission set up by Deutsche Börse and LSE is now being put to the test in terms of its ability to work calmly, and needs to keep in mind the economic rationale of the proposed merger which has gained greater credence through the Brexit vote.

But uncertainty following the Brexit decision is much less due to economics and much more due to politics. Indeed, almost all the economic consequences are associated with political uncertainty. As we all know, economic uncertainty is a product of political uncertainty. The fact that the mechanics of leaving the EU are laid down in Article 50 of the Treaty of the European Union is well-known to most people by now, but it only governs the negotiation process without changing the complexity of its nature in any way. Clearly, the practical implications of a Brexit depend to a large extent on what will be agreed upon in Brexit negotiations.

And this is also true with respect to banks on both sides of the Channel. Many institutions have shaped their business models in accordance with the cooperative financial framework in the EU. European banks based on the continent operate in the UK market and have branches in London. The City of London is also home to a great number of non-European institutions which use the passporting regime of the EU to conduct business in any other EU country, making London a hub for the entire European banking market.

So what could happen with respect to the passporting regime once the negotiation period has ended? One thing is clear: It will very much depend on politics.

In the event that the United Kingdom decides to remain a member of the European Economic Area (EEA), not a great deal would change for banks and enterprises on both sides of the Channel. EU rules for banking supervision equally apply to members of the European Economic Area. Current supervisory powers would likewise remain unaffected.

Naturally, EU membership does not only cover free trade. It also means applying the full body of EU legislation, a key component of which is freedom of movement. On the one hand, financial institutions in London have benefited from the stream of human capital from the mainland. On the other, the negative consequences that it is claimed arise from free movement are issues that numerous “Brexiters” in the run-up to the referendum have cited as reasons why they believe the UK should leave the European Union. For some, EEA-membership is regarded as the equivalent of jumping from the frying pan into the fire. Many other forms of cooperation are therefore also imaginable, including established models such as the WTO framework.

For banks, a situation in which the UK were to become a third country would allow for a spectrum of outcomes, depending on what is negotiated. At the lower end of cooperation, an ordinary third country status would require UK banks and banks from foreign countries to obtain licenses for their branches in any given EU country. Also, working capital would be required as a basis for supervision – I may ascertain this at least with respect to Germany. This should indeed give incentives to banks from third countries to establish subsidiaries in only one EU country and in this manner avoid the need to acquire more than one license in the EU.

Even so, the ordinary third country statutes may significantly interfere with the current business models of banks. For those foreign banks that currently use their UK subsidiaries as a hub for the European market, the UK serving as a third country would compromise their business models in the EU.

Certainly, there would still be room for further bilateral agreements. Thus, German authorities could grant exemptions to foreign institutions. For banks with a British license, a more favourable supervisory treatment is conceivable. Supervision might even be performed in a manner akin to if the UK were an EEA member. But this hinges upon several requirements. Most importantly, the UK would have to follow the internationally approved canon of supervisory policies. If this were the case, EU members would want to protect themselves against any form of regulatory arbitrage. Also, this would require substantial, political willingness on both sides. However, such political goodwill might suffer if and when Brexit goes ahead. We will have to wait and observe.

Generally speaking, we cannot make reliable predictions about the future legal framework for banking across the Channel. Planning uncertainty is bound to be costly. Businesses on both sides of the Channel are unable to make any longer-term plans as long as these conditions haven't been clarified. On the other hand, location shifting takes time and encourages banks to react well ahead of political certainty. Also, it's very much up in the air whether the spell of uncertainty will be over after two years or whether the negotiating parties will have agreed, by mutual consent, to extend the negotiating period.

Moving forward with uncertainty

Ladies and gentlemen, the bottom line of my message is simple: Whatever the legal outcome of Brexit negotiations may be – it better be arranged swiftly. For banks, as for the economy as a whole, any uncertainty should be kept to the very minimum.

In the course of negotiations, both sides will probably be keen to maintain the existing trade links. But, at the same time, there should be no doubt that the EU should resist any efforts by the UK to cherry-pick the most beneficial terms. So, in all likelihood, individual arrangements granting access to the EU markets won't be possible without concessions being made.

While negotiations have not even started, there are some definite conclusions to be drawn from the referendum result:

- Financial institutions have to prepare for a scenario in which euro-denominated trading and clearing is unlikely to have a future outside the EU.
- Regarding the merger between Deutsche Börse and London Stock Exchange, the referendum outcome has even strengthened the economic rationale. But in order to reap the benefits, contracting partners should now invest in a well-balanced governance structure.
- Financial actors in Europe have so far succeeded in digesting the somewhat surprising referendum result. Even ongoing volatility should not serve as an excuse to bypass the pillars of financial stability we have only just set up in the EU.

Please let me shortly expand on this last, but important point. I am referring, in particular, to the challenge of actually making investors in banks liable in case of a bank failure, a concept also known as "bail-in". For that purpose, a codified bail-in mechanism now exists, which has been fully operational since the beginning of this year. If we allow states to provide discretionary aid to their banks, this impedes a core element of the bail-in regime, namely its credibility.

If the bail-in mechanism were to be exposed or even dismantled, markets would no longer exert their disciplinary function. The management of banks will always be likely to maintain a safety buffer over and above supervisory capital requirements as they face resolution in case of falling short of these requirements. If bank supervisors were to observe the dismantling of

the bail-in mechanism, I am convinced the logical and necessary consequence would be for supervisors to raise capital requirements so as to compensate for the lack of market discipline.

In face of the Brexit referendum and the critical attitudes expressed towards EU governance, making our rules more trustworthy should be of even greater concern. The Brexit vote must under no circumstances serve as an excuse to delay reforms or even undo achievements in European integration. Instead, the EU should listen to this wake-up call and react appropriately.

Please allow me one last, and personal, remark: I -probably speaking for most, if not for all of my German colleagues – will greatly miss our British counterparts in European institutions; not at least because of their orientation towards stability and free market economy. But, fortunately, as central bankers, we will continue our collaboration at many other levels such as the G7, the G20, the IMF and the BIS.