

Andreas Dombret: The possible impact of Brexit on the financial landscape

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at zeb (consultancy for financial services), London, 24 February 2017.

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1 Introduction

Ladies and gentlemen,

Good morning. I hope that you enjoyed the breakfast buffet. I am sure that what one says about the quality of breakfast in England is not true here at the new zeb office. Now that you have started the day energised after a good meal, I want to provide you with some thoughts on a most topical issue – something else to chew on, so to speak.

I am talking, of course, about Brexit. Even though this is by no means a new issue, and the element of surprise that it had in June last year has vanished, it still attracts tremendous attention. After all, it is what made all of us gather here today.

And there are many reasons why Brexit is still attracting so much attention. Among them are the profound impact it might have on the world we live in, and the intense uncertainty surrounding its precise effects. This combination of significance and uncertainty makes Brexit a topic well suited for speculation about what might happen. And if you have followed the topic closely, you have probably noticed different and even opposing statements on the same question.

But speculation doesn't help. What makes more sense is scenario-based thinking. Today, I will try to set some things straight – at least regarding the financial sector. The first part of my remarks will therefore cover the potential impact of the Brexit on the financial sector. In the second part, I will look at the bigger picture and share with you my expectations for the negotiations as well as my thoughts on the future of regulation and supervision in the EU and the UK.

2 The possible impact of the Brexit on the financial landscape

Let's start with the potential impact of the Brexit on the financial landscape. First and foremost, this means talking about market access. We should not forget that this is a two-way street, and so I will talk about market access in both directions. But the centre of attention is certainly on market access for UK based financial institutions to the EU, as this potentially has the largest impact for banks and other financial institutions. It affects all institutions, both from the UK and the rest of the world, which currently use London as a hub for their continental European business.

The debate on market access was transformed in mid-January. Prime Minister May made it clear that the UK is looking for a clean break from the EU's single market. For the financial industry, this means that the current model of using London as a gateway to Europe is likely to end. Banks from third countries need a licensed entity inside the European Economic Area to gain access to the whole area, known as "passporting". Shortly before the Prime Minister's speech, CityUK already dropped demands for maintaining access through passports.

Instead, many are now hoping for an equivalence decision to fill the gap left by passporting rights. If the European Commission deems the regulatory and supervisory regime in the UK to be equivalent to that in the EU, market access would be partly retained. However, I am rather sceptical about whether equivalence decisions – may they be likely or not – offer a sound footing for long-term location decisions of banks. Equivalence is truly different from single market

access.

There are three major drawbacks to equivalence decisions. First, they only cover the wholesale business of banks. Second, given the fact that banks need time to build up a new entity elsewhere, an equivalence decision would have to be taken quite soon to actually have a bearing on the location decisions of banks. Third, equivalence decisions are reversible, so banks would be forced to adjust to a new environment in the event that supervisory frameworks are no longer deemed equivalent. These drawbacks lead me to the overall conclusion that equivalence decisions are not a reliable substitute for passporting.

So it seems that the prospects for EU market access through the UK look rather dim. To ease the pressure on financial institutions, a transition period could help. It would reduce risks and increase planning security for banks, which would be economically beneficial. Furthermore, it could support a smooth relocation process by taking pressure off both supervisors and banks, for example by making "first mover advantages" less important. This being said, transition periods would be a politically sensitive topic in the negotiations, and it is unclear how likely such an agreement might be.

As mentioned earlier, we should not forget about the access of European banks to the UK, which is also an important issue. For German banks, for example, the UK is the second-most important foreign market, right after the US. It will be up to the UK Prudential Regulation Authority to decide under what circumstances European banks can retain access to the UK. Whether the UK would be prepared to unilaterally grant access for EU financial institutions in order to retain the attractiveness of London as a financial centre, remains an open question. And let me add that it is of course not regulation alone that plays a role when European banks decide on opening a branch or a subsidiary in the UK. It is also a question of what kind of entity their counterparties and clients want to do business with.

Let me summarise the prospects for market access, at least from my point of view. Continued passporting rights are rather unlikely, and an equivalence decision would be a somewhat imperfect substitute. A transition period could ease some of the pressure, but it clearly is a sensitive issue.

Could a free trade agreement be the solution? According to their Brexit white paper, the UK government will strive for an ambitious free trade agreement with the EU as a long-term solution. But regardless of the fact that negotiating comprehensive free trade agreements is an arduous and time-consuming task, financial services are an especially tricky area. So far, the EU has never fully integrated finance in its free trade agreements with third countries.

Where does this lead us? So far, while acknowledging and accepting the divorce, policymakers are trying to find ways to hold the UK and EU economic areas and jurisdictions together. And they will continue trying so. The reason is that most of us are convinced that harmonised rules eliminate unnecessary frictions and act as a powerful catalyst for business across national borders – for the real economy as well as the financial sector. However, looking at the facts that I've just laid out we also have to acknowledge that it is at least questionable whether this undertaking will be easily achieved. Financial institutions should take into consideration that, in the end, there might well be two separate jurisdictions in which they operate, and that these jurisdictions might diverge over time – or instantly, once the divorce has gone through.

3 Whether and where to move

As a consequence, many banks are now considering moving some of their activities to the EU. First, let me say that I expect London to remain an eminent global financial centre. Nevertheless, I also expect a number of UK-based market participants to move at least some business units in order to hedge against all possible outcomes of the negotiations.

The question that is causing some excitement is: Where will banks go? As a supervisor, my main concern is that banks are supervised according to standards that are both high and consistent. This is best ensured within the SSM area. This also means that I will not promote any particular financial centre. That said, I am open to dialogue with financial institutions in assessing the conditions for moving business units to Germany. And I go as far as to say that – in many respects – these conditions are attractive.

Numerous major market participants have already contacted the German Federal Financial Supervisory Authority BaFin and Bundesbank. We respond to such requests pragmatically. That is, we provide financial institutions with quick and reliable guidance and aid a smooth transition if one of them decides to move business units to the continent. Three weeks ago, BaFin has hosted a workshop for representatives of foreign banks covering all questions surrounding Brexit. And just this Wednesday, Bundesbank has launched a website on the topic, providing information as well as contact details for banks assessing to move part of their business to Germany.

Of course, we also emphasise the requirements for establishing a licensed entity there. For example, this means that we will not accept any empty shells or “letterbox companies” where the business effectively continues to be done out of London. For critical functions such as management, controlling and compliance, qualified personnel need to be present at the non-UK EU subsidiary at all times. And I urge banks not to spend their time inventing strategies to circumvent these requirements. This includes seemingly creative solutions such as “fly-and-drive” banking, where bankers fly in daily from London, or “dual hatting”, where transactions are booked on the EU subsidiary but in fact executed in London.

To summarise: As important as outsourcing strategies will understandably be when banks restructure their business to adjust to the new environment, it has its limits, and we expect any branch or subsidiary to retain chief responsibility for its business.

4 What to expect, and how to prepare

I trust that the vast majority of financial institutions are aware of the many question marks hanging over market access, and that they are assessing their implications. But they should not focus solely on the obvious. Financial institutions need to systematically think through what effects Brexit could have on each of their areas of operations. For example, banks should check what Brexit might mean for covenants, or how it could affect the handling of margin calls.

I said earlier that scenario-based thinking is called for. However, assessing the likelihood of different scenarios is not an easy task by any means. Brexit negotiations will be highly political, and the political debate is already becoming extremely tense. If policymakers on both sides agree on one thing, it's that arranging the divorce between the UK and the EU is going to be very hard. European Commission President Juncker expects the negotiations to be “very, very, very difficult”, and UK's Brexit Secretary Davis predicts they will become the “most complicated” negotiations of all time.

While as a central banker I don't tend to use such dramatic words, the two gentlemen do have a point. European leaders see the bloc as being in an existential crisis and have made it clear that the future unity of the EU 27 is the highest priority, which includes the inseparability of the four freedoms. The UK, on the other hand, aims at regaining control of law-making, the public budget and immigration. With these priorities, the UK government wants to do justice to Brexit voters. According to surveys, the voters put the economy only in third place after sovereignty and immigration when making their decision.

So while economic policy will of course be an important topic during negotiations, we should not count on economic sanity being the main guiding principle. And that means we also have to factor in the possibility that the UK will leave the bloc in 2019 without an exit package, let alone

the sweeping trade accord it is seeking. The fact that this scenario would most probably hurt economic activity considerably on both sides of the Channel will not necessarily prevent it from happening.

5 Regulation and supervision

Ladies and gentlemen, I have laid out my thoughts on the effects of Brexit on the financial world and have shared my views on what mechanisms will steer negotiations. I want to dedicate the remainder of my remarks to regulation and supervision in the light of Brexit.

My main message here is that we must avoid a regulatory race to the bottom at all costs. Given how the Brexit debate developed early this year, this warning is not at all an empty one. A financial centre strategy comprised, among other ingredients, of very low corporate taxes and lax regulation has already been mentioned in the UK as a fall back option for London. And in January, Chancellor of the Exchequer Philip Hammond made it clear that the UK would "do whatever [it has] to do" to regain competitiveness.

Regulation and supervision in the UK have been both highly professional and stability-oriented in the past. I strongly hope that supervisors here will be able to keep up this good work and turn a blind eye to demands for deregulation and lax supervision. The current regulatory and supervisory standards we have set together are an important lesson from the financial crisis and it would be a mistake to roll them back. I am convinced that in the long run, well-capitalised and strictly supervised financial systems are the most successful ones.

To be clear, my call to refrain from using regulation or supervision for the sake of increasing one's competitiveness is equally addressed to the EU. There might be a certain temptation to use Brexit as a chance to strengthen financial centres across the rest of Europe, for example by offering discounts with respect to licensing procedures. This is not a route we should take, and I am confident that the strong role and far-reaching competences of the SSM, including the ECB's responsibility in licensing, will forestall such ideas becoming reality.

While I am serious about my warning of lax rules and supervision, I am cautiously optimistic that we can prevent this scenario from materialising. And this is because I know my colleagues in London very well, and I know that they share my views on this issue. Our cooperation with the UK Prudential Regulation Authority has been exemplary in the past, and we will invest all our efforts in continuing this partnership in the future.

Now, more than ever, we should also harness our relationship to work together closely during Brexit. Information sharing needs to be an important part of this. For example, when European authorities examine the risk models of banks wishing to establish a subsidiary on the continent, we would benefit from knowing what the PRA found in their previous assessment. This includes at what time the PRA last examined the model, under what assumptions, and to what verdict it came. Conversely, we are open to sharing all necessary information that the PRA might need to process applications by EU banks to operate in the UK.

The guiding principle of our cooperation should be to ensure a smooth transition to a post-Brexit world. As supervisors with the necessary distance from political haggling, we can make a substantial contribution by providing pragmatic and efficient solutions. In parallel, I believe that European and UK supervisors should fathom out how we can put our future cooperation on a more formal footing.

6 Closing remarks

Ladies and gentlemen, let me summarize. The financial landscape will change, and we cannot know how. While I have outlined some things to expect and some not to expect, uncertainty will persist for quite some time. The task for financial institutions is to deal with the uncertainty

surrounding Brexit as efficiently as possible.

As regards the course of the negotiations, we should bear in mind that economic rationale might not be the main guiding principle – and will certainly not be the only one. This means that companies have to factor in the possibility that the final deal will not prioritise the economy – or that, in a negative scenario, both sides might not agree on any deal at all.

But whatever happens in terms of our future relations, it is vital to remember that lax financial rules have often paved the route to failure. The outcome became painfully apparent in the financial crisis that erupted just under a decade ago, and its costs are still being felt. None of us wants to see such events again any time soon. And preserving the progress we have made in increasing the resilience of financial institutions is the only way to ensure this.

Thank you for your attention.