Philip R Lane: European financial integration – implications of Brexit

Remarks by Mr Philip R Lane, Governor of the Central Bank of Ireland, at Barclays European Financial Capital Summit, London, 28 March 2017.

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Good afternoon. It is a pleasure to have the opportunity to address this conference, especially at a time when the future of the European financial system is the subject of so much discussion and debate. In my remarks, I will first discuss some of the main issues in this debate before turning to a brief description of the regulatory perspective of the Central Bank of Ireland on Brexit.

In addition to generating myriad practical and logistical challenges, the impending EU-UK negotiations also pose an intellectual challenge in terms of thinking about the nature of international financial integration and international financial regulation in post-Brexit Europe. In particular, it forces all participants to think hard about the differences between a single market in financial services versus cross-border financial trade between distinct jurisdictions.

To add a further layer of complexity, the appropriate analytical framework also should recognise the incomplete nature of the single market in financial services, with banking union and capital markets union in Europe at varying stages of development and differences in supervisory systems across banks, non-bank intermediaries and financial markets. In addition, it is essential to recognise that the European financial system is not a closed loop but is extensively integrated with the wider global financial system.

In addition to the long-standing interconnections between the US and European financial systems, the increasing share of emerging economies in world GDP and world financial assets means that extent and nature of financial trade between the UK and the EU in part depends on alternative global configurations, with trade diversion as well as trade destruction part of the potential fallout from barriers to financial trade between the UK and the EU. The interconnections between asset categories (including across different currencies) as well as between different types of financial intermediaries mean that a holistic perspective in required in evaluating alternative trading arrangements in the post-Brexit environment.

In assessing the implications of the new organisational configurations that will be triggered by Brexit, the lessons from the global financial crisis remain fresh in the minds of the international regulatory community. In particular, the importance of a stringent approach to prudential supervision is widely accepted, such that the post-Brexit evolution of the European financial system cannot involve any dilution in the capacity of supervisors to ensure effective regulation of international financial firms, in relation both to firm-specific and systemic risk.

Similarly, it is essential that regulatory authorities and central banks have sufficient oversight of the operation of financial markets and financial market infrastructures in order to be able to monitor and interpret market shocks and adequately evaluate the desirability of any intervention policies during periods of market distress. Accordingly, an important criterion in assessing the stability of a reconfigured European financial system will be the implications for crisis prevention and crisis management policies. In parallel, it is also essential that there are credible recovery and resolution plans for newly-reconfigured financial entities.

As financial firms work out strategies to manage the implication of Brexit, it is important for the policy community to ensure that regulatory arbitrage does not play a material role. This applies in relation to locational choices and also in relation to options in terms of organisational structures.

In relation to the former consideration, the role of the Single Supervisory Mechanism in bank supervision ensures that a level playing field will apply in relation to banks. Although there is more national autonomy in relation to other types of financial intermediaries and market infrastructures, national regulators operate within the broad framework of the European System of Financial Supervision and there is significant (if incomplete) convergence in supervisory approaches across member states. With a broadly-similar regulatory framework across member states within the EU, the primary focus of firms in relation to Brexit planning should be on non-regulatory geographical criteria such as the existence of local clusters of financial expertise, legal systems, the availability of a skilled workforce, the quality of relevant infrastructure, cost factors and related considerations.

In relation to the latter consideration, it is worth highlighting the points made by ECB Executive Board member and Vice-Chair of the Supervisory Board of the SSM Sabine Lautenschläger in some recent speeches.[1] In particular, she noted that the banks under SSM supervision will be closely monitored in relation to the risks that result from different group structures and from relations between different entities of the same group. She also raised the possibility that EU regulations might need to be adapted so that the largest investment firms are supervised in the same way as banks. In addition, she underlined the importance of sufficient local staff, sufficient local risk management and operational independence. Finally, it is essential that the resolvability of the euro area entity is demonstrable.

Taken together, these points suggest that the European regulatory system will suitably evolve in order to ensure that Brexit-induced corporate reorganisations do not compromise the ability of supervisors to hold firms to account in terms of regulatory expectations and maintain financial stability in an effective manner.

Of course, the ultimate impact of Brexit will depend on the outcome of the negotiations between the EU and the UK. In addition to obtaining clarification on the nature of the new steady-state framework for trade in financial services between the EU and the U.K., it will also be important to specify transition arrangements, especially given the long-term nature of many financial contracts. It follows that the provisional Brexit plans that are currently being formulated may have to be revised over time, if the course of these negotiations take unexpected twists. The value of optionality is high in the current environment: as the negotiations unfold, some options will lose value, while others will gain.

Accordingly, both firms and regulators will need to be pragmatic in recognising the inevitability of periodic revisions to business plans during this phase and the importance of a transitional period to avoid potentially-disruptive cliff effects in the workings of the financial system. The recent speeches by Sabine Lautenschläger have described some of the guiding principles in the context of transitioning of firms, for example in relation to the conditional use of existing internal models.

Finally, turning to the regulatory approach of the Central Bank of Ireland, we have adopted a consistent position in relation to Brexit-related supervisory queries. Our regulatory approach is in line with sound practices being agreed across Europe; our responsibility is to ensure that firms authorised to operate from Ireland demonstrate compliance with EU requirements. To this end, we seek to ensure that an entity will be substantively run from Ireland and that the setup permits effective supervision, with local management accountable for decision making.[2] From a supervisory perspective, it is simply not sustainable to entertain proposals that fall short of these basic requirements.

We are committed to providing transparency, consistency and predictability in our regulatory decisions. Since Ireland is already home to a large-scale international financial services centre, we have considerable experience in dealing with authorisation of financial firms. We are setting up new teams in order to manage Brexit-related authorisation queries across banking, insurance, investment firms, investment funds and financial market infrastructures. This is part of a broader initiative to expand staffing levels in the Bank in view of the expansion of our mandate in recent years, the increase in the size of the international financial services sector and the implementation of our pro-active supervision and inspections model.

A substantial proportion of Brexit-related queries at this stage relate to a further scaling up of already-sizeable lines of activity or an expansion of the range of activities of currently-licensed financial entities. That said, Ireland is likely to become a host to new categories of financial services. Accordingly, we stand ready to expand our range of supervisory activity as required, in close collaboration with our international regulatory colleagues within the European System of Financial Supervision.

Thank you for your attention.

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1 "The European Banking Sector – Growing Together and Growing Apart," LSE, 2nd March 2017; "Caution Should be the Life of Banking," AFME Board of Directors, 22nd March 2017.

2 For an extensive description of our approach to authorisations, see Gerry Cross, "Responding to the Post-Brexit Environment," Finance Dublin, January 2017.