Andreas Dombret: The future relationship between Germany and the UK in finance after Brexit

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at UK Finance, London, 8 February 2018.

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1. Introduction

Ladies and gentlemen

Thank you for your kind introduction, and thank you for the invitation to talk about financial services after Brexit.

Although I am in London to talk about finance issues, I have to confess that the United Kingdom, and especially London, has always been much more to me than just business. This is the birthplace of the industrial revolution and the modern market economy – and the centre of the first wave of globalisation in the 19th century. And this great country and this wonderful city are where the future is made: a place of rare art and cultural diversity and of economic dynamism and innovation. So I am more than happy to be here with you today.

When I read the news of the Brexit vote, I was shocked. As I looked at the news, I simply couldn't believe it. I imagine I was not the only one among us.

It's needless to say that I respect the decision. Yet I am convinced that the UK and the EU going separate ways will be a tremendous loss for both sides.[1]

And that's why the state of shock had to be just a very brief moment. We all have to do our best during the coming months to find pragmatic ways to establish a new, respectful, and friendly partnership.

Today, I will talk about the formal aspects of this future partnership in the realm of finance. However, formalities alone will not make for a partnership founded on mutual trust and amity. What is equally important is the direct involvement of citizens and businesses – because, in the end, this is what underscores friendship and economic partnership. That is why this visit here today is so important to me.

I will start by outlining where we are in the talks about a future agreement and will then discuss the odds of something more than no deal happening. Given that a "no deal" on financial services is – like it or not – a realistic outcome, I will then discuss what pragmatic approaches to this new reality are feasible from my point of view.

2. Where we are: The debate on financial services

Since the leave vote in June 2016, we have seen a steady decline in expectations of how close economic integration between the UK and the EU27 will be after Brexit.

Against this background, it was positive that in December of last year the EU27 and the UK reached broad agreement on the three fundamental divorce issues.[2] After this preliminary settlement, we can now talk about the future model of cooperation and integration. This has improved the chances of reaching a reasonable settlement before the March 2019 deadline. The plan is to have a political declaration on what the future partnership will look like by October this year; at the same time negotiation parties should have a draft withdrawal treaty ready.

But we should make no mistake: in light of the fact that the goals of the UK government are yet unclear to me and in light of the not fully unified positions within Whitehall, such an agreement is anything but a sure thing. First of all, we have to keep in mind that substantial progress has yet to be made on the details of the three separation issues I have just mentioned. Second, a sufficient transition period is not assured at the moment, either. And finally, even the no deal scenario remains possible in light of the fundamental differences between the negotiation blocs.

So what are the implications? What they have been since the beginning: the private sector and authorities have to prepare for a no deal scenario starting March 2019. I will come back to what this means for the financial sector.

But, let's remain at once realistic and optimistic. There is still at least a 50 percent chance of avoiding a "no deal" scenario. So let's think about what this would mean for financial services. Would they be part of an overall deal? And if yes, what would that deal look like?

Like with the overall negotiation, for financial services we have also seen a steady decline in expectations of how deep the integration will be after Brexit. It quickly fell from remaining part of the single market and passporting to the approach of equivalence in supervisory regimes, on the basis of which access could have been granted. The next step down the stairway of expectations was mutual recognition, at least in selected areas – or alignment and mutual recognition, as UK Finance has proposed.[3]

Yet I am sceptical as to whether such a mutual recognition framework is actually possible. Moreover, a future agreement may very well be quite limited – for example, to the exchange of goods. Labour migration is likely to be excluded; at least, this has been mentioned as a red line for the UK government. And free trade in services also seems less and less likely. To quote the negotiator for the EU, Michel Barnier: "There is no place [for financial services]. There is not a single trade agreement that is open to financial services. It doesn't exist […]."[4]

3. Facing difficult realities: The "no deal" scenario

Thus, it is not that unlikely that there will be no free trade agreement for financial services – or other services sectors, for that matter.

What would that mean for financial transactions between the UKand the EU? It would mean that the EU and the UK would trade under rules set by the World Trade Organization – where services sectors are only thinly covered.

Service providers would then have to apply for comprehensive licenses in both jurisdictions and have all the necessary elements of a fully functioning bank ready in both places.

I am very much aware that this sounds like a worst case scenario. And I very much do understand that. We are coming from a highly comfortable position: the single market and the passporting rights allow free trade in services without much legal and regulatory friction. After more than two decades of this freedom we have gotten used to it; it has become our point of reference in debates and for policy proposals.

But it is time to face the facts. The point of reference has changed since the Brexit vote. Where it was the single market and passporting, it is now trade agreements with third countries that do not accept the EU's legal jurisdiction – we all know Mr Barnier's stairway to Brexit.[5] In these arrangements, the free exchange of workers and services tends to be very limited.

It is imperative to accept this new political point of reference, because the old one has somewhat lost democratic legitimacy.

Yes, this is inconvenient and it creates frictions. However, if we take a broader historical perspective, we can see that – in the past – full integration has not been a necessary condition for vibrant international economic exchange. Innovation, growth, and close economic ties are possible even in a world where firms have to adhere to different sets of rules in different countries. This competition of rulesets may even foster institutional innovation and diversity and may contribute to stability.

Rather than clinging to an almost somewhat anachronistic point of reference, we must explore new approaches. And that is why we need constructive proposals from all sides, including the industry.

UK Finance has tabled a proposal as well, and I welcome the effort. Yet I am sceptical as to whether the mutual recognition framework proposed is actually 100 percent feasible. By giving substantial powers to technical cooperative committees of supervisors, it would most likely undermine national sovereignty and democratic legitimacy – thereby crossing the UK's red lines and also infuriating those critical of the EU for undermining national parliaments. A particularly problematic example is the idea that any agreement would need to ensure that this agreement is a baseline for the future, meaning that a country could not "impose more restrictive terms than those applicable at the time the framework is agreed."[6] It is not obvious to me that this would be efficient.

The substantial effort necessary to make this technical, cooperative arrangement work may outweigh the benefits to society. In the end, the effort put into keeping such an arrangement alive might be better invested in making sure that we make the licensing procedures as smooth as possible.

At the end of the day, the decision about the future for financial services will be a political one. But, in any case, it is important that we all work together to find pragmatic solutions under any kind of framework. And a lot of difficult tasks lie ahead of us – for financial firms as well as for central banks and supervisors.

4. Transition phase to the rescue?

In light of these tremendous tasks, many firms and officials seem to be counting on a transition phase that could provide some breathing space for businesses and give them more time for their preparations. Talks about such a phase have just started: last week the EU's chief negotiator Michel Barnier has received directives reflecting the stance of the EU27 on a potential transition phase until the end of 2020. Roughly eight weeks are scheduled for the talks about transition in total, so that an agreement on transition could be reached by March and talks about future relations can take centre stage thereafter.

Many businesses are holding out high hopes that a transition phase will give them certainty on the shape of relations between the UK and the EU, at least until year-end 2020. Some observers seem quite confident that there will be a transition phase. But a number of potential stumbling blocks remain. For one thing, while there would certainly be economic merits to such an arrangement, it's politically tricky to design.

Furthermore, a vague, in-principle political agreement on transition wouldn't tell you too much and would be very fragile. But even if both sides managed to reach a consensus on a detailed legal text by March, this would still only be a preliminary part of the greater deal. Both sides would still have to reach an overall divorce deal, roughly by October of this year. If this endeavour fails or if parliaments don't subsequently ratify the deal, the transition period would be off the table, too. Put bluntly: a deal on the transition phase hinges on an agreement on the overall future relationship – if the UK and the EU can reach a deal on the end state of the future partnership, I am confident it will be easier to find a suitable solution for the transition phase.

The point is: Even if one is cautiously optimistic that a transition phase can be agreed upon – which I continue to be – it still wouldn't give businesses the certainty they crave. Just this

Monday, Mario Draghi has underlined in the European Parliament that political uncertainty will remain for quite some time to come. The transition phase is not a safety net.

5. Acknowledging realities: timely preparation is key

This is why I see no alternative to timely preparation. This holds for all businesses affected, and it holds for the financial sector in particular. Financial institutions should not fall prey to a false sense of certainty that, come what may, there will be an agreement and that they will have sufficient time left to adapt to the new framework. The economic consequences of insufficient preparation in the event of a hard Brexit would far exceed the costs of proper preparation.

Looking at banks, proper preparation includes establishing at least basic entities in the other economic area – that is, the EU27 or the UK – in order to continue doing business there. The concept of a “basic entity” is not easy to define. From our side, I can repeat that we will certainly not accept empty shells or “letterbox companies” where the business effectively continues to be run from London. For critical functions such as management, controlling and compliance, qualified personnel need to be present at the EU entity at all times. We expect any branch or subsidiary to retain chief responsibility for its business.

That is our general approach. When it comes to the details, things get much more complicated very quickly – as has been demonstrated by our experience with the applications of banks for licenses in the context of Brexit. It is not enough to make a decision about what business to move and to submit a ten-page application for a banking license to the supervisor. In reality, it is quite common that applications are changed and amended during the process as a result of ongoing discussions between the supervisor and the applying bank or due to the applying bank having a change of heart due to the emergence of new information.

This should by no means come as a surprise. In many ways, both banks and supervisors are in new territory here. And not only businesses have got their hands full managing the fallout from Brexit, supervisors do, too. In normal times, the European Single Supervisory Mechanism issues about 10 licenses for credit institutions under the Capital Requirements Regulation (CRR) per year, plus a couple of licenses issued nationally for entities such as securities trading banks. But in the context of Brexit, we are looking at more than 100 financial institutions – many of which are highly significant and complex institutions – currently operating out of the UK that potentially need a new or modified license in the EU.

Therefore, we have increased our resources both in the European banking supervision and in the national supervisory authorities. However, our capacities are obviously finite. Should there be a flood of applications at the very last minute, we cannot guarantee that we will be able to prevent capacity constraints that could prolong the application process.

Therefore, I strongly advise banks not to slow down in their preparatory efforts because of a vague possibility of a transitional period. The first quarter of this year has been named by many in the financial industry as a point of no return for pushing the button on their Brexit contingency plans. In my view, this is still a fair estimate. Those who do not complete their plans and start implementing them by March this year risk being left high and dry by Brexit one year later.

To be clear, this also applies to German and other European institutions that operate in the UK. We have learned that there are institutions that have not yet approached the PRA even though they want to maintain their UK business after Brexit.

6. What can bank supervisors do?

Some have voiced the concern that warnings from European officials towards businesses, including financial institutions, currently operating out of the UK to prepare for a hard Brexit could be an attempt to lure business and jobs to the EU27. I want to make crystal clear that this is not our intention. From the day after the referendum I have repeatedly emphasized that we are not the marketing agency for the city of Frankfurt – or any other European financial centre, for that matter. We are supervisors interested in the stability and smooth functioning of the financial sector. And as long as there is no deal on future relations, no divorce deal and not even a reliable and consistent declaration of intent, we have no other choice than to warn financial institutions of the risk of being caught unprepared. This would not be in the interest of either the EU or the UK.

Whatever political decision is taken, bank supervisors will not only do all they can to make the transition to a new regime as smooth as possible; they will also, in the long run, try to reduce unnecessary inefficiencies where possible.

In December last year, the PRA published a draft proposal for a post-Brexit supervisory approach. I very much appreciate the spirit behind this approach. It reflects a solution-oriented, pragmatic, yet stability-oriented approach. In the same vain, the SSM has developed quite pragmatic, cooperative "policy stances" on many of the relevant issues. I am confident that this cooperative style can be an important contribution towards a smooth transition.

7. Conclusion

Ladies and gentlemen, the point of reference for future regulatory alignment has changed since the Brexit vote. It used to be the single market and passporting; now it is trade agreements with third countries that do not accept the EU's legal jurisdiction. The free exchange of workers and services will tend to be very limited under these scenarios.

It is imperative to accept this new political point of reference, because the old one has somewhat lost its democratic legitimacy.

The tasks that come with this new reality are unchartered territory for all of us. But, irrespective of the framework, it is important that we work together to find pragmatic solutions that sustain the strong links between our economies and financial sectors.

I am confident that, even without a financial services agreement, our economies and financial sectors will remain closely integrated. Furthermore, I am confident – and glad, even – that Germany and the UK will maintain their long tradition of partnership based on close cooperation and mutual trust.

Thank you for your attention.

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[1] A Dombret (2016) Opt-in or opt-out? The future of the European Union in light of the UK referendum. Speech delivered at the Atlantik-Brücke, Hamburg, 23 June 2016.

[2] The rights of EU citizens in the UK after Brexit (and vice versa), the border between the Republic of Ireland and Northern Ireland, and the UK's financial contributions to the EU budget over the coming years.

[3] UK Finance (2017) Supporting Europe's economies and citizens. A modern approach to financial services in an EU-UK trade agreement. September 2017.

[4] Interview with the Guardian on 18 December 2017; www.theguardian.com/politics/2017/dec/18/uk-cannot-have-a-special-deal-for-the-city-says-eu-brexit-negotiator-barnier; accessed on 23 January 2018.

[5] Reuters (2017) Stairway to Brexit: Barnier maps out UK's Canadian path. 19. December 2017. Available at uk.reuters.com/article/uk-britain-eu-options/stairway-to-brexit-barnier-maps-out-uks-canadian-path-idUKKBN1ED23R, last accessed 31 January 2018.

[6] UK Finance (2017) Supporting Europe's Economies and Citizens. A modern approach to financial services in an EU-UKtrade agreement. September 2017, p. 12.