Andreas Dombret: Living with fragmentation – post-Brexit realities in financial services

Keynote speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the AIMA Global Policy and Regulatory Forum, Dublin, 20 March 2018.

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1 Introduction

Ladies and gentlemen

Thank you for the kind introduction. It is a pleasure to be in Dublin and at the 2018 AIMA Forum.

"Managing a fragmented world" is, in my view, a well-chosen topic. Most economic policymakers currently have their hands full trying to escape the doom loop of a trade war and a potentially hard Brexit. At the same time, banks, investors and most other firms have to prepare for these worst-case scenarios – not least, because supervisors urge them to.

And of course such fragmentation in financial services and its regulation may cause nightmares for many in the industry as well as for policymakers. And I do understand that – because it implies a great deal of uncertainty.

But we should not, I believe, panic: greater fragmentation seems inevitable after Brexit. Though, repercussions will not be as bad, as some fear, when we succeed in managing this greater fragmentation constructively – that means without resorting to nationalism that would just be destructive for all of us.

My topic today, then, is to look at the estimated extent of fragmentation in regulation of financial services after Brexit and what we should do about it.

2 Brexit and financial services

In Brexit negotiations common ground still seems hard to find. Even the basic principles of a new partnership remain vague. Given that and because time for preparation is running out for firms, uncertainty among businesses weighs heavier every day.

From an economic and financial market perspective, the two most important questions probably are:

- Will there be a free trade or a comparable agreement?
- Would a possible free trade agreement also include financial services?

In my view, there is substantial scope for a general free trade agreement. The main question to me is therefore how far-reaching can this future relationship be. For example an agreement without tariffs would be of high value and is possible. Another, less clear and highly complicated question is how to deal with non-tariff barriers like product standard regulations.

However, with a view to the financial services sector, a far-reaching free trade agreement is rather unlikely given the UK's aspired exit from the single market and the customs union.

Likewise, I am rather sceptical about the approach via mutual recognition or about similar approaches based on regulatory harmonisation through technical committees and independent arbitration mechanisms.

Approaches of this kind could well undermine the ability of jurisdictions to set their own rules and the ability to safeguard financial stability.

The options that remain on the table are a “no deal” scenario or one with quite limited freedoms for financial services, as in the case of CETA.[1] What would such scenarios mean to financial transactions between the UK and the EU?

First, the “no deal” scenario 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.

And second, even a CETA-like deal would most likely not mean far-ranging freedoms to provide financial services in the respective foreign jurisdiction.

3 Living with fragmentation

Therefore, it is – like it or not – quite likely that we will see greater fragmentation in financial regulation and supervision in Europe. What exactly that will mean is, however, unclear up to now.

It is this uncertainty about the exact nature of fragmentation post-Brexit that makes it so hard to assess the costs and benefits of more fragmentation.

Financial firms highlight that fragmentation is likely to mean organisational inefficiencies and higher organisational costs. And there can be no doubt that at least the transition to a new regime and new organisational structure will be costly. However, these costs may be less substantial in the long term – once firms have adapted to the new regime, clever managers will find new organisational solutions that integrate new compliance realities with organisational efficiencies.

Significant as these costs may be, politicians, regulators, and supervisors nevertheless have to take a broader perspective, one that is in line with the changed democratic preferences.

Thus, from the UK perspective, a far-reaching free trade agreement for financial services – and services in general – could be considered an obstacle to taking back legal and regulatory power.

At the same time, from the EU perspective, we cannot accept a liberalised common market, without a common supervision. Otherwise, as a supervisor, I would be concerned about financial stability. It seems therefore that some degree of fragmentation is almost inevitable.

But, should we simply wait for the end of EU-UK financial relations? Should we simply hope for the best?

Of course not. We have to manage fragmentation constructively – we have to find innovative approaches for a new reality.

But let me make one thing very clear: this must not result in a race to the bottom. Fragmentation should not lead to competition through lax regulation or supervision. Such policies may seem to be in the best national interest, but ultimately they represent special interest politics. We must expose these policies for what they really are: threats to financial stability.

And that is why politicians, firms and supervisors have to deliver on three crucial points: first, a transition agreement; second, pragmatic supervisory cooperation; and third, managerial innovation.

Let me take each of these briefly, starting with the transition – or implementation phase, as it is now called.

4 The need for a transition phase

A transitional deal between the UK and the EU was agreed yesterday on negotiators' level. During the implementation phase, which is to last until end 2020, EU rules would continue to apply in the UK and the exact terms of the future partnership shall be worked out. It is of utmost importance in order to give firms more time to adjust to the new realities.

It furthermore can reduce the long-term costs of Brexit. Firms can weigh up their options and decide which markets they want to serve and with which organisational design. They have now time to re-arrange their organisations on the basis of an analytical and forward-looking approach, rather than an approach of simply minimising uncertainty. The inefficiencies and potentially higher costs of financial intermediation can be reduced with this agreement.

I am confident that both sides have apparently recognised the importance of a transition phase in making Brexit less abrupt and, in the long run, less painful.

Despite all this positive news, it is still too early to lay back. Many issues are still to be discussed and the transitional period is still not fully guaranteed. It remains to be subject to a successful conclusion of an Article 50-deal within the next twelve months. For instance, the Irish question – i.e. keeping the border between the Republic of Ireland and Northern Ireland invisible – needs to be resolved. Hence, the recently widely used phrase that "nothing is agreed until everything is agreed" still holds true.

5 Managing financial firms in a fragmented world

But even after a transition phase, Brexit and fragmentation would mean two things. First, future access to financial services markets would be more like the access given to a third country. Second, a successful conclusion of the Brexit negotiations is not guaranteed as it depends on whether a fully-fledged long-term agreement is achieved and ratified.

This is why I see no alternative to timely preparation, and to preparing for the worst-case scenario of a hard Brexit without any free trade agreement.

Looking at banks, proper preparation would include 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. As far as we are concerned, 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.

And banks have to begin implementing their plans and submitting their license applications no later than at the end of the second quarter of 2018. Otherwise, it will be very difficult to prevent a cliff edge.

Firms have a lot to complain about with regard to Brexit, and I do not mean to play this point down. But if the UK and the EU are attractive markets, I think there is something to be said for innovative approaches to comply with this new regime. That's why firms will have to find new, efficient organisational strategies. For example, I am convinced that profitable business models can be organised with two independently licensed entities.

6 Managing regulation and supervision in a fragmented world

But don't get me wrong: regulators and supervisors, too, have to be pragmatic and innovative to achieve our goals of efficiency, stability, and ensuring the real economy is provided with credit.

With financial sector firms relocating their business between London on the one hand and Frankfurt, Dublin and other cities on the other hand, close supervisory cooperation becomes even more important, especially over the coming years when we have to break new ground in supervision.

The cooperation between the EU and the UK authorities will have to be put on a new foundation. We will need to ensure information exchange, and of course we will have to think about how we can reduce unnecessary burdens from double licensing.

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[2] 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 stance. In the same vein, the SSM has developed quite pragmatic, cooperative policy stances on many of the relevant issues. I am confident that this cooperative style can make an important contribution towards a smooth transition.

7 Conclusion

Ladies and gentlemen, greater fragmentation will most likely be an inevitable result of Brexit.

Instead of wishing to do away with what is beyond our control, we should set about finding pragmatic and at times innovative solutions to managing Brexit and the ensuing fragmentation constructively.

However, such a constructive approach will take time, because it means many complex answers have to be developed – which is why we need a sufficiently long transition phase.

And I have to say that I was really facilitated well and truly relieved when I heard the news yesterday that a transition phase had been agreed, because this could make Brexit less abrupt and, in the long run, less painful.

During that phase, supervisors will have to find solutions that enhance financial stability without undermining economic efficiency.

And financial firms will have to find innovative and pragmatic ways to comply with the new demands while maintaining their efficiency and profitability.

For all the bullet points on our to-do list, we need an honest dialogue – if unnecessary problems and burdens arise, firms and investors should always come and talk to us. Brexit is both too complex and too important to muddle through.

Thank you for your attention.

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1 Comprehensive Economic and Trade Agreement between Canada and the EU.

2 Prudential Regulatory Authority.