Joachim Wuermeling: Brexit means Brexit - but what does it mean for Europe as a financial centre?

Speech by Prof Joachim Wuermeling, Member of the Executive Board of the Deutsche Bundesbank, at the annual reception of the Association of Foreign Banks in Germany, Frankfurt am Main, 20 June 2018.

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1 Introduction

Ladies and gentlemen

It gives me great pleasure to be able to speak to you today about the future of Europe as a financial centre after Brexit. There are three aspects which I would particularly like to address.

- The first of these is that banks looking to relocate their business to the EU or expand their presence here after Brexit will be asked to satisfy the same minimum prudential standards that foreign banks already operating within the Union and domestic institutions are expected to comply with. At the same time, we will need to find solutions that prevent any unnecessary additional expense.
- My second point is that in future, institutions that conduct cross-border business will be heavily dependent on how the respective supervisors oversee third-country institutions – as they will then be – and how the authorities involved will cooperate internationally.
- And third, when considering Brexit, we tend to dwell on the negative side of things and think about how best to cushion the impact. As important and justified as these considerations are, we nonetheless need to continue to press ahead with our vision of a harmonised financial market in the EU – a digital financial centre of Europe which offers as yet untapped potential.

2 Leaving the single market means separate supervisory regimes

Two years on from the Brexit vote, we can only assume that cross-border economic relationships look set to face noticeable headwinds going forward. For the financial markets, this means one thing: the financial services passport is dead.

This immediately raises the question: could it be feasible to have something like a diet version of the financial services passport, or to perhaps create a range of exceptions?

The clear answer to this is that there cannot be, nor will there be, any permanent exceptions. Institutions that relocate operations to the EU or expand their presence here following Brexit will have to comply with the same high supervisory standards that apply to the institutions that already operate here.

This answer is underpinned by the fundamental belief that supervisors must be capable of intervening in the business activities of institutions operating within their own jurisdiction at all times. This is a *sine qua non*, and it should not be up for grabs.

At the same time, this credo should not prevent us from thinking about whether, and if so where, we can cushion any additional operational outlay caused by time pressure.

A transitional period, at least as outlined in principle in March, could help with this. It would lower the long-term costs of exit by allowing firms to reflect on their options and decide which markets they want to operate in and which organisational structures would best allow them to strike the right balance between compliance and profitability. However, we cannot count on there being a transitional period right now, since negotiations could break down at any time.

3 Supervision of future third-country institutions: requirements and cooperation

But whether or not there is a transitional period, one thing is certain: what standards apply to the future third-country institutions will ultimately boil down to how they are treated by the relevant supervisor after Brexit and how the authorities will work together in this context. To shed light on this issue, the SSM has already adopted a whole bundle of supervisory policy stances.

However, in the SSM, our baseline assumption is still the worst case, ie a no-deal scenario. And judging by recent developments in the United Kingdom, this seems more than appropriate.

With the next meeting of EU heads of state or government fast approaching, it doesn't look like solutions to a number of quite fundamental issues concerning the future partnership will be found any time soon. The border with Northern Ireland is just one of these sensitive topics. This means that a huge package of agreements would have to be hammered out at the next summit but one in October, which would then, in turn, have to be reviewed by the parliaments in the shortest of timeframes. And even if this all went smoothly, it would be no more than a framework that would have to be fleshed out in detail to forge a future treaty – which would itself take many years. And because a breakdown in negotiations – and therefore a hard Brexit – remains possible at any time throughout the entire process, enterprises should be prepared for this.

That is why we banking supervisors are so concerned that a number of banks are easing off in their efforts to establish a licensed and operational entity in the EU or UK in good time ahead of March 2019. Let me say in no uncertain terms that these institutions cannot rely on our leniency. We expect all banks to make provisions for a hard Brexit. And that's why I would strongly urge all institutions to make the necessary preparations to keep their business operations running even if there is a hard Brexit on 29 March 2019. Institutions that submit an application after the end of the current quarter will find that the likelihood of their licensing procedure being concluded in time will diminish considerably.

We also expect these applications to satisfy our supervisory policy stances. Let us take a brief look at the key aspects.

- First, there are the principles for authorisation and for governance, risk management and outsourcing. In essence, the several hundred pages of requirements boil down to this: "empty shells" will not be permitted. Banks in the euro area must be able to manage all their material risks independently and locally. To achieve this, they need to have control over their books and all their positions, and have locally independent governance and control functions that report to the local board of management – particularly in the areas of risk management, compliance and internal audit.
- That brings us to the question of booking models. Will back-to-back hedging still be accepted? Here, the SSM expects banks in the euro area to have sufficient local capacity to manage at least an evident portion of their euro-denominated business themselves and not to fully outsource it to other entities within the group. The local entities have to be established in the local market, to ensure that, in the event that other group entities fail, they can participate in the market autonomously. However, we at the Bundesbank naturally see the economic advantages of back-to-back hedging. To some extent, transactions such as these serve as a pipeline to international capital resources at other locations.
- Some parties are hoping for an overarching supervisory or legal solution to the issue of the continuity of financial contracts. In response, I warn against relying on us for this, as it is not so much a supervisory issue as a civil law problem.
- One very important issue – and not just for foreign banks – is the supervision of future third-country CCPs from the UK. In the Bundesbank's view, there have to be clear rules and

safeguards here ensuring that continental European authorities have both sufficient rights to obtain information and robust powers of intervention in respect of UK CCPs – otherwise, it seems a relocation to the EU would be all but unavoidable.

The more we look at the whole issue, the more clearly we can see just how serious the repercussions will be when CCPs we consider to be systemically important leave our jurisdiction. Volker Brühl from the Center for Financial Studies gave a systematic summary of many aspects in a recent study on the topic. He set out and simulated with painstaking accuracy the implications of problems at a third-country CCP for:

- monetary policy transmission in the euro area,
- the functioning of our resolution regime,
- having recourse to national central banks, especially the Bundesbank, as a lender of last resort.

These scenarios, over which I would have no supervisory influence whatsoever, fill me with increasing unease.

And if my colleague, Brian Bussey from US Commodity Futures Trading Commission (CFTC), stresses that a lead supervisor is crucial, but says the US has more interest in LCH than anyone else in the world, then I think we are already back in third place. Given the CCP's systemic importance for the euro area, this would be unacceptable.

The ECON Committee of the European Parliament has recently taken an initial stance regarding migration – and here, too, the possibility of relocation continues to play a major role.

For us at the Bundesbank, this is not a matter of structural policy or trade issues. We are competitively minded and neutral. Our mandate is to safeguard price and financial stability, and these decisions affect this stability in a major way.

These policy stances already stake out a clear, transparent framework of expectations in the SSM.

4 The future of Europe as a financial centre

Ladies and gentlemen, as much as we greatly regret the United Kingdom's decision to leave the EU, we must nonetheless look forward and consider how financial services can be delivered in the European Union in the future.

First, we need to observe the consequences of Brexit from the perspective of each individual bank. Banks have so far avoided making any major changes, not least because they are also busy coping with large-scale acute challenges and their financial implications. So it is easy to lose sight of strategic issues. It's not just Brexit that's shifting the tectonic plates under banking – digitalisation and regulation are two other key drivers of change. When traditional structures and markets are broken up this way, the cake will be redivided – some will lose out, but some will get a bigger slice. There is a real danger that adhering at all costs to traditional positions in London risks missing out on new opportunities in the EU – though not by everybody: those who don't will be the winners. So I would urge you not to lose sight of medium and long-term strategic options.

Second, we also have to consider the repercussions of Brexit in terms of its impact on the EU financial market as a whole. What we are looking at here is nothing less than the financing of the European economy, especially at a time when the global economic and financial order is becoming increasingly shaky. Earlier EU initiatives – the single financial market, the banking union, and the capital markets union – all had an inward focus. And with London, Europe had an international financial centre. This will now change. Hence the question of whether we in the EU 27 should aspire to developing a globally competitive financial centre that is more than the sum of its parts here in Frankfurt, Paris, Amsterdam or Dublin. François Villeroy de Galhau, the governor of the Banque de France, recently spoke of an integrated network with centres specialised in various activities – and I am thinking along the same lines, which include major efforts to harness digital potential as well.

I would like to help kick off a broad, forward-looking debate surrounding the concept of a digital financial centre of Europe.

It's an idea based on three pillars.

First, a networking pillar. Today, Europe's financial services potential is spread over various locations. It does not have a cumulative effect. However, for a fully-fledged financial ecosystem to truly flourish, there needs to be enough providers and users of financial services in the local market. At present, no European financial centre can tick this box. The continental venues could, however, tap into an aggregate potential if they were to form a network in which any financial product can be bought and sold in any quantity at any time, just as you would expect from a globally competitive financial centre.

The second pillar is digitalisation. Financial centres in continental Europe need robust digital market infrastructure that leverages all the state-of-the-art digital capabilities – of which distributed ledger technology (DLT) is but one. Only then can these centres overcome fragmentation and replicate agglomeration effects of physical proximity. The Eurosystem will also be expected to contribute here, seeing as it already provides a key piece of infrastructure for payments in the shape of the TARGET system.

These first two pillars create a digital network across European financial centres. But to make the most of Europe's potential as a "financial Amazon", market-driven specialisation will also be needed as a third pillar. Specialisation can help deliver economies of scale, increase the potential for innovation, and achieve excellence. In an environment of "coopetition" – a neologism merging the words cooperation and competition, European financial centres could cooperate, compete and, at the same time, hone their own areas of expertise. But this is a vision for the future.

It's a picture of the future that is also very much in our own inherent interest as a central bank, because the more that financial flows end up where our system is in force, the more we are able to promote financial and price stability as well as a strong currency.

5 Conclusion

Ladies and gentlemen, "Brexit means Brexit" – but at the end of the day, what this means for the financial centre of Europe is very much up to us.

This goes for those of you who are domestic and foreign banks, for those of you who make policy at the regional, national and European level, and for us as central banks and supervisors.

Now a change of perspective is in order: let's see Brexit as an opportunity for us, not by naïvely whitewashing what is a regrettable development, but by planning a sober yet forward-looking model.

Thank you for your attention.