Burkhard Balz: How is Brexit transforming the global financial landscape?

Speech by Mr Burkhard Balz, Member of the Executive Board of the Deutsche Bundesbank, at the 2018 Bavarian Banking Day (Bayerischer Bankentag), Munich, 9 November 2018.

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1 Introduction

Mr Diederich,

Ladies and gentlemen,

I would like to thank you very much for inviting me to Munich.

I am delighted to have the opportunity to talk to you here at the Bavarian Banking Day (*Bayerischer Bankentag*) about the implications of Brexit for the global financial landscape. I am especially looking forward to our discussion afterwards.

Many of you have no doubt been following the Brexit negotiations over the past few weeks.

As things stand, whether the two sides can come to a joint and orderly agreement on exit arrangements remains highly questionable. Consequently, we may not be spared a hard Brexit.

As much as I personally regret the UK's decision to leave the EU, we cannot close our minds to the uncertainty it brings with it and to the changes that will need to be made, particularly in the financial sector. On the contrary, all stakeholders, chief among them banks and regulators, should be actively tackling these issues. In the current situation, which is fraught with uncertainty, adopting a wait-and-see attitude and hoping for the best is not the right strategy. Or to put it another way: "If you fail to plan, you plan to fail."

2 Brexit as a driver of change

Ladies and gentlemen,

So what needs to be done and what specific changes can we expect on the global financial stage? As I see it, this question concerns two key topics.

First, credit institutions domiciled in the UK and the EU will need to restructure their cross-border business in the face of Brexit and the regulatory changes that will accompany it. Only by doing so will they be able to continue trading, potentially in a slightly modified form. Up to now, credit institutions domiciled in the EU have been able to manage their EU-wide business from the UK as well thanks to the EU financial services passport. This will probably no longer be an option in the future.

On the one hand, the UK wishes to no longer be subject to Single Market rules after Brexit.

On the other hand, however, the British government is calling for greater flexibility and room for manoeuvre with respect to the financial sector. Given these points, a continuation of the current regime is not a realistic prospect.

The conclusion that can be drawn from this is clear. Credit institutions with cross-border business will be forced to either relocate to the EU or expand their already existing EU sites if they want to continue conducting business in the EU – and most likely vice versa, too. This should be the current working hypothesis for all credit institutions concerned.

And it goes without saying that the impact of this will be felt by more than just European institutions. International big banks, in particular, including some from the United States, have been managing a large part of their EU operations from the UK – that is to say, the City of London – using the EU financial services passport. They, too, will have to respond to Brexit and reposition themselves.

Looking at the current market structure of European financial centres, I expect that the inevitable relocations triggered by Brexit and the expansion of already existing sites will further strengthen major financial centres on the continent, such as Frankfurt and Paris, in the medium to long term. Furthermore, institutions domiciled in the UK should also bear in mind that, after leaving the EU, it will no longer be possible to participate in the TARGET2 payment system in the same way. The affected credit institutions therefore need to take action. The Bundesbank has already been in touch to this effect with account holders that may be affected and, where necessary, offered support.

3 Central clearing in the derivatives market

Ladies and gentlemen,

In addition to responding to changes relating to the EU financial services passport, I see a second major area in which the financial community will have to adapt: the central clearing of derivatives.

To put things better into context, I would first like to briefly look back at how things used to be. Some of you will doubtless still recall that the current global regulatory framework for derivatives trading is a direct result of the last financial market crisis. In light of the lessons learned from this crisis, the G20 heads of state and government formulated two key objectives concerning the treatment of OTC derivatives: first, improve market transparency with a view to making existing risks easier to identify and, second, strengthen the management of risks incurred so as to make the derivatives markets more secure.

The result was an ambitious effort at reform on the part of the G20 – more specifically, better regulation of the global derivatives market. Focal points included the increased use of central counterparties (CCPs). The G20 advocated that, going forward, OTC derivatives be subject to a clearing obligation, at least in those cases where they are sufficiently standardised. The CCP, as a neutral party, would then assume the risk management, in particular, of what were previously bilaterally concluded derivatives contracts. This was a crucial paradigm shift.

As a result, adjustments were made to the regulatory frameworks both in the United States and the EU. In 2010, the United States was the first country to pass a comprehensive law on the regulation of its financial sector in the form of what is commonly referred to as the Frank-Dodd Act. As suggested by the G20 countries, the regulations on OTC derivatives were tightened and clearing obligations were imposed, requiring transactions to be cleared through CCPs. Within the EU, this was achieved through the introduction of the European Market Infrastructure Regulation (EMIR) in 2012.

This new regulation ultimately led to a substantial increase in the importance of CCPs offering services for derivatives contracts which were now subject to a clearing obligation. Among the main beneficiaries of this development within the EU were the CCPs domiciled in the UK, with their focus on clearing interest rate and credit default derivatives. Both the size of London’s financial centre, which is the most important one in the EU in its current form, and the liquidity available there certainly contributed towards the success of these CCPs.

For historical reasons, many CCPs specialise in certain products and currencies. For global market players, in particular, there is thus always s certain need to make use of CCPs outside their own jurisdiction. It is, consequently, not unusual for global credit institutions to be a member of or participant in several EU and US CCPs, either directly or indirectly through a subsidiary.

However, market participants are only able to use third-country CCPs and thus participate across regulatory borders if the supervisory authorities responsible for them recognise the regulatory framework of the third country in question as being equivalent. This has been the common practice to date regarding the EU and the United States. I will elaborate on the future relationship between the two jurisdictions later on in my speech.

4 Brexit and central clearing

Ladies and gentlemen,

let us now return to the present – and specifically to the impact of Brexit on the central clearing landscape.

The need for change in light of Brexit is obvious. As things stand, EU market participants make intensive use of UK CCPs to clear their transactions.

From my point of view, this already appears to be of systemic importance for the EU's financial system. In future, the UK CCPs will no longer be governed by the EU's common supervisory and regulatory framework, EMIR. The combination of the systemic importance of UK CCPs and the loss of supervisory control and powers of intervention on the part of the EU calls for the supervisory and regulatory framework for third-country CCPs to be revised.

The option currently available under EMIR to recognise third-country CCPs once their supervisory and regulatory regimes have been deemed equivalent is not a viable long-term solution for the United Kingdom after Brexit. There is therefore a general risk that the regulatory framework for the UK financial system will diverge from the EU's, which means that the EU financial system and ultimately EU taxpayers could face losses in the billions if risks materialised. In addition, the decisions to recognise third-country CCPs based on equivalence do not take adequate account of their systemic importance for the EU's financial system. This is why the current provisions do not serve as a basis for the UK's large CCPs after Brexit.

EU lawmakers view the situation similarly and have put forward corresponding proposals over the past year on how to reshape the European supervisory regime for third-country CCPs; I am referring to the EMIR II directive here. These proposals are currently still subject to intense debate within the Council. Nevertheless, three fundamental changes seem almost certain.

First, the systemic importance of third-country CCPs or parts thereof shall become the decisive factor determining which supervisory obligations third-country CCPs will have to fulfil in future in order to be recognised by the European Securities and Markets Authority, ESMA.

Second, if there is an ongoing threat to the financial stability of the EU or individual member states, there should be an option to deny recognition of a third-country CCP or parts thereof.

The consequence for EU market participants would be that they would no longer be able to use the affected third-county CCPs to meet their clearing obligations. These third-country CCPs would only be able to continue conducting business with EU market participants if they moved their operations to the EU and applied for authorisation under EU rules.

Third, the Eurosystem, as the central bank issuing euro currency and thus also the central bank of issue (CBI), should be involved in determining third-country CCP's systemic importance and in supervising systemically important third-country CCPs.

Naturally, changes of this magnitude to the supervisory and regulatory regime are always accompanied by criticism and a degree of uncertainty. EU market participants, in particular, are wondering which third-country CCPs they will be able to use going forward, and rightly so. It is not my intention to gloss over the fact that the current situation is unsatisfactory for many. It also remains unclear to date whether the UK's systemically important CCPs will be able to continue to conduct business with EU market players indefinitely in the current form or whether they will be denied recognition. What we need here is a thorough review. Looking ahead, what is crucial in my view is to ensure the stability of the EU's financial system. The announcement by the Bank of England to forcibly uncouple EU clearing members from UK CCPs in order to ensure that they remain functional in the future and to avoid jeopardising financial stability is just one example of how fragile the current situation is. This process, referred to as “off-boarding”, has caused great concern amongst market participants.

5 Consequences for the United States

Ladies and gentlemen, these market participants are not the only ones who are currently criticising the revision of the supervisory and regulatory framework for third-country CCPs.

In the United States there is mounting criticism of the path that the EU has embarked upon, particularly on the part of the Commodities Futures Trading Commission (CFTC), which is responsible for major US CCPs. The CFTC has said that it finds it difficult to imagine that US CCPs will also be directly supervised by the European Securities and Markets Authority (ESMA) and the Eurosystem as the CBI for the euro.

Admittedly, the American CFTC is rather unfamiliar with the idea of central banks participating in the supervision of CCPs – which is now a long-standing practice within the EU. This is undoubtedly also related to the historical differences in European and American regulatory practices. Parts of the supervisory structure that arose within the EU through EMIR are far more complex. EU CCPs are primarily supervised by their respective national supervisory authority, which takes on a leading supervisory role and is thus comparable to the CFTC in the United States. However, there is also a joint supervision component, known as the EMIR college of supervisors, which has to give its approval to major supervisory decisions. This college includes various national banking supervisors as well as national central banks from across the EU.

The inclusion of the Eurosystem in its role as the central bank of issue is also a particularity of the European supervisory regime for CCPs. This is deliberate, however, as, in the event of a crisis at a CCP or one of their clearing participants, i.e. banks, it is the central banks that are able to support them with liquidity assistance.

This, in my view, makes the Eurosystem's involvement in the regulation of CCPs absolutely essential. EMIR2 will now continue to pursue this path and will assign the Eurosystem, as the CBI for the euro, a corresponding supervisory role for systemically important third-country CCPs.

It is understandable that our American supervisory colleagues want to continue the equivalence regime that was mutually agreed after long and intense negotiations. Nonetheless, our need for a secure financial system in the EU should also be recognised. It is also not at all clear how individual US CCPs will be classified by supervisory authorities in future. At this point, I'd like to emphasise once again that EMIR2 will not classify individual third-country CCPs automatically. It will only set out the path and the criteria that are to be applied, and these criteria will be applicable to all third-country CCPs and not just to the central counterparties in the UK. This is because the aim is to ensure an appropriate level of supervision and regulation of third-country CCPs, with the security of the EU financial system being paramount. In light of this, the future European supervisory regime will be very flexible. For example, CCPs that the EU considers to be less important could continue to be recognised on an equivalence basis.

This could also apply to US CCPs, depending on the outcome of a review into their systemic importance, at least for the current transaction volume. That said, this cannot be guaranteed. Incidentally, US supervisors also have stronger powers of intervention in third-country CCPs that they consider to be systemically important.

From the EU's perspective, I think it would be preferable if, after Brexit, clearing services were again settled to a greater extent via EU CCPs and thus governed by the EU's own supervisory standards. But this is not guaranteed. It is also conceivable, for example, that US CCPs, too, will benefit to a greater extent from changes in the derivatives market following Brexit. If EU market participants use the latitude they have to rely more and more on US CCPs, the EU needs to be able to react appropriately for the purposes of achieving sufficient supervisory control and avoiding risks to its financial system. EMIR does not currently have this flexibility, so all the more reason to ensure its implementation in EMIR2.

6 Conclusion

Ladies and gentlemen, the final date for the United Kingdom's exit from the EU is getting closer and closer and the fact that the Brexit negotiations do not appear to be making progress means that uncertainty continues to grow among market participants. This makes it all the more important for all market participants to prepare for a "hard" Brexit. We should not be deluded into thinking that everything will somehow continue as before. Quite the opposite, in fact, is true. Brexit will bring about fundamental changes in the global financial community. In my view, it is ultimately only a question of how fast this will happen.

On that note, I would like to end with an old Chinese proverb:

"When the wind of change blows, some build walls, others build windmills."

Thank you for your attention.