

Speech

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Uncertain times – Brexit and its impact on the financial sector

Remarks delivered at Boston Consulting Group

Frankfurt am Main | 07.02.2017

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1 Introduction

Ladies and gentlemen

Thank you very much for the kind introduction.

Since June of last year, Brexit has held our attention. It is one of the few topics that have endured in the news despite the Trump administration taking office. The reason lies in the intense uncertainty surrounding Brexit and its exact implications. I expect this is also what brought most of us here today. We are all looking for answers.

The political debate surrounding Brexit became increasingly tense recently. It seems that the closer we get to the start of the divorce proceedings, the louder the sabre-rattling becomes. And there is clearly a lot at stake for both the European Union and the United Kingdom. Many complex problems will need to be resolved, and tough decisions will need to be made over the months and years ahead.

But a confrontational approach is not in the interest of either the UK or the EU. Interconnectedness between the UK and the EU is significant in terms of both the real economy and financial markets. A cooperative stance that perpetuates the close links between our economies is now called for. And I hope that this will be the guiding principle of negotiations.

2 Major questions regarding Brexit

This period of uncertainty is not the time for speculation, but for scenario-based thinking. And at the Bundesbank, we are looking into different scenarios and outcomes, especially for the financial sector. Let me now give you a broad idea of my thoughts on some of these issues: first, on everything related to market access and the location decisions of banks. Second, I will touch upon the question of what Brexit means for the future of clearing in London. I will then close with some thoughts on the preparations banks on both sides of the Channel are making for Brexit and the prospects for future regulatory regimes in the EU and the UK.

2.1 Future market access

The debate on market access for UK-based financial institutions was transformed mid-January. After Prime Minister May's most recent speech, a "hard" Brexit is to be expected. For the financial industry this means that the current model of using London as a gateway to Europe is likely to end. Banks from third countries would need a licensed entity inside the European Economic Area to gain access to the whole area – this is known as "passporting". TheCityUK, a banking lobby group, have already dropped their demands for continued passporting rights.

Many are now hoping for an equivalence decision to fill the gap left by passporting rights. If the European Commission deems the regulatory and supervisory regime in the UK to be equivalent to that in the EU, market access would be partly retained. And the chances for equivalence seem to be good at first sight. Directly before Brexit, the UK regime will be equivalent to that of the EU. However, I am very sceptical about whether equivalence decisions offer a sound footing for banks' long-term location decisions. Equivalence is miles away from single market access.

There are three major drawbacks to equivalence decisions. First, they only cover banks' wholesale business. Second, given the fact that banks need time to build up a new entity elsewhere, an equivalence decision would have to be taken quite soon to actually have a bearing on banks' location decisions. Third, equivalence decisions are reversible, so banks would be forced to adjust to a new environment in the event that supervisory frameworks are no longer deemed equivalent. These lead to the overall conclusion that equivalence decisions are no ideal substitute for passporting.

But let's not forget about European banks' access to the UK. For German banks, for example, the UK is the second-most important foreign market, right after the US. It will be up to the UK Prudential Regulation Authority to decide under what circumstances European banks can retain access to the UK. One possibility here is asymmetric equivalence. That is, the UK could unilaterally grant access for EU financial institutions in order to retain London's attractiveness as financial centre.

A transition period could ease the pressure on financial institutions. It would reduce earnings risks for banks, which would be economically beneficial. Furthermore, it could support a smooth relocation process by taking pressure off both supervisors and banks, for example by preventing

"first-mover advantages". However, transition periods would be a politically sensitive topic in the negotiations, and it is unclear how likely such an agreement might be.

Let me summarise the prospects for market access. Continued passporting rights are highly unlikely, and an equivalence decision would be an imperfect substitute. A transition period could ease some of the pressure, but it is a sensitive issue. According to their Brexit white paper published last week, the UK government will strive for an ambitious free trade agreement with the EU as a long-term solution. But financial services are an especially tricky area. So far, the EU has never fully integrated finance in its free trade agreements with third countries.

2.2 Location decisions

Consequently, many banks are now considering moving some of their business to the EU. You can read reports about major firms taking new decisions daily – some are true, some are rumours. First, let me say that I expect London to remain an important financial centre. Nevertheless, I also expect many UK-based market participants to move at least some business units to the EU in order to hedge against all possible outcomes of the negotiations.

The question that is causing some excitement is: Where will banks go? As a supervisor, my main concern is that banks are supervised according to standards that are both high and consistent. This is best ensured within the SSM area, which means I will not promote any particular financial centre. That said, I am open for dialogue with financial institutions in assessing the conditions for moving business units to Germany.

Financial institutions are right to contact their potential future supervisors early on. And numerous market participants have already contacted the ECB, BaFin and the Bundesbank. We respond to such requests pragmatically. That is, we provide financial institutions with quick and reliable guidance and clarity on the requirements for establishing a licensed entity here in Germany and aid a smooth transition. One important issue in this regard are the rules related to outsourcing. Here, we explain that German law requires any subsidiary domiciled in this country to retain chief responsibility for its business. This means that we will not accept any empty shells or "letterbox companies".

2.3 Future of clearing

Market access and location decisions are the primary point of interest. A close second is the future of clearing in the UK. Will UK-based clearing houses be stripped of their ability to clear euro-denominated transactions? At present, the Eurosystem does not have regulatory competence to restrict clearing in the UK. However, continuation of clearing strongly depends on the acceptance of the European Court of Justice, as Mario Draghi emphasised yesterday. And so far, the UK government has indicated that it would leave the European Court of Justice after Brexit.

Furthermore, the EU has introduced clearing obligations for some interest rate derivatives and credit default swaps, and more are in the pipeline. If the UK were to establish a regulatory and supervisory

regime for its clearing houses that is not deemed equivalent to EU standards, the UK-based clearing of derivatives subject to the EU's clearing obligations would become impossible for EU market participants. What is more, resilient clearing houses need a reliable source of euro liquidity. Ensuring a continuous and dependable supply of euro liquidity is certainly easier within the euro area than outside it. Against this backdrop, I see strong arguments for having the bulk of the clearing business inside the euro area.

3 Looking beyond the obvious

The areas I have touched upon so far are the major issues for the financial sector. I trust that the vast majority of financial institutions are aware of them and are assessing their implications. But they should not focus only on the obvious. Financial institutions need to systematically think through what effects Brexit could have on each of their areas of operations. For example, banks should check what Brexit might mean for covenants, or how it could affect the handling of margin calls.

This is important advice for all companies – not just banks – that want to avoid a rude awakening after Brexit. And I believe Wolfgang Dörner will talk later about preparations that companies and financial institutions should make.

But overall, I believe that both financial institutions and supervisors have already made good progress in preparing for Brexit. I therefore do not expect financial stability repercussions in Germany or Europe or a significant shortage of credit supply.

4 Retaining a cooperative stance

Ladies and gentleman, Brexit fits into a certain trend we are seeing towards renationalisation. I strongly believe that this negatively affects the well-being of us all. We should therefore invest all our efforts in containing these trends. This holds for the private sector as well as for supervisors and policymakers in the EU and the UK.

To give you an example from the private sector, the merger between Deutsche Börse and London Stock Exchange could serve as a counterbalance to renationalisation. In fact, Brexit has made the business case for the undertaking more compelling. If sensibly implemented, the project can serve as a bridge between EU and UK financial systems and strengthen financial markets. But there are also certain risks associated with the project, for example related to the concentration of market power or to counterparty risks. These and other questions surrounding the envisaged merger are currently being examined by the European Commission.

Looking at the EU, the Capital Markets Union project must be continued. Once implemented, the project will facilitate the funding of the real economy and foster risk sharing. While the CMU's positive welfare effects would have been greater had the UK opted to remain in the EU, I am convinced that it remains a sensible project. What I do believe to be important is that, when the CMU is established, we make sure the door is left open for intensified cooperation between the EU and UK financial systems.

With regard to the UK, it will be important that the UK retains a regulatory and supervisory framework that is stability-oriented. But some voices are calling for deregulation after Brexit. One such example is the "financial centre strategy" that is being discussed as a fall-back option for the City of London. Parts of this recipe are low corporate taxes and loose financial regulation. We should not forget that strictly supervised and well-capitalised financial systems are the most successful ones in the long run. The EU will not engage in a regulatory race to the bottom.

5 Closing remarks

Ladies and gentlemen, we can expect uncertainty to persist in the months ahead. The fog will only slowly clear during negotiations. Policymakers on both sides of the Channel should take a pragmatic approach and not let themselves be swayed by populist or nationalist voices.

The EU has made it clear that its future unity has the highest priority, and that this includes the inseparability of the four freedoms, these being the free movement of goods, capital, services, and people. The challenge for those involved in negotiations will be to reconcile these conditions with the UK's wish to "take back control", for example on matters like immigration.

Until the negotiations are concluded, the challenge for companies is to deal with continued uncertainty as efficiently as possible.

Thank you for your attention.