SHORT-TERM IMPLICATIONS OF BREXIT FOR THE EU

1. Preparedness of the financial sector for Brexit

1.1. Preparation is generally satisfactory despite current uncertainty

The Chair introduced the session by mentioning that there have been many preparations for Brexit at both the national and European levels including for the worst case no-deal scenario. There however remain questions about whether all players are prepared and if the financial industry will be able to function smoothly and ensure a continuity of service in all situations.

An official believed that the level of preparation within the financial industry is generally satisfactory. Everything that can be done to prepare Brexit has been done, but that does not preclude there being risks. But the only way for there to be no risk would be for the UK financial sector to remain in the EU, which is not what the UK wants, so there is a trade-off. There is risk from moving from having a single market with the UK to not. This is however also an opportunity to demonstrate the benefits of the single market.

A policy-maker noted that the level of uncertainty regarding Brexit is such, including around what course the UK wishes to take, that the only thing to do is to prepare for all eventualities. Europe is completely prepared. The Commission has published no less than 90 stakeholder-preparedness notices, including 10 for financial services and encouraged all stakeholders to prepare for a no-deal scenario. Those messages have been heard. Financial firms, the larger ones in particular, are increasingly well prepared. Gradually smaller firms are also preparing for Brexit. The endgame is not known, so preparation means being able to cope with a large variety of risks. This is very costly since some risks will never materialize and it is not certain whether all risks related to Brexit are correctly priced in at this stage, but this is now a sunk cost and the focus should be on the future.

A regulator agreed that most of the preparation work has now been completed. It has been very costly but much has also been learned. Clients have been repapered when necessary in most cases. Paradoxically the high level of uncertainty concerning the Brexit negotiations has pushed market players and public authorities to speed up their preparations. Member states have all warned their industries to prepare for the worst outcome and many of them have also issued legal decrees providing for a transition period covering intermediaries (i.e. banks and insurance) and also OTC derivative activities. From an administrative and legal point of view, almost everything is in place.

An industry representative noted that at the time of the referendum their organisation had all activities based in the UK (a bank and a broker-dealer) with branches in certain other EU countries. All services were passported throughout the EU. A great deal of preparatory work has been conducted to make sure that everything would be ready for the initial Brexit date i.e. 29 March. New parallel entities were created in Germany (a new bank and a new broker dealer). The domestic and EU public authorities were very supportive during that process, but it required a major investment in real estate, people, systems, etc. Some problems are still to come. One question is whether customers are prepared, and there the picture is mixed. Very large customers are well prepared. With smaller customers the situation is not as clear, and they need a great deal of assistance and guidance, which can lead to conduct risk in the way information and assistance is provided.

1.2. Measures taken to ensure continuity in the securities and derivative markets

An official emphasized that in order to ensure business continuity, it seemed sensible to focus first on systemically relevant activities. That primarily concerns central securities depositories (CSDs) and clearing houses (CCPs) based in the UK and providing clearing and settlement for EU based customers and counterparties, for which temporary equivalence arrangements have been put in place. An area that has not been addressed is systematically important private market participants that might provide important services for financial companies in the Union, because banks and other financial institutions are expected to take care of themselves. Efforts were made nevertheless by the public authorities to raise awareness about the need to prepare for Brexit.

The Chair mentioned that solutions in the OTC derivatives market had been left to the member states and wondered whether this would lead to sufficient consistency in the market.

An official explained that this was the case in this area because OTC derivatives are not covered by EU directives or regulations. Some countries require licensing for third-country OTC activities, so it is up to them to deal with their licensing rules with respect to Brexit. Other countries have no specific rules, so the situation there will continue as it is.

2. Expected short-term impacts from Brexit

2.1. Fragmentation, operational and volatility risks

Firstly, a policy-maker emphasized that Brexit will create fragmentation which will inevitably lead to additional costs for the financial sector and its customers. One of the primary benefits of the Single Market is the possibility to scale up and achieve economies of scale. With Brexit there will be scaling down and increased costs, at least in the short-term. In the longer term, there may be some adaptations and improvements, at least for the EU27, depending on how the capital markets union (CMU) evolves.

An official indicated that the risk of fragmentation should serve as a wakeup call to complete the Banking Union and to work harder on the CMU in order to further integrate EU financial markets. Part of the attraction of London for European financial institutions based there, is the legal system and the ease of doing business there, thanks to the wide ecosystem located in the City. A question is how some of these aspects could be developed in the EU. There is a need to think about how to make the legal systems in the EU, especially in the area of insolvency, more attractive for well-functioning debt markets in particular. This is an essential component of the CMU. Unfortunately member states are generally very reluctant to change insolvency rules for instance.

An industry representative added that fragmentation could also create operational risks, although these will probably not be systemic. There will indeed be regulatory fragmentation with Brexit, and dealing with that will require more work and preparation and will also create inefficiency. For example it will be more difficult to centralize sales and marketing resources in the UK, as is the case at present. There is the question of how to utilise these resources in the future. The new bank and broker-dealer subsidiaries that the speaker's organisation has set up in Germany are not yet autonomous and need a great deal of support. This will require service-level agreements (SLAs) and also collateral management, therefore potentially creating some operational risk.

There is also a culture and people risk due to these changes, the industry representative added. For example it is not certain that there will be enough resources available in Frankfurt with the appropriate experience to answer the needs of all financial firms These governance aspects are understated in many reviews of Brexit. The industry representative's organisation will be moving from a unipolar world, with a single hub running its European business, to two hubs one in London and another in Germany. The governance of the firm will need adjusting to make that new structure work.

The industry representative reiterated that the main short-term issue is preparation. There will be risks and it is a painful process, but it will be manageable. There are also opportunities for growth as Brexit is a 'generational change' to be seized, which requires looking beyond the short-term to see what the longer-term possibilities might be. There will be cost implicit in the changes, but there will also be the possibility for new growth, new efficiencies and new structures.

Brexit moreover creates potential volatility risks. A policy-maker believed it is fair to assume that there will be some volatility or market stress in the short-term, albeit not systemic, in areas where preparation is less strong. In the long-term, that will evaporate because there will be other trends. In addition, depending on how liquid markets are, they should able to eventually absorb Brexit impacts. A regulator agreed that volatility is highly likely because Brexit is a unique event, although it is difficult to predict precisely what will happen. However, public authorities are prepared to react to any excessive volatility.

2.2. Risks related to back-to-back trading

The Chair mentioned that some people in the UK believe that a large part of Brexit-related impacts can be alleviated with back-to-back trading arrangements[1] which involve deals taking place in the EU and being in effect booked in London where the related risk would be passed. An official believed that this type of evolution is not the intention of European supervisors. This has been addressed in the recently adopted investment firm directive in particular. However it does not make sense to try to keep all of the risk in the EU if EU and UK regulation and supervision are deemed equivalent, following assessments of the nature of the risks and how they are being dealt with. If that is not the case, there have to be some circuit-breakers in place to avoid shifting risks to another jurisdiction that cannot be controlled and could have repercussions later for the EU were something to go wrong e.g. in the context of a cross-border bank resolution.

The industry representative explained that there is a "regulatory glide path" to get to a situation where organisations are fully operational. Risk management, marketing and booking have to be progressively adapted, but this is not yet finalised. The objective is to de-risk the Brexit project as much as possible, including the risk management of trades. That may require some form of guarantee or insurance provision by the group company or some form of back-to-back arrangement. Trying to keep risk within the EU is not necessarily the best approach in all cases, so a balanced approach will be necessary. Over time, the right structure will be found. The industry representative's organisation will act in accordance with the requirements and rules of the national competent authorities. There is much complexity in this area with different legal clauses and appropriate judgement is needed in their enforcement. Back-to-back structures can work and be helpful in some cases, but there must be caution and the feasibility and conditions should be analysed on a country-by country basis.

2.3. Expected impact of Brexit on the provision of financial services to the EU

A policy-maker noted that another potential risk is the under-provision of financial services in the EU and the UK following Brexit, but hopefully that will not be the case thanks to all the preparations. For CCPs and CSDs, the Commission took two measures to facilitate transition, so in the short-term the risk should be eliminated, both for the UK and the EU in this area.

An official noted that the equivalence decisions for CCPs and CSDs based in the UK was necessary because European CSDs and CCPs currently would not be able to absorb all the volume. Whether that will still be the case at the end of the transition period if it is put in place will have to be further assessed.

A regulator added that another potential issue is the impact of Brexit on the financing of the EU economy. However, at present, banks are by far the main funding source providing around 75% of financing, and more in some member states where SMEs are largely predominant and / or where capital markets are under-developed. Therefore, even if there might be some impact from Brexit in the short-term, it should not be the case in the medium to long-term because banks should be able to provide the resources needed and also be able to face up to any shocks following the increases in capital that have been made in the previous years.

A policy-maker agreed that there would be no financing risks in the short-term in the EU, where there is no shortage of banks and transitional measures have been taken for CCPs and CSDs. In addition a number of banks based in the UK are assessing plans to move some activities to the EU27. The real issue is preparing the longer term. This could be 'wasting a good crisis' because Brexit should be a catalyst for developing the CMU and diversifying the financing of SMEs in the EU. Significant efforts have been made to develop instruments such as securitisation, pension funds, covered bonds etc. and to further integrate certain markets such as investment funds but there is a risk of not realising fully the opportunity to grow capital markets in the EU if financing needs are covered by other channels.

3. Longer term issues and opportunities regarding the UK's future relationship with the EU

3.1. The risk of regulatory and supervisory divergence between the UK and the EU

The Chair believed that it is difficult to anticipate at this stage what will happen after Brexit. The UK may decide to follow EU rules and obtain equivalence or on the contrary progressively detach itself from the EU and play a more global role, endeavouring to bridge EU, US and other capital markets. Many people in London are in favour of the latter which involves a stronger participation in global organisations and their strengthening in line with the important role already played by the UK in multilateral organisations such as the Financial Stability Board (FSB).

An official and a policy-maker believed that there is not that much space for deviation between the EU and the UK, because many rules in financial services, such as bank capital requirements and total loss-absorbing capacity (TLAC), are based on rules driven by G20 decisions.

A regulator agreed that room for manoeuvre for the UK to depart from the EU financial framework should be limited because there is pressure from other third countries such as Asian countries for example to use common rules. Deviations are possible but they will take some time. In addition supervisory cooperation works well between the UK and other EU countries and it is expected this will remain unchanged, at least in the short-term. There is currently a harmonised approach to supervision in the capital markets across Europe. ESMA, on behalf of the different member states, concluded a memorandum of understanding with the UK and, so far, cooperation has been very good.

An industry representative agreed that the point about rules defined at G20 level is very important. The UK has generally been at the forefront of strong regulation for global financial activities and the expectation is that that will remain the case. This should provide an element of stability in the longer term, regardless of whether there is some form of 'enhanced equivalence' with the EU. However, around the margins, there will be differences and those may be challenging matters to manage for banks as there is potential for additional complexity and risk. The fact that regulation is partly a political act that will inform short-term behaviour of the UK needs to be considered, because the argument that too much equivalence with the EU would effectively undermine Brexit and its potential benefits exists in the UK.

3.2. Improving third-country equivalence arrangements

A policy-maker reported that a paper on equivalence and how it could evolve in the future was issued by the Commission at the beginning of 2017. Equivalence arrangements will be evaluated on a case-by-case basis. Many relevant regulatory areas are G20-driven, so there is not much space for deviation. However putting in place an equivalence agreement on insurance with a faraway country is different from doing so for the whole UK banking sector because of its size, importance for the EU and proximity. In this case it will not be possible to grant equivalence and let the business get on with it. A continuous monitoring will be needed in order to ensure that regulatory changes are not made 'through the back door'. Although the denomination might be the same, it is a different approach to equivalence.

Following a remark that the way equivalence was assessed (i.e. line-by-line or based on general outcomes) would also make a significant difference, a regulator believed that this would not be the main issue in the short-term. The equivalence assessment exercise would be quite straightforward with the UK at the starting point because the rules and the supervisory practices are the same at present. The difference will come subsequently and be in terms of how to continue to monitor possible changes. Having a common supervisory authority at the EU level for financial markets would ease the exercise. It is extremely inefficient to do it at the member-state level, as the same exercise would have to be repeated many times.

An official emphasized that going towards a system of enhanced equivalence with something like continuous monitoring of equivalence would require a great deal more resources at the European level and this would not be achieved in the short-term. At present there are relatively few financial areas where equivalence is proposed and they do not need much monitoring. Going beyond this is a political decision and requires budgetary resources and changes in the institutional organisation that need to be decided and cannot be implemented in the short-term.

1. So-called "back-to-back" trading allows an entity in one jurisdiction to carry out a duplicate transaction in a larger location. So a deal done on the ground for a client in a given EU country can actually be booked in London. Banks, which already use the mechanism routinely to book business from Asia, Africa and Latin America through London, could do the same for transactions originated in the EU27. This would allow them to continue centralising their European capital needs and risk management in London and reduce potential needs for staff movements. EU supervisors e.g. the European Banking Authority has however cautioned that local operations must not be "empty shell" units and the scale of transactions involved must not be excessive.