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Brexit – Key aspects according to the Savings Banks Finance Group

August 2017

The Chief Economists of the Savings Banks Finance Group see the Brexit negotiations as a real opportunity to highlight the added value of the European unification project. They consider the following points to be of importance in shaping the future relationship between the United Kingdom and the European Union:

→ All financial institutions should retain free access to the single market and the capital market in the euro area and the wider EU. It must be made clear to the United Kingdom that reverting to WTO standards in the financial services area would be a serious step backwards.

→ There should be no further decline in the number of clearing providers.,

→ Banks and savings banks in the euro area and the wider EU should not be subject to additional regulatory costs and disadvantages if Brexit discussions create competition for new locations.

→ Legal clarity should be maintained for stock exchanges, financial products, business operations and transactions with the United Kingdom.

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The negotiation situation remains unclear

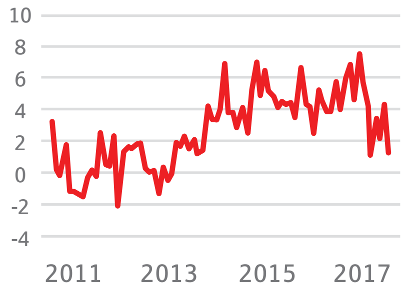
Uncertainty remains

The snap general election in early June of this year backfired for Prime Minister Theresa May. Her aim in seeking a bigger mandate at the polls was to extend her power base and to broaden the basis for a „hard" negotiating stance vis-à-vis the remaining EU states. However, Prime Minister May in fact achieved the opposite of this: the result of the election has increased uncertainty about the outcome of the EU withdrawal process.

Although Mrs May's weak result was also influenced by many non-Brexit factors, it has given strength to the Tory advocates of a „soft" Brexit. Furthermore, the Conservatives' partner in government, the ultra-conservative Northern Irish unionist party DUP, might well oppose withdrawal from the customs union, as their overriding priority is to avoid the creation of a hard border between the Republic of Ireland and Northern Ireland. May's narrowed government majority also plays into the hands of the hardline Brexit advocates, who can now increase their push for a „hard" Brexit (i.e. an exit from both the EU single market and the customs union).

Given this unclear constellation on the British side - in which even new elections cannot be ruled out - the outcome of the negotiations is shrouded in uncertainty; all the more so given that the EU is maintaining a closed position („no cherry-picking"). It can therefore not be ruled out that we will see a Brexit cliff-edge scenario at the end of March 2019 in which UK-EU trade will revert to WTO rules. To further compound the matter, it is unclear whether there will be a transitional arrangement between the EU and the UK and, if so, what that might look like.

Dampened desire to spend
UK retail sales; percentage change in year-on-year terms

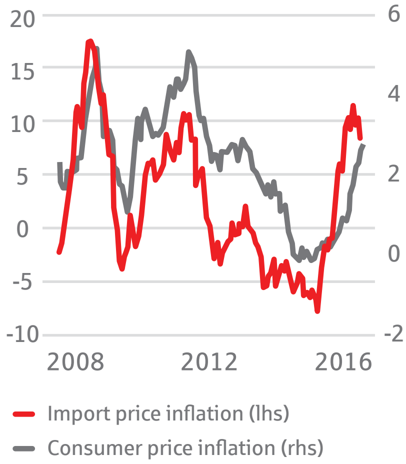


Sources: ONS, BayernLB Research

Clear indications of a slowdown in economic activity

As yet, the British decision to leave the EU has had far fewer economic repercussions than was originally expected: in real terms, the gross domestic product (GDP) expanded by an impressive 1.8 percent last year. Furthermore, 2017 is also unlikely to witness the feared slump in economic activity. However, there are increasing indications that economic momentum is slowing. For example, GDP growth was down to as low as 0.2% quarter-on-quarter and 0.6% year-on-year in the first quarter. Contributory factors here were sterling's fall and the subsequent sharp surge in inflation: with the latter having an increasingly negative impact on real incomes and therefore on the purchasing power of British consumers .

Import prices are rising, with CPI following suit, Percentage change in year-on-year terms

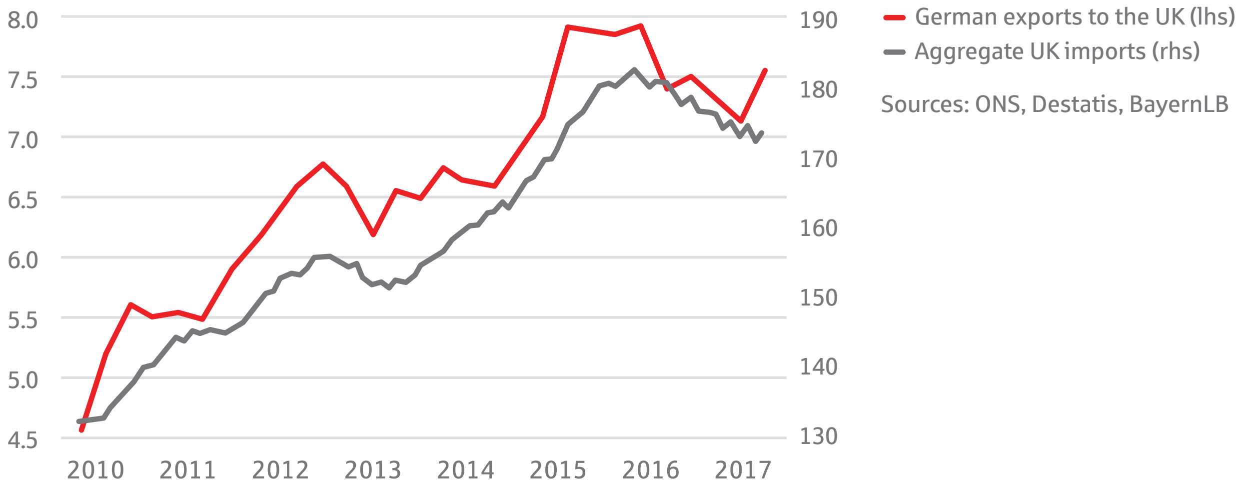


Sources: ONS, BayernLB Research

UK private consumption probably reached its peak for the time being last year at 2.8% in real terms: only marginal growth rates are on the cards for 2017 and 2018. The UK economy is therefore being deprived of one of its most important mainstays. This effect is also making itself felt in other EU states, not least in Germany; with German exports to the United Kingdom already trending downwards.

Britisch economy slows down

The decline in imports into the UK is spilling over into German exports,
EUR billion; German exports: Six month moving average;
UK imports: Quarterly figures



Sources: ONS, Destatis, BayernLB

Avoiding a „hard“ Brexit

Even though the economic effects have so far been modest, they make it clear that the EU‘s institutions and the remaining 27 member states need to do their utmost - despite, or indeed because of, the unclear political situation in the UK - to avoid a „hard“ Brexit, while preserving the four fundamental freedoms. In view of the fact that a definitive negotiation result is unlikely to materialise by the end of the two-year negotiating period on 29 March 2019, viable transitional arrangements need to be put in place to prevent the UK from falling off a Brexit “cliff-edge”at the end of March 2019.

Avoiding Brexit-Cliff

If the United Kingdom were to remain a member of the European Economic Area (EEA), there would be a solid platform from which to strike a definitive deal. If the UK were to fall from a Brexit cliff-edge, the damage would not be limited to reverting to WTO rules for EU-UK trade relations. Numerous agreements in the fields of security, foreign relations and financial relations would have to be reassessed (involving some 700 agreements, including 295 trade agreements). This would have major drawbacks for the UK and the EU alike.

Quite apart from the implications of Brexit for general economic and trade relations between the EU and the UK, there are also a number of specific rulings which apply first and foremost to the financial sphere, but which are also of great importance for overall economic development:

The post-Brexit status of the UK branch offices of German financial institutions should be defined according to their business activities

For financial institutions on both sides of the English Channel, the future configuration of the rules governing their business activities is at stake. As things currently stand, it would appear highly likely that UK based banks will lose EU passporting rights. This in turn would probably lead to the UK withdrawing the passporting rights of EU financial institutions in the UK.

Take note of the Regulatory Burden

For German financial institutions active in the UK, great importance is therefore attached to how branch offices in Great Britain, which are key partners for German companies operating on the British side of the Channel, are going to be treated post-Brexit. Will they be able to continue operating as branch offices? Or will they be required to set up stand-alone subsidiaries (with autonomous governance and risk-management structures and the obligation to comply with UK capital and liquidity requirements)? Depending on the customer groups involved and the type of financial products offered (e.g. no deposit-taking activity), it should be possible for such entities to continue operating simply as foreign branch offices in the UK.

From the point of view of the EU non-bank sector, this would be a favourable solution as it would avoid higher regulatory costs which, ultimately, would be passed on to customers. Provided that they are using comparable business models, the same rules should apply to the activities of UK institutions active in the EU.

Relocation of clearing activities should not further increase cluster risks

Both the European Commission and the ECB have stressed the importance of post-Brexit regulation and oversight of UK-based clearing houses. For instance, the Commission reserves the right to prohibit major clearing houses from handling euro-denominated derivatives from London. The UK capital currently accounts for three-quarters of overall business on this score - business which is of great significance for the non-bank sector as it involves currency hedging and interest-related transactions.

The European Commission is planning to provide the Paris-based European Securities and Markets Authority (ESMA) with more powers. In a first step, the

ESMA is to enjoy „extended" supervision of clearing houses from third countries that are licensed to do business within the EU.

Precedent here is the power of the US authorities, who have the right to monitor dollar transactions in London and to inspect sensitive data. A second step would then be for the ESMA to decide whether third-country clearing houses are „systemically relevant" (i.e. whether it would threaten the stability of EU financial markets if they were to become distressed). If a clearing provider had a particularly high degree of systemic relevance, the ESMA's final step could be to rule that the clearing house, or the relevant branch office, should be moved to the EU and therefore made subject to EU financial supervision. This proposal still has to be approved by EU national governments as well as by the European Parliament.

Although clearing houses located in the euro area should be in a position to take over the business of London-based clearing houses, it is vital for financial market stability that the number of clearing providers does not further decrease. Some banking institutions are already of the opinion that there is a major cluster risk. This risk must not be allowed to be aggravated by Brexit.

Taking a proactive approach to competition for UK financial institutions

Euro Area – attractive location

The competition to attract UK financial institutions wishing to migrate from the UK has already begun. And it should be noted that it is not just EU states which are vying for UK-based institutions; so too are international locations such as the USA which are intent on using planned deregulation to hone the competitive edge of their financial services providers. To prevent a regulatory „race to the bottom," it is imperative to insist that the agreed standards are complied with at an international level. At the same time, the opportunity must be grasped to enhance the locational attractiveness of the euro area and of the wider EU by applying differentiated regulation (to financial service providers in particular). Within the EU, national supervisory authorities - which continue to play an important role despite the advent of the SSM - should present those UK institutions wishing to move to the continent with a uniform catalogue of requirements.

However, it is important to ensure that newly-arrived institutions are not given any advantages over institutions already operating in the respective member country. It would be worth considering a review of labour and tax laws in order to make a German financial location more attractive for UK institutions. The objective here should be to minimise disadvantages over other EU member states. Here too, however, the same basic principle would have to apply: that new provisions granted to UK institutions and their employees would also be enjoyed by existing German institutions.

When advertising its credentials as a business location, Germany should be confident about drawing attention to its advantages, especially such things as its decentralised structure or the low rate of non-performing loans.

As a financial location, Frankfurt am Main in particular has a number of features that set it apart from rival EU cities (e.g. Dublin or Paris). These include direct proximity to the European Central Bank, including banking supervision, a major airport within easy reach, the city's location in the heart of Europe, the high level of legal certainty, about 1½ million square metres of available office space, as well as the fact that the quality of life in Frankfurt is higher than that of its competitors (good medical care and infrastructure, low crime rate).

It should be borne in mind that additional competences in the field of investor and consumer protection should not be transferred to the ESMA in the wake of Brexit. This type of idea at a European level should be strongly opposed. Unlike the plans to grant the ESMA additional powers for the supervision of clearing houses or in certain market-infrastructure segments, the plans to extend the ESMA's competences in the field of investor and consumer protection should be rejected. There are good reasons why national financial markets differ so significantly. Furthermore, investor and consumer protection is deeply rooted in the respective country's civil laws and is therefore a core responsibility of national supervisory authorities.

Jurisdictional uncertainties must be eliminated

According to announcements by Prime Minister Theresa May, the UK also wishes to withdraw from the jurisdiction of the European Court of Justice (ECJ). This needs to be analysed, particularly with respect to the repercussions for financial products based on English law. One of the items which needs to be investigated in this context is whether lawsuits filed in connection with such products may also be filed at courts in other EU member states. A recent French initiative may be a trailblazer in this regard.

Install specific Brexit-Court

A special court is to be set up at the French court of appeal to handle original and appellate cases involving international trade-related and financial market-related disputes governed by English law. It is important that the Brexit negotiations produce regulations which determine what happens to existing contracts permitting an appeal to the ECJ, and which clarify how contracts and complaints are to be handled which originate during a possible transitional period, i.e. before the final Brexit deal is completed (after March 2019).

Conclusion

The Brexit negotiations are likely to prove difficult in view of the unclear political situation in the UK. Nevertheless, it will be important to avoid the „hard“ Brexit which Theresa May has been propagating and especially the risk of a Brexit cliff-edge. In order to limit the negative macroeconomic knock-on effects, those at the negotiating table should pay due attention to a number of areas which admittedly only directly affect the financial industry, but which also have wider implications. From a financial stability perspective, it is important to ensure when shifting euro derivative clearing from London to the EU that the number of clearing providers does not dwindle to an even greater extent (cluster risk).

Another factor of particular importance concerns how the rules governing financial service providers („EU passport“) are to be framed in future - this applies in particular to the status of German branch offices in the UK. If the UK does indeed withdraw from the jurisdiction of the ECJ, it will likewise be important to clarify the jurisdiction of financial products which are governed by English law. To enable the opportunities presented by Brexit to be seized in full, it is also important to work to improve the attractiveness of Germany, and Frankfurt am Main in particular, as a financial location; one possible means to this end would be to implement amendments to labour and tax laws.

Disclaimer

The present position paper of the Chief Economists does not necessarily correspond to the attitude of the DekaBank or the attitude of the respective Landesbanken and Savings Banks.

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