Finanzgruppe
Deutscher Sparkassen-
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STANDPUNKT DER
CHEFÖKONOMEN

Brexit-Update – Important aspects from the perspective of the Savings Banks Finance Group

Time is running out to reach a settlement on the withdrawal agreement and subsequent transitional period after Britain's official exit from the European Union in 2019. The Chief Economists of the Savings Banks Finance Group are greatly concerned that an agreement might not be reached, which would lead to a hard Brexit. However, agreement should not be reached at any price; it should be noted that:

- → a "cliff-edge" Brexit, which could have severe consequences for enterprises, consumers and financial institutions, can no longer be ruled out. We believe that the probability of a no-deal outcome is now over 20 percent – despite the fact that both sides have recently expressed a strong willingness to reach agreement. In the event of a no-deal outcome, we expect growth to decline by up to two percentage points in the UK (the United Kingdom of Great Britain and Northern Ireland) and by half a percentage point in the euro area and in Germany.
- → Equivalency decisions can be useful in specific cases, and the examination of these areas should begin as soon as possible.
- → Euro clearing can probably remain in London. However, the financial centres in the euro area and in particular Frankfurt should be strengthened.
- → Uncertainties over jurisdiction should be eliminated.

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Cliff-edge Brexit still not ruled out
Many contentious points still have to be clarified during negotiations to ensure that the UK does not leave the European Union without a withdrawal agreement - a "cliff-edge" Brexit - on 29 March 2019 (the end of the two-year period after activating Article 50 of the Treaty on European Union). The British government has recently been moving towards a "softer" Brexit. The "Chequers plan" put together by Prime Minister May foresaw greater free trade between the UK and the European Union than in trade agreements with other countries such as Canada. This was also underlined by EU Commission President Juncker in his State of the Union Address. Compared with the other agreements, the ties with the UK will always be of a "sui generis" nature. The Chequers plan provides for a free-trade area for goods with the European Union. As far as services are concerned, however, the UK wishes to go its own way and accepts that future market access in this sector would be considerably restricted; the UK hopes that it will also continue to have access to the EU market in this field by means of mutual recognition.

Border demarcation Ireland-Northern Ireland problematical

However, the EU has largely rejected the Chequers proposals, referring to the integrity of the single European market, and it has also rejected the British proposal for a combined customs territory. There is little room for manoeuvre left for Prime Minister May; if she were to make further concessions, she would probably be overthrown by the hard Brexiteers in her own ranks. Failure to reach agreement on longer-term trade relations as proposed in the Chequers plan would lead to another problem: the border situation in Ireland. To avoid a hard physical border, the European Union is insisting on a backstop regime. Without a "Northern Ireland backstop", the European Union is unwilling to approve a withdrawal agreement – and without the latter, there will be no transitional period, thus increasing the risk of the much cited cliff-edge Brexit. This would not only mean that trade relations would resort to WTO rules, but many agreements in the fields of security, foreign and financial relations would also come under scrutiny. And although the British government has begun to make contingency plans for such a scenario, it is apparent that the UK – as well as the EU – are unprepared for such an outcome and that considerable turmoil

Emergency plans important

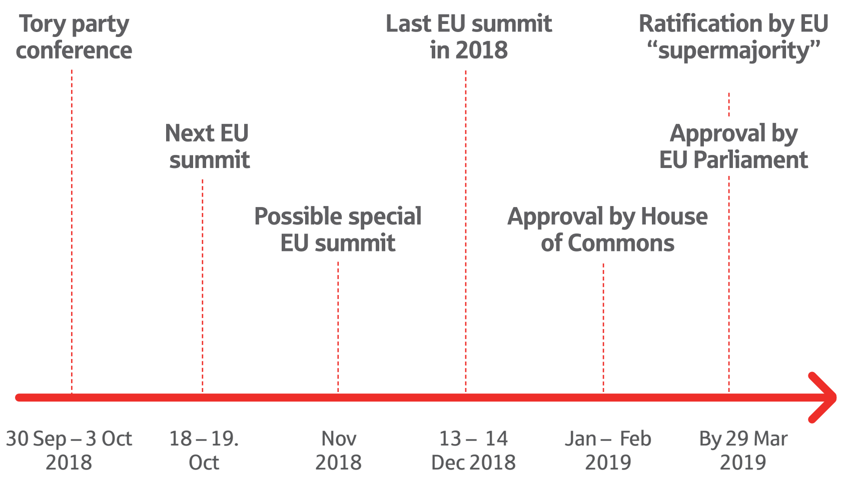
would arise in the movement of goods and services. In this case, the UK would probably slip into recession, and growth would slow by up to two percentage points. This would also have an impact on the euro area and in Germany, where growth would decline by half a percentage point, although recession would probably be avoided.

The situation therefore continues to be confused and in the UK there is also increasing discussion about a second referendum. Many proponents of a referendum hope that this would cut the Gordian Brexit knot – e.g. if there was a choice of several options – and that it might at least ensure a clear British position during the Brexit negotiations. It is hard to imagine though that another referendum might completely reverse the Brexit vote. However, it might pave the way for a "Chequers Plus" approach that would also be more acceptable for the European Union.

Risk of Brexit-Cliff high

Since the hurdles are high for a referendum and since a referendum would not necessarily produce a more acceptable option for the European Union, the risk of a hard Brexit is high. In addition, there would probably only be sufficient time to implement another referendum if the two-year transitional period were unanimously extended by the remaining 27 EU Member States (Article 50 TEU). Either way, there is little time left to conclude the withdrawal agreement, which would have to be completed by December (see Brexit timeline) in order for it to be ratified in time by the British Parliament, the European Parliament and the European Council.

Brexit-Timeline



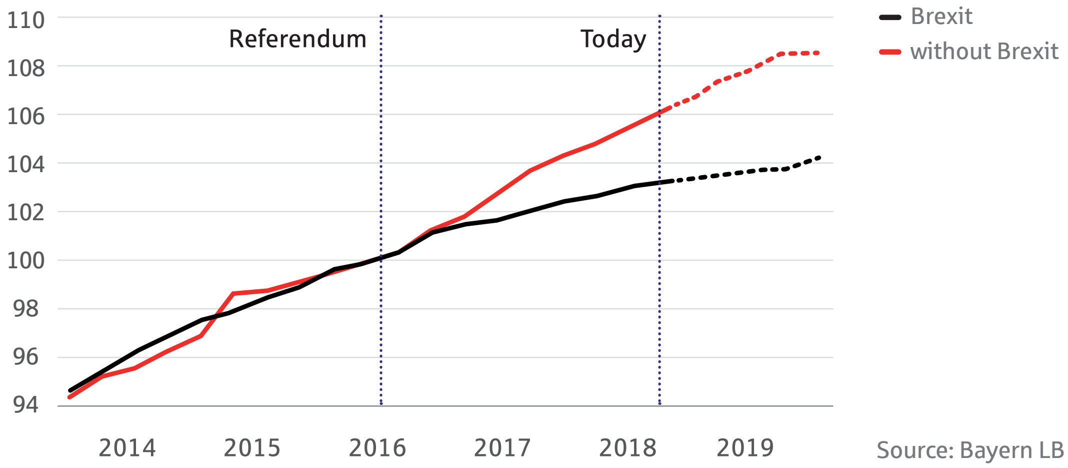
Source: Bayern LB

Economic Growth

Eurozone with stronger growth than UK

While the euro area is expected to grow by over 2 percent this year, economic growth in the UK has slowed significantly, and GDP growth is expected to be only slightly above 1 percent in the UK in 2018. As support from the global economy is weakening, the negative effects of the Brexit vote (in particular the reluctance to invest) are becoming increasingly visible. The main purpose of the Bank of England's two interest rate hikes was to support the ailing British currency. However, this also exacerbated the weakness of the British economy. Modelling of growth in the UK with "Brexit" and "without Brexit" shows that, since the referendum in 2016, growth has already declined by over 2 percent in the UK. And this slump in growth will probably increase to over 4 percent by 2020.

UK growth with and without Brexit, forecast, indexed



Source: Bayern LB

Use of the "equivalence regime"

With the presentation of its white paper, the UK government has made it clear that it will go its own way in future as far as services are concerned. This means that UK-based financial institutions will most likely lose their EU passport and, conversely, the UK will probably demand another passport for the UK from EU financial institutions. Nevertheless, the British government has proposed once again that the UK and the EU should continue to recognise each other's rules automatically after Brexit. However, this is something that the European Union ruled out early on, as it is one of the privileges of membership in the single European market. In return, the European Union has offered the UK a regime of "equivalent" agreements; albeit only covering market access for certain segments of the financial sector, and its rules can be revoked unilaterally by the European Union within a pe-

Principle of equivalence practicable way

riod of 30 days. For UK financial institutions, this legal basis is too uncertain for long-term business decisions. The UK has therefore proposed an "extended" equivalence regime, which means that in the event of extensive regulatory changes in the UK, for instance, the European Union would be informed or even consulted in advance. However, since this would probably also apply to the other side, the European Union is critical of such a proposal.

In principle, equivalence decisions are useful in specific cases, and their examination should begin as soon as possible. In the long run, a thorough revision and extension of the equivalence regime would be expedient to increase reliability and predictability and also to harmonise procedures. In addition, this might help to reduce costs arising from different regulatory regimes, which would contribute to a deterioration of financing terms on both sides of the Channel. In the final analysis, however, this principle can only be applied if rules are genuinely equivalent. Regulatory arbitrage must be avoided (keyword: UK as a "European Singapore").

Furthermore, both sides of the Channel should ensure that, after Brexit, trading in cross-border derivative contracts continues smoothly. The Bank of England recently warned that, after Brexit, counterparties may no longer have the necessary authorisation to service contracts. According to an estimate by the Association for Financial Markets in Europe (AFME), the volume of cross-border financial products and services of British banks amounts to approx. EUR 1.3 trillion. From the perspective of German financial institutions operating in the UK, it is also essential to clarify how German branches – which are important partners for German enterprises in the UK – will be treated after Brexit. The application phase for banking licenses from the British Prudential Regulation Authority (PRA) is currently ongoing. For large European institutions, the application phase has also begun for licenses from the European Central Bank (ECB). Depending on their customer groups and the type of financial products they offer (e.g. no acceptance of deposits), it should be possible for foreign institutions to continue to operate foreign branches in the UK (instead of independent subsidiaries, which would require separate governance and risk management, as well as compliance with UK capital and liquidity requirements). This would be highly desirable.

Euro clearing can probably remain in London

In view of the approaching withdrawal of the United Kingdom from the European Union, derivatives clearing would take place outside of European Union jurisdiction. This might entail considerable legal risks which could jeopardise stability. However, the first steps have been taken to create greater clarity with regard to euro clearing: Clearing houses for euro-denominated transactions will not necessarily have to move to another EU Member State after Brexit. In mid-May 2018, the EU Parliament adopted the EU Commission's pertinent draft legislation. Although this legislation still needs to be ratified by the Member States, it is likely that the settlement of payments for euro-denominated transactions will initially remain in London after Brexit. However, this is subject to the following key prerequisite: if the regulatory authority in a non-Member State – i.e. the Bank of England – does not cooperate sufficiently with the supervisory institutions of the European Union, the parties involved may be forced to relocate their clearing activities for EU customers to the European Union. The barriers for such relocation are expected to be high. Nevertheless, clearing activities in Frankfurt and Paris have already increased significantly. A clear division of labour is currently emerging in this matter: while Frankfurt is concentrating on interest-rate derivatives transactions, credit transactions are expanding in Paris. With the support of Landesbanken and DekaBank, the German clearing house ECAG has initiated programmes designed to increase the attractiveness of clearing in Germany/Frankfurt.

Competition for UK institutions is in full swing

Meanwhile, competition is in full swing to attract financial institutions willing to leave the UK. Although the "Brexit hype" – suggesting, for instance, that tens of thousands of bankers might move to Frankfurt – has now subsided, it is indisputable that Frankfurt as a financial centre has proven to be the biggest beneficiary of Brexit to date. According to press reports, over 3,000 jobs might be relocated to Frankfurt next year, followed by Paris with approx. 1,500 jobs. In Frankfurt itself, Brexit has had hardly any effect so far; and the run on international schools has also been limited. Nevertheless, some banks have already presented specific plans: Barclays has announced the relocation of between 150 and 200 jobs to Frankfurt; JP Morgan will transfer "a few dozen" employees with customer contacts and in risk management (working both in investment banking and asset management) to continental Europe (Paris, Madrid and Milan) by early 2019. Although only a few banks have so far made public announcements about specific job relocations, preparations are probably underway behind the scenes. Jobs will probably not be relocated in a single stroke, particularly if a transitional period is agreed; instead, the relocation process would be spread over several years. On the downside, Frankfurt did not succeed in its struggle for the seat of the European Banking Authority (EBA), which will be located in Paris in the future.

Frankfurt attractive as a financial location

In order to increase the attractiveness of Germany as a financial base for UK institutions, continued efforts should be made to modify labour and tax law. Approaches to such modifications can be found in the German government's coalition agreement, where the government explicitly agreed to loosen protection against dismissal for top bankers. More specifically, "risk takers" with an annual gross income of at least EUR 234,000 should be subject to the same protection from dismissal as executive employees. However, nothing has been implemented in this regard. According to the Finance Minister for the State of Hesse, plans will take shape in the next few months. In this context, the concerns expressed by the United Leaders Association (ULA) in Germany ("erosion of protection against dismissal") should be taken into account in order to reach a compromise solution.

Eliminating uncertainties with regard to jurisdiction

Furthermore, there is still uncertainty with regard to future jurisdiction. The white paper published by the UK government provides for a departure from the jurisprudence of the European Court of Justice (CJEU). According to the white paper, British courts would merely give "adequate" consideration to the case-law of the EU's supreme judges. On the other hand, the European Union insists that the CJEU must have the last word when it comes to the issue of interpreting European law. No agreement is in sight with regard to this point. Jurisdiction is crucial, in particular regarding the effects on financial products which are based on English law. In this context, it should be examined, inter alia, whether actions relating to these products can also be brought before courts in EU Member States. In the negotiations, provisions should be agreed for dealing with existing contracts which, in the past, could be escalated to the CJEU.

Clarification is also needed in dealing with contracts concluded and legal actions brought during a potential transition period, i.e. before the conclusion of the definitive Brexit deal (after March 2019). According to an estimate by Nomura's Capital Solutions Team, bank bonds with a volume of approx. EUR 120 billion are currently managed under English law by European banks which are not based in the UK. In the event of a hard Brexit, the investors of high-risk bonds (e.g. tier-1 bonds) might be forced to agree to transpose the clauses in the documentation of the bonds into local law as they no longer comply with EU regulations. In the case of government bonds of highly indebted euro countries, such as Italy or Portugal, this is often not desirable. In the final analysis, this will probably be particularly problematic for financial institutions based

Contract continuity on the test bench

in the European Union as English law is likely to remain predominant in the foreseeable future due to its worldwide reputation. For investors from Asia and America, English law still is an important prerequisite.

Conclusion

The risk of an uncontrolled withdrawal of the UK from the European Union at the end of March 2019 remains high; its probability is over 20 percent. The UK government's shift towards a "soft" Brexit has changed very little. Nevertheless, every effort should be made by the European Union to avoid a "cliff-edge" Brexit and to insist on the planned transition period, during which the UK would remain a member of the single market, at least temporarily. From the perspective of financial institutions, two aspects remain crucial: a thorough revision and extension of the equivalence regime, as it is highly likely that institutions based in the UK will lose their EU passport; and clarification of the jurisdiction for financial products based on English law. As far as euro clearing is concerned, conditions are taking shape which will allow market players to continue to operate in a reliable environment. Competition for "Brexit refugees" is already in full swing; however, a major relocation wave to the European continent has not yet materialised. Nevertheless, efforts should continue to be made to increase the attractiveness of Germany and in particular Frankfurt as a financial centre in order to seize the opportunities provided by Brexit.

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 or the DSGV.

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