Financial fragmentation & Brexit

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Private risk-sharing in the Banking Union is impaired

- Quantity-based indicators of financial integration have been flattening out in the Euro Area [upper left chart – blue line]
- M&A transactions in the Euro Area have followed a steady decline (number and value) and have become increasingly domestic (rather than cross-border) [lower left chart]
- The credit channel (cross-border borrowing and lending) has been acting as a shock amplifier rather than shock absorber since the financial crisis struck [upper right chart]
- **Private risk sharing in the Banking Union is impaired**
## Ring-fencing and distrust

### In response to the financial crisis:

- Ring-fencing of local establishments;
- Repatriation of foreign business;
- Inward-looking bank restructuring and consolidation choices;
- National public interventions leading to retrenchment;
- Heterogeneous use of the macroprudential toolkit affecting cross-border banking decisions

### 10 years since the financial crisis struck, despite ongoing partial macroeconomic recovery, substantial progress in banks balance sheet repair and the Banking Union reform – distrust is persistent and this is reflected in current policy debates:

- Completion of the EU safety net: (i.e. mutual loss insurance) European Deposit Insurance Scheme (EDIS) and the Common Backstop
- Solo-level application of own funds, liquidity and MREL requirements within cross-border groups
An EBA perspective

**Banks in the CMU:**
- Cross-border bank funding;
- Cross-border risk transfer to banks and non-banks;
- Cross-border transfer of legacy risk

**EBA perspective**
- STS Regulation (OJ Dec 2017)
- EU Covered Bonds Directive
- EU Secured Notes
- NPL secondary market
- Benchmarking Loan enforcement

**Banks in the BU:**
- Direct cross-border lending;
- Cross-border banking via establishment:
  - Branches
  - Subsidiaries

**EBA perspective**
- Single Rulebook
- Single Supervision and Single Resolution Mechanisms
- EU Safety Net: EDIS and Common Backstop to provide ex-ante confidence and mitigate ring-fencing policies;
- Supervisory/regulatory factors on cross-border M&As: Capital/Liquidity/MREL prepositioning
- Insufficient contractual safeguards to host authorities (IFSA, cross-border guarantees)
- Separability in resolution
- Use of systemic buffers
- Use of Macroprudential toolkit
- Use of Pillar 2
- Broader banking protectionism

Private risk sharing via diversification

Cross-border M&A as post-crisis consolidation adjustment channel

Efficiency and profitability via economies of scale/scope

Enhanced resilience and productivity

Financial fragmentation & Brexit – Madrid October 2018
Brexit: a fragmentation event in the heart of EU financial markets

- London major center for clearing of euro-denominated IR derivatives (upper bar chart);
- London primary European international wholesale banking center, with presence of major EU and US entities;
- UK 3rd-country scenario: business re-location to the EU-27 is a fragmentation event (economies of scale and scope, duplications, increased costs);

**UK’s OTC daily interest rate euro-denominated derivatives turnover, average (Xafa 2017 on BIS 2016 data – US dollar bln on y-axis)**

![Bar chart showing turnover from 2004 to 2016 for United Kingdom, United States, and Other]

**European operations of top five US investment banks: turnover (end-2014)**

<table>
<thead>
<tr>
<th>Countries</th>
<th>Panel A: Turnover by Country (EUR millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>22,744</td>
</tr>
<tr>
<td>Germany</td>
<td>513</td>
</tr>
<tr>
<td>France</td>
<td>361</td>
</tr>
<tr>
<td>Italy</td>
<td>193</td>
</tr>
<tr>
<td>Ireland</td>
<td>201</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>276</td>
</tr>
<tr>
<td>Other EU</td>
<td>438</td>
</tr>
<tr>
<td>Total</td>
<td>24,727</td>
</tr>
</tbody>
</table>

**The UK banking system (end-2014 GBP bln and % of total)**

<table>
<thead>
<tr>
<th>Type of Banks</th>
<th>Total assets (in £ billions)</th>
<th>Wholesale banking in London (in £ billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Major UK International banks</td>
<td>3,570 (45%)</td>
<td>1,100</td>
</tr>
<tr>
<td>Major UK domestic banks</td>
<td>1,160 (15%)</td>
<td>-</td>
</tr>
<tr>
<td>Other UK banks</td>
<td>250 (3%)</td>
<td>-</td>
</tr>
<tr>
<td>Rest of the World Investment Banks</td>
<td>1,730 (22%)</td>
<td>1,730</td>
</tr>
<tr>
<td>Rest of the World Other Banks</td>
<td>460 (6%)</td>
<td>310</td>
</tr>
<tr>
<td>Branches from EEA banks</td>
<td>790 (10%)</td>
<td>530</td>
</tr>
<tr>
<td>Total UK banking system</td>
<td>7,960 (100%)</td>
<td>3,750</td>
</tr>
</tbody>
</table>
Brexit: a fragmentation event in the heart of EU financial markets

To date, the EBA has highlighted various risks arising in the context of Brexit:

- Loss of access to Financial Market Infrastructures (including CCPs)
- Risks to contract continuity (especially derivatives contracts)
- Loss of access to funding markets in the UK
- Inability to transfer data between the UK and EU27

No empty shells (EBA 2017), no letterbox companies (ESMA 2017) – meaningful substance must shift from UK to EU27

Relocations to the EU27

General principle (EU-wide and global): trade-off transparency & cooperation in supervision Vs fragmentation outcomes

Commission proposal on EMIR 2 an interesting blueprint

Readiness and contingency planning!
Brexit: preparedness overview

- EBA Opinions on Brexit-related matters issued in October 2017 and June 2018
- Focused on the risks of a ‘no deal’ scenario → the risks with an increasing probability giving the state of political negotiations and time left for implementation
- EBA is working with the competent authorities on monitoring institutions’ contingency planning and progress with their implementation

- Plans more advanced and cover more institutions
- Institutions are progressing with getting necessary licences and relocating their businesses → close engagement with national authorities
- Institutions claim progress in:
  - diversifying access to funding
  - introducing contractual bail-in clauses into newly issued MREL
  - introducing contractual clauses to facilitate data transfers

- Delays in licencing applications of the EU27 institutions in UK due to introduction of temporary permissions regime
- Concerns over the degree of the preparations of smaller and less sophisticated institutions, and payment service providers

1) Stock of derivatives
   - Centrally cleared derivatives, future role of UK-based CCPs?
   - OTC derivatives and ability to continue performing life-cycle events
   → ECB-BoE technical group is scoping on both issues

2) Communication to customers is limited
   - Retail banking
   - Payment service and E-money providers