Financial fragmentation & Brexit

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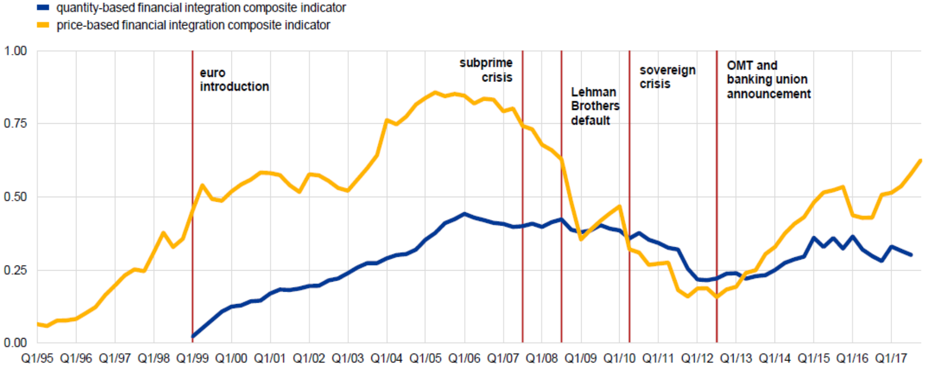
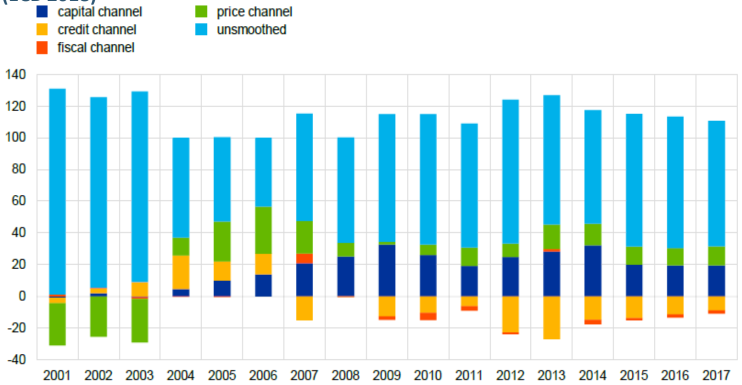
Private risk-sharing in the Banking Union is impaired

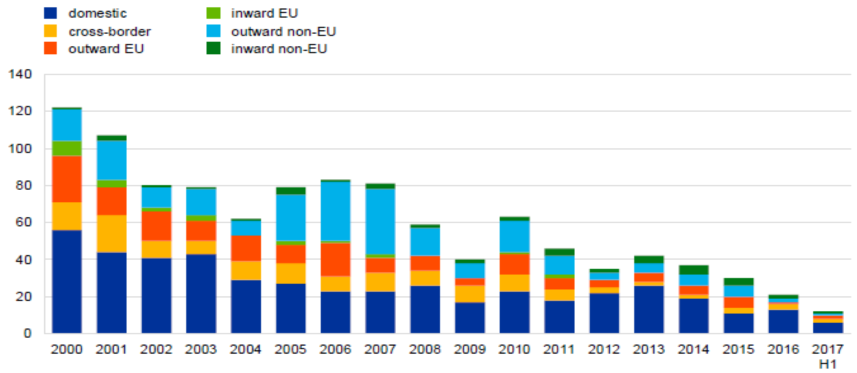
Price-based and quantity-based composite indicators (y-axis) of financial integration (ECB 2018)



Consumption risk sharing in the Euro Area and its channels: % of shock smoothing (y-axis) (ECB 2018)



Bank M&As – number of transactions (y-axis) in the Euro Area (ECB 2017)



- 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

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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

Brexit: a fragmentation event in the heart of EU financial markets

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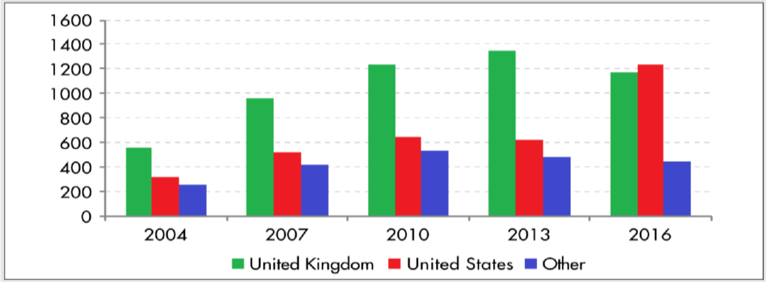
UK's OTC daily interest rate euro-denominated derivatives turnover, average (Xafa 2017 on BIS 2016 data – US dollar bln on y-axis)



- 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);**

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

Countries	Panel A: Turnover by Country (EUR –millions)	
United Kingdom	22,744	92%
Germany	513	2%
France	361	1%
Italy	193	1%
Ireland	201	1%
Luxembourg	276	1%
Other EU	438	2%
Total	24,727	100%

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

Type of Banks	Total assets (in £ billions)	Wholesale banking in London (in £ billions)
Major UK international banks	3,570 (45%)	1,180
Major UK domestic banks	1,160 (15%)	-
Other UK banks	250 (3%)	-
Rest of the World Investment Banks	1,730 (22%)	1,730
Rest of the World Other Banks	460 (6%)	310
Branches from EEA banks	790 (10%)	530
Total UK banking system	7,960 (100%)	3,750

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

→ Readiness and contingency planning!

Relocations to the EU27

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

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

Commission proposal on EMIR 2 an interesting blueprint

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

<u>1) Stock of derivatives</u>

- 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

<u>2) Communication</u> to customers is limited

- Retail banking
- Payment service and E-money providers

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