Finance Watch
Making finance serve society

Statement by Prof. Rainer Lenz, Board director at Finance Watch at the

Public Hearing of the „Ausschuss für Bundes- und Europaangelegenheiten und Regionale Entwicklung des Niedersächsischen Landtages“

Brexit and its potential impact for Lower Saxony

Hannover, 3 May 2018

About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society.

For further information, see www.finance-watch.org

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Honourable Members of the Niedersachsen Parliament, ladies and gentlemen,

I would like to thank you for the opportunity to speak at this important hearing today. The UK withdrawal from the European Union will have an inevitable impact on both the UK and the 27 remaining members of the EU. This hearing is important because preparations need to be made to minimise any negative impact as far as possible. Although we are talking here about impact on our economy and companies, it will ultimately affect citizens. This is why Brexit is such an important issue and why Finance Watch is looking at how it will impact financial services.

It now seems likely that there will be a 'hard' Brexit, at least in the case of services provision. By 'hard' Brexit we mean the situation where UK companies no longer fall under EU law and existing authorisations to provide services in the EU, following a UK exit from the single market and EU as a member state. Similarly this means that EU companies would no longer fall under UK law and existing authorisations to provide services in the UK would no longer be valid. Put in the simplest terms it is the situation where the UK leaves the EU without having a new trade agreement in place. This is certainly the premise that authorities in both the EU and the UK are working under. Preparations that can take a considerable amount of time will need to be made well in advance of the UK exit from the EU. Even if this situation unexpectedly changes at the last moment, given that the current likely scenario is a hard Brexit, preparations will have to be put in motion now taking this into account. The European Commission has issued a series of advice for stakeholders[1] to ensure that they prepare and take appropriate measures to deal with the implications of the UK exit from the EU. It clearly states that private companies, not just EU and national authorities, are also expected to properly prepare for the UK withdrawal from the EU. Financial institutions are ultimately responsible for ensuring that they can continue to meet their contractual obligations.

Niedersachsen has a particular link with financial service and specifically insurance as the home of Hannover Re, one of the largest reinsurance companies in Europe. Hannover Re also claims to be one of the largest life reinsurance companies in the UK currently. This means that the Brexit discussions around financial services also have particular relevance to Niedersachsen.

The financial services industry will certainly be affected by Brexit, especially considering that financial services are not currently covered by any EU trade agreements. Furthermore, for the most part EU financial services legislation does not include the possibility for third country equivalence to be used. Out of the 40 pieces of post-financial crisis EU legislation only 15 include third country provisions. This option has also proven politically unacceptable to the UK in its current form. Equivalence decisions have in any case been criticised as there is not currently a single framework to ensure consistency and transparency. The European Parliament has recently published an own-initiative opinion calling for such a framework to be introduced and for greater parliamentary scrutiny over these decisions. This will be essential if equivalence decisions are to be more widely used, including to improve and better assess cases where they are already in effect.

An important point to raise here is that even with a transition period there is now very little time for companies to react to ensure there is no negative impact on their consumers. The process for registering a third-country branch of a company or a subsidiary can be expected to take at least 18

[1] https://ec.europa.eu/info/brexit/brexit-preparedness_en

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months and possibly longer. Then if a transfer of a portfolio of business is needed this can take an additional 18 months. The process is dependent on the national supervisor and its capacity, but the point remains that action should be taken in a timely manner to ensure that contracts can continue to be serviced.

The UK is considering for its part a 'Temporary Permissions Regime' (TPR) for EU firms and funds passporting into the UK. The Financial Conduct Authority (FCA) in the UK is already conducting a survey to ascertain which companies might be interested in this option. Companies will be required to notify the FCA that they wish to be covered by the TPR and then would be allowed to undertake new business that falls under their existing permissions and continue to service existing contracts and obligations.

One of the key points that needs to be at the fore of the debate around the UK exit from the EU is to continue to better enforce and improve the EU financial legislative framework that has been jointly built. Neither UK nor EU financial services companies should seek to use the UK withdrawal from the EU to create regulatory loopholes. This risks undermining the legislative framework, which is still yet to properly address the issues with the financial services industry exposed by the financial crisis. A general collective focus of the both EU Member States and the UK must remain on continuing to improve and build a financial legislative framework that can protect their citizens from suffering the consequences of another financial crisis. In the case of a TPR, this means that the FCA must ensure that the same level of protection and financial regulation remains in place.

Here we can look to the example of the insurance and reinsurance and Brexit. An issue with potential to create regulatory loopholes is the registration of third country branches or subsidiaries of financial services companies. As previously mentioned this will be one of the solutions of many companies. This may include attempting to set up a 'brass plate' company, which is used to sell services without actually being a properly staffed and functioning operation. Reinsurance could then potentially be used in the case of these 'brass plate' companies to relocate capital back to the UK or vice versa. National supervisory authorities should not be tempted to soften their authorisation processes to allow these practices to take place, despite the possible incentives of high tax returns and jobs. The European Insurance and Occupational Pensions Authority has already issued an opinion[2] calling consistency of authorisation processes for the relocation of insurance undertakings from the UK. The European Securities and Markets Authority has also specifically denounced outsourcing and delegation that could lead to regulatory arbitrage.

It is worth mentioning that according to the European Supervisory Authorities (ESAs) the overall investment exposure of European Economic Area insurers to the UK is only around 2.13% of the total premiums written[3]. There could, however, be companies that are more exposed to UK assets and could be affected by a drop in the value of some asset classes in the short and medium term. The extent of this impact is difficult to predict with so many unknowns at this point in time. However, the ESAs believe that UK households and corporates could end up with less access to finance in the short

[2] https://eiopa.europa.eu/Publications/Opinions/EIOPA-BOS-17-141%20Opinion_Supervisory_Convergence.pdf
[3] https://esas-joint-committee.europa.eu/Publications/Reports/Joint%20Committee%20Risk%20Report.pdf

term. Combined with possible portfolio transfers, restructuring and effects on market confidence this could impact on market liquidity and risk premiums.

To conclude, there are a number of areas that need to be closely monitored by authorities at all levels to ensure that Brexit does not have a serious negative impact on financial services and then ultimately citizens. The current EU financial regulation framework is by no means perfect and needs to continue to be developed. This will involve a coordinated effort and a consistent approach from authorities, especially in the case of the risk posed by a likely hard Brexit. However, a large burden of trust also rests on the shoulders of financial institutions to properly prepare and ensure that consumers are not negatively impacted. 10 years after the financial crisis we have not seen the changes in the behaviour of financial institutions that are needed to earn citizens' trust. This is another test where they risk further damaging this trust if they try to profit from undermining the regulatory framework.