Keynote address “Challenges for EU-Japan Partnership in Financial Services: A Perspective from a Third Country” at the EIAS seminar “Collateral Damage: How Brexit Affects Japanese Financial Services in Europe” on 6 March 2018

Jutaro Kaneko, Chief Representative in Brussels,
Japan Center for International Finance

Many thanks for your kind introduction, Erik-san.

Ladies and Gentlemen, thank you very much for being here today. It is a great honor for me to speak to such a distinguished audience.

I was born in Geneva, and I studied and worked in Germany from 2000 to 2004. Witnessing the historical introduction of hard currency euro, I was really fascinated with the irrevocable progress of the EU integration. Without exaggeration, I am a BIG fan of the EU, and I believe that the EU has a plenty of valuable experiences and lessons for Asia to learn for its regional stability. I am also excited about the EU-Japan Economic Partnership Agreement (EPA) to be concluded hopefully very soon. I really wish the EU and Japan would further enhance the economic and political ties and deepen mutual understanding based on the agreement.

Having said that, I must unfortunately admit that it is difficult to be very optimistic about the future relationship between the two jurisdictions in the area of financial services. The EU is fundamentally reviewing its regulatory policies to be more protective visa vie the third countries, namely non-EU/EEA countries, including Japan against the backdrop of Brexit and other external factors. I assume that it is something neither the EU nor Japan is going for. This is why I say Japan is suffering collateral damage. So, I would like to share my personal views on how to proceed with the partnership development, avoiding unintended

consequences arising from the lack of due attention to the risk. This is the purpose of my presentation.

Here is the outline of my presentation. I will first explain the background of the issue, and then recent regulatory and supervisory developments in the EU, followed by the activities and predicaments of the Japanese financial institutions in the EU, and finally, personal proposals towards enhanced partnership between the EU and Japan in financial services.

To begin with, let's take a brief look at the current situation facing the EU and the EU's countermeasures under discussion.

I think there are a few external factors which are making the EU skeptical against third countries. First and foremost, Brexit. Stakeholders in the financial market are very concerned about the future treatment of the UK's access to the EU's financial market after Brexit. But to be fair, I find it pretty reasonable for the EU to be cautious and nervous, since the EU is likely to have a new third country of the UK in just 12-13 months which is far more important than any existing ones.

I don't mean to offend any audience from the US and China, but to me it seems that the US and China are also influencing the EU's attitude. The examples are US's Dodd Frank Act which introduced a requirement for foreign banks to establish intermediate holding companies in the US and direct supervision over UK's clearing house/CCP which is short for central counterparties by a US market regulator, as well as China's rapidly growing direct investment in the areas of the EU's strategic interests, including financial institutions.

Against the backdrop, there seems to be growing concern among the EU legislators over regulatory and supervisory regimes in the third countries as a whole. I can exemplify concern over “race to the bottom” lead by third countries which wish to attract financial transactions and institutions to themselves, as such. I am afraid the EU’s counterreactions will only accelerate market fragmentation, decrease market liquidity and lead to increase of cost for doing business in Europe at the end of the day.

Now, I would like to show you some recent regulatory and supervisory developments which I find as signs of the EU’s skepticism against third countries.

First, the European Commission proposed to introduce a requirement on large third country banks to set up intermediate parent undertakings in November 2016. The policy intends to retain enough financial resource within the EU to ensure smooth resolution of those banks for the case they fail, which is known as “ringfencing”. It just mirrors a very similar requirement in US Dodd Frank Act I mentioned. So, this is a tit-for-tat between the two large jurisdictions with the attempt to protect their own markets, investors and depositors over those of the other.

Second, the EU is discussing to strengthen regulation over critically important third countries’ CCPs clearing euro denominated transactions based on the Commission’s proposal in June 2017. In this regard, compulsory relocation to the EU and direct supervision by the EU institutions could be a condition for recognition of those CCPs, irrespective of regulatory equivalence. This measure is obviously aimed at UK CCPs such as LCH Ltd which clears most of

the euro denominated interest rate swaps; a type of financial derivatives.

Third, the Commission proposed to make the third country regime more stringent in September 2017. Under the current regime, the EU permits access to the single market with institutions of third countries which it thinks have regulations equivalent to its own in terms of certain areas of financial services, although there are limitations compared to single passport and it doesn't cover commercial banking for example. If the revision is realized, it will decrease regulatory predictability and bring about chilling effect over third countries' financial institutions active in the EU, due to the anxiety that the EU's equivalence decision might be withdrawn more easily and abruptly. Frequent and stringent equivalence tests will also increase compliance cost of the authorities and the financial institutions in third countries, given the fact that it is a lengthy and resource consuming process.

Fourth, the Commission notified the financial industry of the possibility that investment outsourcing to the UK asset managers might be forbidden in February 2018 in the context of Brexit. It will damage not only the London financial market but also a large number of investment funds in the EU which rely on UK asset managers.

Fifth, the Commission published a new legislative proposal on screening inward foreign direct investment in the areas of the EU's strategic interests in September 2017, as anticipated in the President Junker's last State of Union speech.

As for financial supervision, EU institutions including European Central Bank and European Securities and Market Authority are emphasizing repeatedly in the light of Brexit that they will not grant

business licenses for financial services such as banking and broker dealing to third countries' subsidiaries without sufficient capital, capacity and staff. The so-called "no letterbox/shell company policy" means that third countries' institutions licensed only in the UK must substantially duplicate their UK presence in the EU in order to retain their single passports. In addition, processes such as development of IT systems and recruitment of local staff take a long time, apart from obtaining licenses. Therefore, there is little time left for third countries' financial institutions to wait and see the outcome of the Brexit negotiation despite the persistent uncertainty.

I understand that the uncertainty arises primarily from the UK side. But, uncertainty is uncertainty, wherever it arises from.

According to major researches, London is ranked as the world's best financial market and the current evaluations of the best markets in the EU27 such as Frankfurt are far below London. London has developed its so-called "ecosystem" consisted of a wide range of elements including law firms and accountant offices in the last decades. Therefore, I expect that important functions of European financial markets will be divided in different countries of the world, due to the difficulty for any of the continental European markets to replace London completely in a short term.

Under these circumstances, the Japanese financial institutions have been practically forced to establish/reinforce subsidiaries in the EU27 immediately, while retaining their existing subsidiaries in the UK to prepare for the worst case scenario: Hard Brexit with a short/no transitional period which is well known as cliff edge.

As you see in this table, many of the major Japanese financial institutions already announced their plans to establish new subsidiaries in the EU27.

Now, I would like to explain briefly about activities of the Japanese financial institutions in the EU.

As you may remember, Japan experienced a severe recession after the burst of the bubble economy in 90's. It was at that time when the Japanese financial institutions began concentrating their European business in London in order to cut cost through consolidation of subsidiaries and branches. Although the business conditions have been improved since then, profitability in the European market remains basically unchanged for many of the Japanese institutions. As the result, they are licensed only in the UK.

I would like to bring your attention to the fact that the Japanese banks have continuously supported the EU credit market even during the last global financial crisis when the US and European banks reduced their lending exposure.

This slide illustrates infrastructure development projects backed by "The Investment Plan for Europe"; the Juncker Plan. The firms written in red are the Japanese financial institutions.

The characteristics of the Japanese banks in the EU can be summarized in the three points. First, small presence in the EU retail market which means that they are not competing with the EU firms in this area.

Second, doing little risky and complex transactions such as derivatives famous for the jump to default risk.

Third, active involvements in the Juncker Plan.

The Japanese financial institutions are increasing their investment in stocks in euro area and the current level is higher than the level before the global financial crisis, as the blue line in the chart shows.

In this slide, you see that many major Japanese financial institutions are directly participating in a most important UK clearing house; LCH Ltd. If the EU doesn't recognize this clearing house as a qualified third country CCP after Brexit, arguing that the UK's CCP regulation is not equivalent to that of the EU, participants of LCH Ltd will have to replace their outstanding euro denominated positions to a CCP in EU27. But, to switch CCPs, especially to migrate positions from one CCP to another CCP is a highly risky and costly task. This is particularly the case with interest rate swaps of which average maturity is very long like years.

I am very proud that Japan is the third country which has been given with the most regulatory equivalences in financial services by the EU[1]. As Japan shares with the EU fundamental values such as freedom, the rule of law and democracy and is contributing to EU's economy, EU and Japan can further deepen partnership based on mutual trust, resisting surge of egoisms in global environment.

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[1] Based on Commission Staff Working Document "EU equivalence decisions in financial services policy: an assessment" published on 27 February 2017.

However, if the EU's legislative revisions are implemented as proposed, the Japanese financial institutions' net profit is very likely to shrink towards the break-even points due to significant increase of costs related to holding more physical presences in Europe, to migrating clearing contracts, and reduction of size and efficiency of the EU single market after Brexit.

I dare say that this may result in some shift of Japanese financial institutions' resources in Europe as an entirety, irrespective of whether in the EU27 or in the UK to outside Europe like Asia or North America. I hope and believe that this is not in line with the intent of the EU.

I assume that the decrease of attractiveness of the EU financial market will be offset by completion of the banking union project and capital market union project. But I don't know to what extent it will be.

Please listen to the voice of my heart. (Music) Yes, indeed! So, what can we do to avoid such an unintended consequence?

Finally, I would like to conclude my presentation by expressing my wishes towards the better future between the EU and Japan.

In a nutshell, Brexit is not a lose-lose game for the EU and the UK, as is often said, but a lose-lose-LOSE game, because it is a massive loss not only for the two jurisdictions but also for third countries!

And Japan is suffering collateral damages against the backdrop of the EU's growing skepticism against third countries.

Even if damage is inevitable, it needs to be controlled and minimized to the extent possible.

To tackle with this issue, I hope that the EU-Japan EPA will include a special agreement on financial services. I understand that the EPAs that the EU and Japan have concluded respectively so far are principally nothing more than WTO rules in terms of financial services and the EU has denied the possibility to cover financial services in an economic agreement in the context of Brexit. Nonetheless, I hope for such an EU's preferential treatment for Japan.

Another idea is to differentiate third countries in accordance with their individual risks to EU financial system. I would call it a "clear and foreseeable risk-based approach" under the new third country regime.

Alternatively, a regulatory and supervisory agreement on enhanced cooperation between the EU authorities and the UK authorities would be effective to mitigate market fragmentation. In this regard, allowance for the EU subsidiaries of third country institutions to rely on the capital, the staff and the systems related to risk management of the UK subsidiaries will be most welcome, because it can reduce the cost for setting up new subsidiaries in the EU27 to maintain access to the single market.

Thank you very much for your attention. As I said at the beginning, the views expressed in my presentation are completely personal, and I am most happy to have different opinions and assessments from you in the following session. Once again, thank you very much.