Key points

The immediate impact of the Brexit referendum was a period of heightened financial market volatility which has mostly receded relatively quickly. This represented a stress test of market structure in the wake of the post-crisis regulatory reforms and, at least to date, the global financial system has withstood the event well.

The net asset price response across most major markets to date is lower sovereign bond yields and expectations of easier monetary policy. Within this there has been considerable regional and sectoral variation, with particularly sharp falls in some UK asset prices – including the pound – and banking sector equity prices, particularly in Europe. The depreciation in the pound has contributed to higher UK equity prices on some measures.

Our assessment, and that of most observers, is that the overall economic impacts over both the short and medium term will be negative and concentrated on the UK economy. Over the longer term, the magnitude of the impact will depend on the degree to which the UK reduces links with the EU and is able to engage with others. Beyond the UK, the main negative short-run economic effects are expected in Europe, reflecting trade and financial links and associated uncertainty. Global economic activity is widely expected to be only modestly affected by Brexit, given the UK's relatively small share (just over 2 per cent) of global GDP.

Brexit, however, presents an additional downside risk to the global economic outlook if it were to trigger exit movements within the EU, which for euro area countries would be more disruptive given the common currency. Ongoing banking sector fragility in the region remains a downside risk. Market movements reflect increased apprehension about banks in a number of European countries, most notably Italy, post Brexit.

Short-term policy responses to the Brexit result focused on central bank provision of additional liquidity to support market functioning – although this support has only been drawn upon in a limited way – and reported intervention in foreign exchange markets by some countries to relieve pressure for currency appreciation. The Bank of England has given a strong indication that it may ease monetary policy in the near term as part of a 'host of measures and policies' to support the UK economy.

Australia has proved resilient during past periods of financial market volatility and remains well placed to manage the economic and financial market response to Brexit. The effect on economic activity in Australia, and the financial sector, is expected to be small. Trade links to the UK are small, and there has not been a large reaction in commodity prices. The links of the Australian banking system to the UK have declined in recent years, with Australian banks reducing UK exposures and UK banks retreating from Australia in the post crisis period.

In the event that concerns about the viability of the euro area escalated, funding and operating conditions for Australian banks could deteriorate. That said, banks have significantly improved their resilience post crisis, with stronger capital and funding positions. In case of a significant tightening of funding conditions, Australian dollar liquidity remains available through Reserve Bank facilities.

Council of Financial Regulators (CFR) agencies, including through their overseas footprint and Australia's diplomatic network, were quick to gather international intelligence and coordinate around the Brexit

decision and will continue to monitor Brexit-related developments. Monetary and fiscal policy options remain available if needed.

The uncertainty and market disruption created by Brexit further emphasises the need to remain focused on progressing international efforts to strengthen financial stability and address risks. Protracted exit agreement negotiations may challenge the capacity of the UK and EU to engage fully in other international forums and institutions in the short to medium-term.

1 Introduction and background

On 27 June 2016, the Prime Minister and the Treasurer wrote to the Reserve Bank Governor, in his capacity as Chairman of the CFR, requesting a report on the implications of the UK's vote of 23 June 2016 to leave the EU (Attachment A).

The vote has generated considerable financial market volatility, economic uncertainty and political instability, particularly in the UK. The UK Prime Minister has resigned and the leader of the UK Labour party has lost a vote of no confidence. It is unclear when the formal process for exit, dependent on the UK triggering Article 50 of the Lisbon Treaty, will begin, let alone the timing and nature of the eventual agreement between the UK and the EU. At the same time, there have been renewed calls for Scottish independence and for similar referendums in some continental European countries.

This report reflects the consolidated view of the CFR agencies: the Reserve Bank of Australia (RBA); the Australian Prudential Regulation Authority (APRA); the Australian Securities and Investments Commission (ASIC); and the Treasury. The report is informed by CFR agencies' close consultation with their respective counterparts in the UK, Europe and other jurisdictions. It takes into account developments up to and including Tuesday 5 July.

The report discusses:

- short-term impacts on the domestic and international financial systems and economies and associated responses by authorities;
- medium- to long-term implications for the domestic and international economic outlook, the future of the EU, international economic cooperation and the financial regulation reform agenda.

2 Short-term implications for Australia and the world

2.1 Financial market reactions

The vote to exit the EU was a surprise to financial markets. Financial markets were very volatile in the days following the referendum. There were very sharp falls in bond yields and equity prices (particularly bank share prices) and large movements in foreign exchange markets (particularly a depreciation of the pound). Despite this, market functioning was generally orderly, and asset prices have largely stabilised and in a number of cases retraced their initial falls.

Table 1: Financial Market Indicators

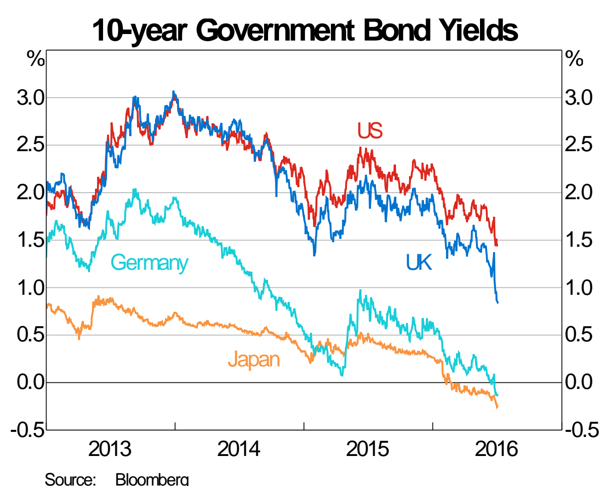
Change since 23 June 2016*

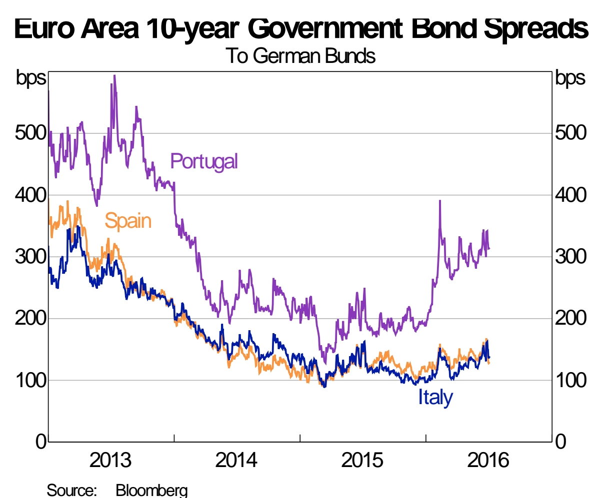
	Exchange rate[(a)]	10-year govt bond yield	Share prices – broad market[(b)]	Share prices – banks	Interbank spreads	Bank CDS premia
	(per cent)	(bps)	(per cent)	(per cent)	(bps)	(bps)
UK	-12.5	-60	1.1	-12.8	15	27
Europe	-2.7	-28	-7.2	-21.9	-2	22
Japan	4.2	-11	-3.2	-10.1	2	3
US	1.8	-37	-1.2	-9.0	3	6
Australia	-2.0	-31	-1.0	-3.9	3	5

* As at close of business 5 July
(a) Against US dollar, TWI for the US
(b) FTSE350 for UK
Source: Bloomberg

Monetary policy expectations have generally been wound back in the developed economies. Comments from Bank of England (BoE) Governor Carney and market pricing suggest that the likelihood of monetary easing by the BoE has risen since the referendum, consistent with the weaker near-term and longer-run outlook for the UK economy as a result of the 'Leave' vote (see below for further details on the economic effects of Brexit). Speculation of further easing measures by the European Central Bank (ECB) has also risen. Market-implied expectations for the US federal funds rate have been scaled back sharply following the Brexit vote, with the next policy tightening now not priced in until 2018.

Major market sovereign debt yields fell sharply in the days following the Brexit vote. A little harder to understand development was the particularly large decline in UK 10-year government bond yields, despite S&P and Fitch downgrading the UK's credit rating and Moody's placing the country on negative outlook. Spreads on bonds issued by governments in the euro area periphery to German government bonds widened following the Brexit vote, alongside concerns about the implications of the UK exit for the stability of the EU.

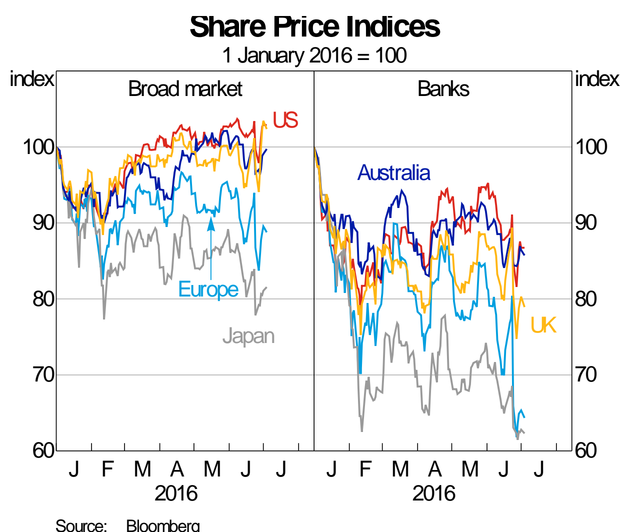


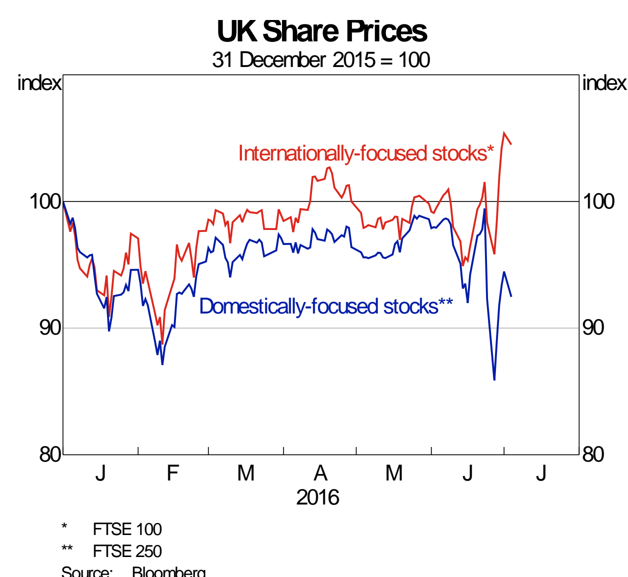


Falls in sovereign yields have helped to keep borrowing costs in developed bond markets at very low levels, despite a small widening of spreads. In corporate bond markets, spreads for both investment and non-investment grade bonds in developed markets widened following the Brexit vote, especially in the UK. Similarly, spreads for bank funding (relative to risk-free rates) widened a little following the referendum,

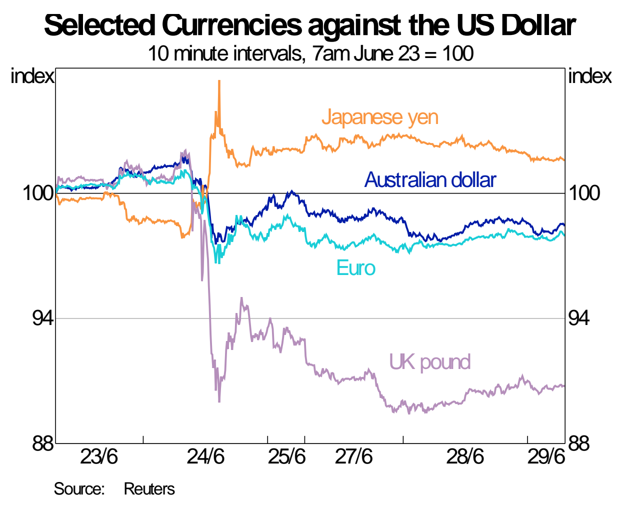
with a larger widening in the UK. The cost of borrowing US dollars in foreign exchange swap markets and repo markets generally increased following the vote. Nevertheless, money market functioning remained orderly.

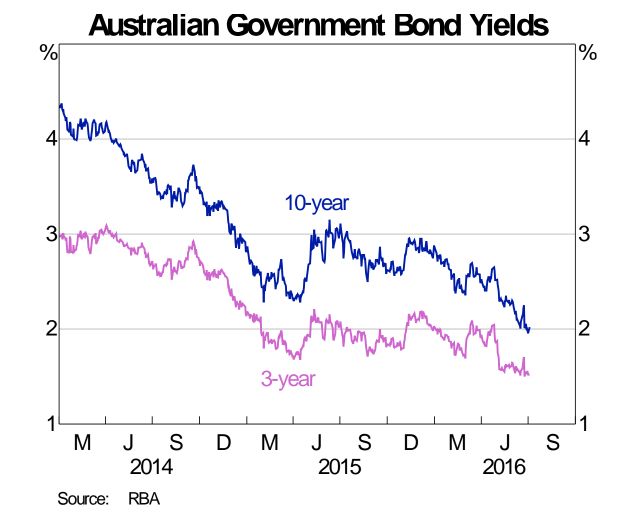
Global equity prices fell sharply following the Brexit referendum, although the initial falls have been in many cases wholly retraced. UK equity prices fell by less than those in many European countries as the depreciation of the UK pound was seen as supporting the earnings of internationally focused companies. The share prices of euro area banks and UK banks with a predominantly domestic focus have fallen by 15–30 per cent. At the same time, yields on riskier types of debt issued by these banks and the price of credit default insurance have increased, but by less than during the pronounced market volatility in early 2016.





Foreign exchange markets were also volatile following the UK referendum. Heightened risk aversion contributed to an appreciation of the US dollar, Japanese yen and Swiss franc, while the UK pound, euro and other currencies depreciated. The UK pound has depreciated by 11 per cent against the US dollar since the referendum, to be at its lowest level since 1985. Foreign exchange markets functioned well given the outcome and the size of the price movements.





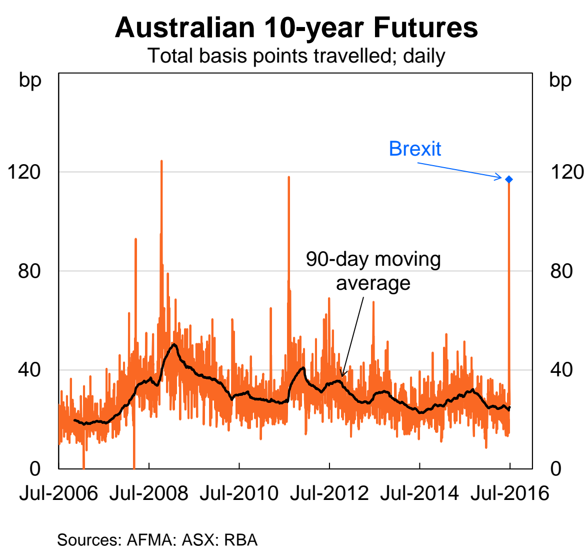
The Brexit result has prompted concerns about the outlook for UK property prices, particularly commercial property. In the days following the result a number of UK commercial property funds have responded to increased withdrawal requests by suspending redemptions.

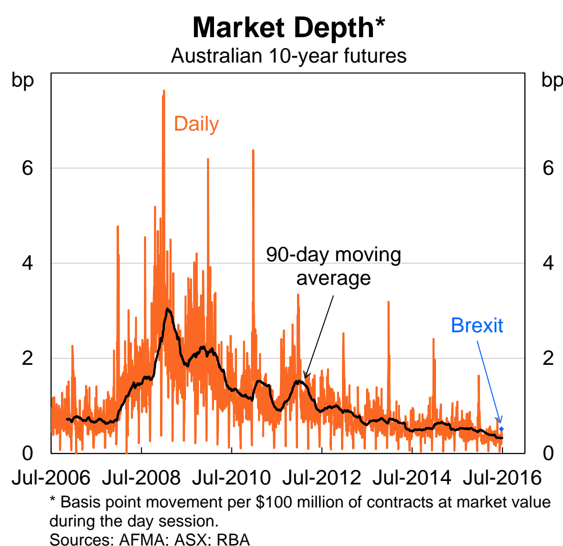
In emerging markets, yields on local currency-denominated sovereign bonds generally increased somewhat following the Brexit vote. Spreads on US dollar-denominated emerging market corporate bonds widened, and equity indices fell. Emerging market currencies depreciated following the outcome. These movements have generally been wholly or partly unwound in the days since.

Australian financial markets also reacted strongly to the UK referendum.

- Long-term interest rates fell sharply after the referendum outcome, with the 10-year bond yield reaching a then record low of 1.95 per cent.
- Bank bond yields also fell, despite a slight widening in spreads to benchmark rates.
- Spreads between bank bill and OIS rates widened slightly following the Brexit result, but remain below those seen in late 2015.
- There was a short-lived increase in market expectations for a near-term easing in monetary policy.
- Australian equity prices fell by 3.2 per cent on the day of the referendum outcome, but have since retraced the fall; the share prices of companies with large UK exposures, including some financial institutions, fell particularly sharply.
- The Australian dollar was volatile on the day of the referendum outcome, initially appreciating before depreciating as the 'Leave' result became likely, but it is a little higher on a trade-weighted basis than at the start of June.

Despite intraday volatility Australian financial market functioning has been orderly. Market depth in the 10-year bond futures contract was resilient, even though intraday volatility was as high as that seen during the peaks of the global and European crises. In Australia's equity and futures markets, no extreme volatility controls (including trading halts) have been triggered on ASX or Chi-X equity trading platforms since the referendum result. Short-selling activity on the Australian equity market has remained at relatively low levels, despite a spike in total volume sold short on Friday 24 June.





On Monday 27 June, the Australian Office of Financial Management's tender for five year bonds was well subscribed with coverage over four times.

Key financial market infrastructure functioned well during a period of higher trading volumes and increased market volatility.

- The central counterparties (CCPs) that serve key markets in Australia were all well prepared to manage increased financial risk around the referendum, with clearing participants advised to expect intraday margin calls should large mark-to-market price moves occur. In the event, the significant price changes observed in equity and interest rate markets triggered large and extensive intraday margin calls to cover the associated exposures to the CCPs. All margin calls were met on time by participants, which ensured that the CCPs remained adequately covered.
- Australian CCPs also made additional initial margin calls in the afternoon of the Australian trading day on 24 June, to increase collateral held to cover forward-looking volatility ahead of the European and US trading days. These calls were met on time. In light of the outcome of the vote, this additional collateral was retained by the CCPs in the week following the vote. The CCPs are reviewing their initial margin requirements to ensure that they remain well placed to withstand a potentially extended period of heightened uncertainty and volatility.
- High-value payment and settlement systems in Australia experienced high processing volumes. All relevant systems accommodated these volumes with adequate capacity headroom and completed settlement without incident.

2.2 Policy and regulatory measures

2.2.1 International actions

Central bank actions associated with the UK referendum mainly relate to additional liquidity provision and foreign exchange intervention.

Prior to the Brexit referendum, major central banks – including the BoE, the ECB, the Bank of Japan (BoJ) and the US Federal Reserve – announced they were prepared to enact measures to address potential dislocation in markets, including the provision of local currency liquidity and foreign currency liquidity through the existing swap lines. Following the referendum result, several emerging market economies' central banks also announced they were ready to provide liquidity as required to prevent disorderly market conditions. Use of swap lines has been negligible.

The BoE offered three additional indexed long-term repo operations in the weeks around the UK referendum on top of its regular monthly auction. Demand in the auctions was generally low and pricing remained at minimum levels ahead of the referendum, before picking up slightly in the final operation after the referendum. The total amount allotted in June does not suggest a substantial need for additional liquidity. The BoE will hold weekly liquidity auctions until the end of September.

The BoE has also reduced its countercyclical capital buffer from 0.5 per cent to 0.0 per cent with immediate effect. In addition, the BoE has given a strong indication that it may ease monetary policy in the near term as part of a 'host of measures and policies' to support the UK economy.

On liquidity support, it is notable that the European Commission has reportedly authorised the Italian Government to guarantee up to €150 billion of new debt issuance by Italian banks to support their access to funding. Also, the Italian authorities are reportedly in discussion with the EU about a potential state-funded capital injection for Italian banks.

Following the referendum outcome, the Swiss National Bank conducted foreign exchange market intervention to mitigate further appreciation pressure on the franc. The central bank in Denmark also

reportedly intervened in the foreign exchange market after the outcome to maintain its peg to the euro. A number of other central banks have also reportedly intervened to curb depreciation pressures on their currencies. In addition, the Japanese authorities have expressed concern about the sharp appreciation of the yen.

Market regulators the UK Financial Conduct Authority (FCA), US Securities and Exchange Commission and US Commodity Futures Trading Commission released statements confirming that they are monitoring developments in financial markets. The FCA has not announced any direct policy response, but has reminded firms to continue to abide by their obligations under UK law.

More broadly to manage the exit from the EU and the subsequent negotiations, the EU and UK each have established a taskforce of officials that will include examining, at a technical level, the terms and conditions regarding Britain's exit from the EU.

2.2.2 Australian CFR agency actions

Council agencies have intensified contact with foreign agencies throughout the period. For example, the RBA has engaged internationally through fora such as the Bank for International Settlements (BIS) Governors Meeting, specific conference calls on the issue among East Asian and Pacific Central Banks Deputy Governors, and the BIS Markets Committee, as well as numerous bilateral consultations, including with the Bank of England. ASIC has participated in an IOSCO Asia Pacific-Regional Committee conference call and had bilateral contact with the FCA. Treasury has engaged with G20 Finance Deputies and had discussions with authorities via its overseas-based officials, including in the US, UK, Japan and China as well as the Financial Stability Board (FSB), OECD and IMF. APRA has been in contact with the UK Prudential Regulation Authority and will meet with them this week, though international consultations have been low key as APRA does not consider that any Australian regulated entity is placed at risk as a result of Brexit.

Council agencies have also been actively engaging with domestic institutions and monitoring developments. For example, APRA is running regular requisitions for bank liquidity projections – a 'fire drill' requirement to provide up-to-date liquidity data with a one day turnaround that was incorporated into the prudential standards introduced post-crisis. APRA has also contacted the larger banks to discuss funding and liquidity, market risk exposures and margining, exposures to the UK and developments in offshore funding markets. The results from this work indicate that Australian bank liquidity has not been materially affected by Brexit. RBA and ASIC have engaged with ASX Clear about activity post Brexit.

2.3 Australian banks

The Australian banks are well placed to handle negative shocks such as the fallout from Brexit, with stronger capital positions, more stable funding, and higher liquidity buffers than before the global financial crisis. As noted elsewhere in this report, financial market functioning has remained orderly since the referendum outcome and the effect of Brexit on the Australian economy is expected to be very small. Accordingly, the direct impact on Australian banks' operations and resilience is expected to be minor.

2.3.1 UK and European Exposures

Australian banks' exposures to the UK and Europe are limited, particularly after NAB divested its UK operations in early 2016. On an 'ultimate risk' basis, exposures to the UK amount to just under $100 billion, of which one quarter is to UK-resident banks and the other three-quarters is to non-bank institutions (both public and private). Almost one third of this exposure is held by one major bank, with the other three majors accounting for a further 15-20 per cent each. Overall, this equates to around 2½ per cent of

consolidated assets, or around half of Common Equity Tier 1 capital. Australian banks have an additional $50 billion exposure to the euro area, or 1¼ per cent of consolidated assets, mostly to Germany, the Netherlands and France, with these exposures spread relatively evenly across individual banks.

Table 2: Australian Banks' Exposures to Europe

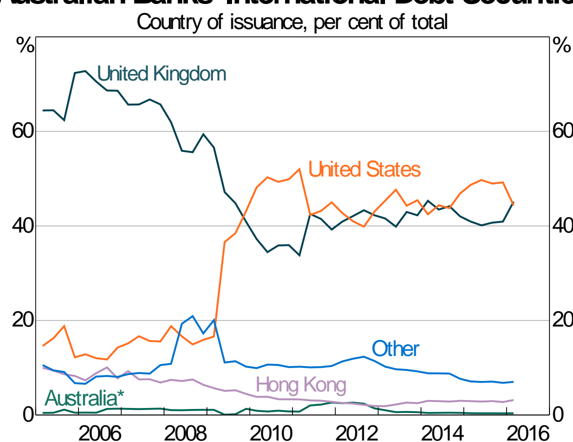
Ultimate risk basis, March 2016

	Exposures to banks	Exposures to non-banks	Total exposures	Share of consolidated assets
	$b	$b	$b	Per cent
UK	27	69	96	2.4
Euro Area	21	30	51	1.3
- Germany	*8*	*10*	*17*	*0.4*
- Netherlands	*5*	*6*	*11*	*0.3*
- France	*5*	*5*	*11*	*0.3*
- Ireland	*0*	*3*	*3*	*0.1*
*- Other periphery**	*1*	*3*	*4*	*0.1*
*- Other core**	*2*	*3*	*5*	*0.1*
Other Europe	5	7	12	0.3
Europe	**53**	**106**	**159**	**4.0**

* Other core includes Austria, Belgium, Finland and Luxembourg; all other countries considered to be periphery.
Sources: APRA; RBA

2.3.2 Funding positions and other considerations

The fallout from Brexit could also affect Australian banks by raising the cost or reducing the availability of funding. As noted earlier, spreads on banks' short-term and long-term debt funding widened slightly following the Brexit result. But the functioning of short-term money markets in Australia has remained orderly. The Australian banks also maintain substantial liquidity buffers, and the RBA stands ready to provide liquidity to the system should it be required. Australian banks have also raised considerable amounts of longer-term debt in 2016 to date, which further suggests that they are well-placed to withstand any temporary disruptions to funding markets, should they arise.



* Foreign currency-denominated debt issued in Australia.
Sources: APRA; RBA

Australian bank funding raised in UK debt markets amounts to about 5 per cent of total liabilities, down from around 10 per cent a decade ago. Some Australian banks use the UK to 'passport' into EU debt capital markets (and would have to make alternative arrangements to access those markets following the UK's exit). Reflecting this, roughly 45 per cent of Australian banks' foreign debt securities are issued in the UK (around $200 billion currently outstanding), although only 20 per cent of this is in pounds sterling (the largest share is in euros).

UK banks, and European banks more broadly, had already wound back their Australian operations considerably in the post-crisis period, and now collectively account for only 5 per cent of Australian banking

system assets. This reduces any potential impact on economic and financial conditions in Australia if these banks were to respond to Brexit by pulling back further on their activities here.

2.4 Short-run economic effects on Australia and the world

A range of studies suggest that the short-run economic effects of Brexit will be negative, concentrated in the UK and to a much lesser extent Europe. The long-run economic effects are similarly expected to be negative (see Section 3 for more detail).

In the UK, economic activity is expected to be weaker in the short run as agents react to the weaker and highly uncertain long-run outlook, with factors such as the nature and timing of the final agreement between the UK and the EU, and the political leadership to negotiate that agreement, still highly unclear.

The IMF estimates that by 2017, UK GDP could be between 1 per cent and 3¾ per cent lower than if the UK had voted to stay in the EU.[1] Key channels include reduced investment, hiring and spending by businesses and households, as well as the effects of lower asset prices (such as some equities and property). A lower exchange rate, and potentially easier monetary policy, should be at least partly offsetting and UK Chancellor Osborne has also signalled corporate tax cuts to support economic activity. Dampening effects from uncertainty, albeit much smaller, are also likely in Europe. Global economic activity is expected to be only modestly affected, notwithstanding the potential for heightened financial market volatility, capital flight towards perceived safe havens and reduced trade flows.

The short-run negative effect on economic activity in Australia, through channels such as reduced trade, lower commodity prices and financial linkages, is expected to be very limited for several reasons. The effect on global activity is expected to be small, Australian trade is oriented more towards Asia than Europe, and Australian banks have limited direct exposure to the UK and Europe and are well-placed to handle disruptions to funding markets.

3. Medium to longer-term implications for Australia and the world

3.1 Growth prospects and risks

The medium- to longer-term implications for the UK and Europe, and the global economy more broadly, will depend on the degree and persistence of uncertainty, and the length and outcome of negotiations on exit. In the UK, business investment growth was already weak prior to Brexit and is likely to weaken further, at least until the nature of any future trade agreement with the EU, by far the UK's largest export market, is known. Some firms may also choose to relocate from the UK to EU countries if their businesses depend on access to the single market. Concerns over job security and negative wealth effects will be a drag on household spending.

Prior to Brexit, the IMF indicated that should Britain vote to leave the EU, GDP in the EU could be lower by up to 0.5 percentage points and GDP in the rest of the world could be up to 0.2 percentage points lower by 2018.[2] There is a significant degree of uncertainty around the estimated economic impact of Brexit. The IMF forecast a wide variation in output losses across individual economies, reflecting differing trade and financial exposures to the UK, as well as the policy space to respond to negative spill-overs.

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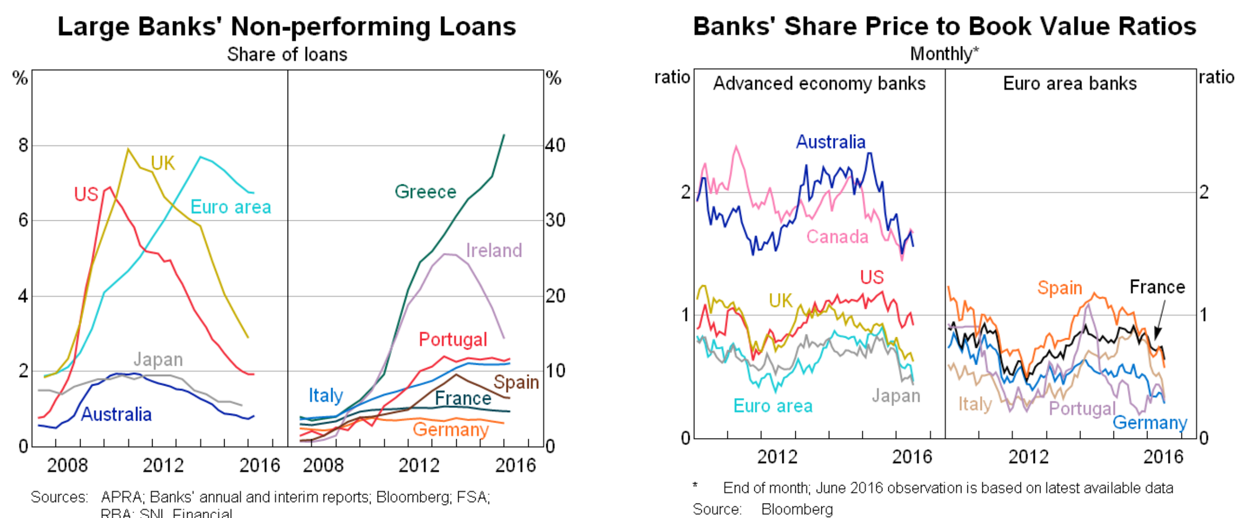
1 International Monetary Fund, 2016, 'United Kingdom selected issues: Macroeconomic implications of the United Kingdom leaving the European Union', *Staff Report on the 2016 Article IV Consultation*, http://www.imf.org/external/pubs/ft/scr/2016/cr16169.pdf

2 International Monetary Fund, 2016, 'United Kingdom selected issues: Macroeconomic implications of the United Kingdom leaving the European Union', *Staff Report on the 2016 Article IV Consultation*, http://www.imf.org/external/pubs/ft/scr/2016/cr16169.pdf

Beyond the central forecasts, the Brexit result has arguably added to global tail risks, particularly through heightened risk in Europe. The result could potentially strengthen exit momentum within euro area countries, which if successful would be considerably more disruptive given the common currency. Ongoing banking sector fragility also remains a potential trigger for political discord and financial instability. European banks have been grappling with weak profitability and a high stock of non-performing loans for many years, which has been reflected in low share price valuations. Market movements reflect increased apprehension about banks in a number of European countries post Brexit, most notably Italy, where the Italian Government has been denied permission by the EU to inject capital into its banking system. The newly established European bank resolution framework, which favours bail-in of private creditors and substantially precludes government support, is largely untested.



Overall, tail risk considerations aside, the implications of Brexit for the Australian economy are not likely to be significant, but will depend upon the nature and length of the transition to new arrangements. Australia has proved resilient during past periods of financial market volatility and remains well placed to manage the economic and financial market response from the UK referendum outcome.

Additionally, Australia has a relatively small direct trade exposure to both the UK (2.8 per cent of goods and services exports) and the rest of the EU (4.6 per cent of goods and services exports). However, Australia's major trading partners have larger exposures to these markets. For example, the EU (including the UK) accounts for 15.6 per cent of China's goods exports and 18.2 per cent of the US's goods exports. A sharp slowdown in the EU economies with spill-overs into other major economies would place downward pressure on the demand for Australia's exports.

The Australian economy may also be affected if the UK transition out of the EU is not orderly and uncertainty remains heightened for a significant period. This poses some downside risk to the domestic outlook, with negative wealth and confidence effects having the potential to affect household consumption and business investment.

3.2 The United Kingdom and European Union relationship following Brexit

The process for the UK to leave the EU is complicated and unprecedented. The medium-term implications for Australia and the world from Brexit will depend on how long it takes for the UK and the EU to reach agreement on their post-Brexit relationship and the nature of this agreement, which in turn will influence the effect on output and adjustment for the UK and EU economies. There are a range of alternative models that could form the basis for this post-Brexit relationship, which essentially trade off access to the EU single

market against independence from EU membership obligations. The UK already occupies a unique position in the EU with existing carve-outs in its membership that have the effect of exempting it from the commitment to 'ever closer union'. The UK is not part of the euro area or the Schengen area that permits passport-free travel for European citizens.

Though formal renegotiations have yet to commence, the EU has already publicly stated its non-negotiable positions on a post-Brexit relationship. This centres on access to the EU's single market and the adherence to its key pillars:

- the four freedoms of the movement of goods, services, labour and capital;
- the approximation of relevant laws, regulations and administrative provisions between member states;
- EU-wide competition policy administered by the European Commission; and
- a system of common external tariffs.

The EU has clearly stated that there would be no '*à la carte*' option on the single market for the UK.[3] The UK's approach to these negotiations is yet to be outlined, but a central tension appears to be a trade-off between EU single market access and the free movement of labour.

3.2.1 Possible models of UK-EU relationship post-Brexit

Based on existing arrangements the EU has with non-member states, there are three broad possible alternatives to EU membership for the UK (Table 3).

Table 3: Possible alternative models for UK-EU relationship

European Economic Area	Bespoke bilateral agreement	WTO membership
A Norway-type arrangement with the EU, which includes: • a high level of single market access; • limited say over EU rules, but adherence to the 'four freedoms' of the single market; and • no access to the EU's FTAs, being outside the EU's customs union.	Bilateral agreements similar to Switzerland's, which includes: • access to some EU sectors; and • most trade would be tariff and quota-free but subject to the EU customs union. Switzerland has not been granted broader access to EU financial (and other) services, but must adhere to the freedom of movement.	• Default option with access to the EU single market through WTO membership. • Bilateral trade subject to the EU's external tariffs.[4] • UK not have to follow EU obligations and directives, pay contributions to the EU budget, or adhere to the 'four freedoms'.

More access to EU single market ← → *More independence from EU obligations*

3.2.2 Economic impacts of the agreement and the negotiating process

The expected effect of any of these models on the UK economy will be observed through a number of channels including trade, foreign investment, the labour market and incomes. Loss of single market access would have a negative effect on the UK economy over the medium to long-run to varying degrees across both the traded and non-traded sectors from factors such as higher transaction costs to foreign divestment

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[3] 'Remarks by European Council President Donald Tusk after the informal meeting of 27 EU heads of state or government', 29 June 2016, http://www.consilium.europa.eu/en/press/press-releases/2016/06/29-tusk-remarks-informal-meeting-27/

[4] The EU's tariffs levied under WTO rules in 2014 were around 5 per cent on average.

and company relocation from the UK to the EU. That said, the enhanced policy autonomy may provide greater flexibility for implementing productivity-enhancing reforms over the longer-term.

The extent of the trade and investment impacts will mostly depend on how much access to the single market the UK loses. The effects on EU economies will depend on the extent of their relationship with the UK – Ireland and the Netherlands are likely to be most affected according to IMF analysis.[5]

It will take time for the UK to identify its fundamental economic, political and strategic interests and thereby balance the need to reflect the decision to leave the EU while maintaining mutually beneficial engagement with the EU.

Equally, as negotiations proceed and the EU arrives at the type of relationship that satisfies its interests, the economic and institutional durability of the EU could be tested. This may offer both challenges and opportunities for strengthening the EU by motivating collective action on Europe-wide issues such as structural reforms to reinvigorate and rebalance its economy and enhance the financial stability of the euro area. That said the negotiation process itself could take away the critical political capital for such reforms.

As negotiations unfold and both the EU and UK's interests are explored and tested, markets may shift their consensus on what is a likely possible post-Brexit relationship. If this shift in expectations is rapid, there is potential for another period of market adjustment.

3.3 Implications for international economic co-operation

Brexit will have important ramifications for international economic cooperation. Most immediately, there are a wide range of institutional agreements that underpin cooperation in a range of policy areas. More broadly, the UK and major European economies are prominent members of the G20 and International Financial Institutions and protracted exit negotiations could come at the expense of broader political and economic cooperation in the short to medium term.

3.3.1 Specific areas of bilateral economic cooperation with the EU and UK

Australia has a wide range of institutional agreements both with the EU and UK, ranging from memoranda of understanding through to formal treaties and agreements. In a number of cases these will need to be reviewed and amended post-Brexit, or new agreements negotiated independently with the UK where they are currently relevant at the EU level.

Specific agreements include, but are not limited to:

- a Memorandum of Understanding (MoU) with the European Commission on consumer protection;
- information sharing across competition and consumer issues with the UK, including in relation to the oversight of major mergers and acquisitions;
- recognition by the European Securities and Markets Authority of our clearing facility licensing and derivatives regulation frameworks and related MoUs; and
- the Australia-EU Free Trade Agreement that is currently being scoped.

Australia will need to consider carefully how it can respond in the short term and position itself for the medium term as the form of the renegotiated UK-EU relationship model takes hold. While identifying areas of concrete action that can be pursued with the EU and UK, Australia can also assist by encouraging cooperation and progress through multilateral and international institutions. The next G20 Finance

[5] International Monetary Fund, 2016, 'United Kingdom selected issues: Macroeconomic implications of the United Kingdom leaving the European Union', *Staff Report on the 2016 Article IV Consultation*, http://www.imf.org/external/pubs/ft/scr/2016/cr16169.pdf

Ministers and Central Bank Governors Meeting will be held on 23-24 July 2016 and provides a timely opportunity for Australia to reaffirm to the UK our close relationship. There is also the opportunity for Australia to consider a fully-fledged free trade agreement with the UK.

3.3.2 Cooperation through multilateral fora and international institutions

The uncertainty and market disruption created by Brexit further emphasises the need to remain focused on progressing international efforts to strengthen financial stability and address risks. Protracted exit agreement negotiations may challenge the capacity of the UK and EU to engage fully in other international fora and institutions, such as the G20 and IMF. It may also make it more difficult to identify and pursue pan-European interests within that climate of negotiation. Together these factors have the potential to mute progress on international economic cooperation on key global economic and financial issues such as international tax, financial regulation and strengthening the global financial safety net. A key test of any reshaping of global cooperation will be seen as early as December 2016 with Germany taking over as G20 President and Italy hosting the G7.

Over the medium term, if Brexit reflects a broader introspection and re-evaluation of economic integration, strengthening the multilateral fora such as the G20 that boost economic cooperation, promote resilience and improve global economic governance is critical. While the global economy remains fragile, the IMF can also play a key role in promoting stronger global economic governance by being 'a voice for global cooperation and collective action'[6] and maintaining its key role in global economic surveillance.[7] Ensuring stability and adequate resourcing of the international financial architecture and coordination between the layers of the global financial safety net will be priorities for Australia and where we may need to continue advocating strongly in global fora. Potential exists for Brexit to precipitate regulatory competition to capture market share in European financial services. Therefore, it may be necessary to use international fora to ensure that there is no competitive retreat by either the UK or the rest of the EU from commitments to international financial regulation reform.

3.4 Implications for financial policy settings

The outcome of the vote on 23 June represented an appreciable negative shock, but the impact on domestic and international financial systems and markets was well-contained and orderly. On the evidence to date, it suggests that the domestic and international financial reform agenda adopted following the financial crisis is on the right track.

Still, it is uncertain how the UK's exit will proceed and what the associated impacts on the stability of the rest of the EU will be. This will be a source of continuing uncertainty and market volatility for some time, against the backdrop of an already fragile global economy. Significant shocks could also come from other sources. While the Australian financial system has weathered the immediate reaction to the vote well, the event underscores the importance of pressing ahead with further reforms to enhance our system's resilience.

The strengthening of the banking system's capital position over recent years to meet the new 'Basel III' requirements represents a material increase in the banking sector's ability to withstand a significant deterioration in asset quality. The Financial System Inquiry highlighted the importance of ensuring the soundness of the financial system. The Government endorsed its recommendation that capital standards

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[6] International Monetary Fund, 27 June 2016, 'Remarks by the IMF's First Deputy Managing Director David Lipton', https://www.imf.org/external/np/speeches/2016/062716.htm

[7] International Monetary Fund, 27 June 2016, 'Remarks by the International Monetary Fund's First Deputy Managing Director David Lipton', https://www.imf.org/external/np/speeches/2016/062716.htm

be set such that bank capital ratios are ‘unquestionably strong’. While Australian banks are well-capitalised, a further increase in capital ratios is likely to be required over the coming years to satisfy the ‘unquestionably strong’ benchmark. The Government has also endorsed the implementation by APRA, over time and in line with emerging international practice, a framework for loss absorbing and recapitalisation capacity.

APRA is also introducing further reforms to strengthen the resilience of the banking system. Of particular note, on 1 January 2018, APRA will implement the Basel III Net Stable Funding Ratio (NSFR) to discourage banks from being overly reliant on less stable sources of funding. The NSFR will be part of APRA’s prudential liquidity rules and will complement the Liquidity Coverage Ratio – introduced on 1 January 2015 – that requires banks to hold sufficient ‘high quality liquid assets’ to withstand a 30-day period of stress. APRA is currently consulting with the industry on the design of the NSFR and intends to finalise proposals by the end of 2016.

Consistent with the Government’s response to the FSI, further work is needed to clarify and strengthen regulators’ powers in the event a prudentially regulated financial entity or financial market infrastructure faces distress. A recent peer review by the Financial Stability Board identified some gaps and deficiencies in the Australian resolution framework and work is progressing on this as a matter of priority.

More broadly, such episodes of significant shocks and market volatility reinforce the value of Australia’s financial (and economic) policy frameworks. The separation of responsibility for prudential regulation and market conduct regulation (between APRA and ASIC), the operation of independent monetary policy and a floating exchange rate continue to serve us well.

6 July 2016

ATTACHMENT A: LETTER TO THE CFR CHAIR

PRIME MINISTER TREASURER

27/06/2016

Mr Glenn Stevens
Governor
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001
AUSTRALIA

Dear Governor

We write to you in your role as Chairman of The Council of Financial Regulators (CFR) the coordinating body for Australia's main financial regulatory agencies.

There remains considerable uncertainty about the short and medium term outlook for financial markets after the Brexit poll result.

CFR's role is to contribute to the efficiency and effectiveness of financial regulation and to promote stability of the Australian financial system. Consistent with this role, we request that you initiate consultation between CFR agencies and their counterparts in the UK, Europe and other relevant countries and international fora to get detailed information on the following:

- short term impacts to the Brexit vote and policy and regulatory measures taken to mitigate early risks
- an assessment of global responses to Brexit and implications for Australia – immediately and in the medium to longer term.

Based on the information obtained and the views of CFR, I ask that a report be prepared to be available next week for the Government to consider.

Yours sincerely

PRIME MINISTER The Hon Scott Morrison MP

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