BREXIT BCCG EXPERT GROUP
BANKING & FINANCIAL SERVICES

FITTING BREXIT
A FINANCIAL SERVICES
INDUSTRY PERSPECTIVE

Following nine months of uncertainty and speculation, on 29 March 2017, PM Theresa May gave official notice to European Council President Donald Tusk under Article 50 of the Lisbon Treaty:

“Today, therefore, I am writing to give effect to the democratic decision of the people of the United Kingdom. I hereby notify the European Council in accordance with Article 50 (2) of the Treaty on European Union of the United Kingdom’s intention to withdraw from the European Union.” 1)

This notification marked the beginning of the negotiations about the exit of Britain from the European Union and began the countdown of a two-year period that can only be extended if all remaining 27 EU member states agree to it.
The 23 June 2016 referendum mandated the British government to reclaim national sovereignty and immigration control. In her Lancaster House speech on 17 January 2017, PM Theresa May initially laid out the strategy for the negotiations: to exit the EU and its single market and to negotiate “a new, positive and constructive partnership between Britain and the European Union”2) with the freest possible trade agreement.

However, the EU’s goodwill might be limited. Battling with its own problems, the EU is somewhat expected to undermine and reject the UK appeal with the aim of establishing a precedent for those that might wish to follow suit.

This became a reality when Donald Tusk presented the yet-to-be-approved draft guidelines on Brexit negotiations.

The guidelines state that an agreement on the future UK-EU relationship “can only be concluded once the UK has become a third country”3). This somewhat counters Theresa May’s desire “to agree the terms of our future partnership alongside those of our withdrawal.”4) It is thus about the divorce settlement first.

With regard to future relationships, the guidelines state that “a non-member of the Union, that does not live up to the same obligations as a member, cannot have the same rights and enjoy the same benefits as a member.”5) And in order to preserve “the integrity of the Single Market” the guidelines exclude “participation based on a sector-by-sector approach”6), a strategy the British government had hoped to deploy in order to potentially protect the country’s financial services and automotive industries.

Negotiations will be long, complex and difficult. Ultimately, if no agreement is reached in two years, the UK’s access to the single market will automatically cease to exist and it will trade on World Trade Organisation terms with the EU, a situation commonly referred to as a “hard Brexit”.

What does this mean for the financial services industry, and why do we believe that it is impacted more than any other industry, at least in the short run?

Today the UK, and London specifically, is Europe’s major centre for financial and related services. Its importance can be evidenced by the sheer size of the trading surplus it generates for the UK. In 2015, it added up to $97 billion. TheCityUK’s report ‘Key Facts about the UK as an International Financial Centre’ 7) also highlights that London

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- hosts the greatest number of foreign banks (250),
- has the largest share of international bank lending in the world (17%),
- has the highest share of international equity markets in the world with more than 518 foreign companies listed in the city.

These stats indicate that financial markets are dependent upon cross-border activity. In 2014, total exports of financial services between EU countries reached € 96bn, with the UK accounting for the majority of these intra-EU activities.8) For example, "78% of European foreign exchange trading, 74% of European interest rate derivatives trading and 50% of European fund management activities take place in the UK."9)

With Brexit looming, this is now at risk. The referendum led to financial market participants considering its impact on London as a financial hub and their business activities across Europe.
The centre of their concern is the so-called "passporting", a principle that allows a financial market participant authorised to conduct certain financial activities in one EU member state to conduct those activities in any other EU member state, as well.
Over the years, passporting enabled London to persuade financial institutions to conduct their European business through London. Today, according to the Financial Conduct Authority, 5,476 UK-registered firms use passporting to do business elsewhere in the EU, while 8,008 financial services firms from the EU and EEA passport into the UK.

The threat of a hard Brexit and a subsequent ceasing of passporting would significantly disrupt the supply of financial services across the EU. Given the existing uncertainty regarding the outcome of the negotiations and potential transition agreements, there is no alternative but to plan for the worst-case scenario: a hard Brexit.

The operational implications of setting up new entities and/or expanding existing entities are complex, time-consuming and require significant investment.

And, as though the uncertainty surrounding the implications of Brexit were not enough, the financial services industry continues to battle with the aftermath of the financial crisis. Besides the low interest rate environment and its impact on profitability, the complex list of regulatory reforms (e.g. MIFID II, UK Financial Services Banking Reform, CRD V/CRR II, …) and their implementation deadlines conflict with the Brexit timetable.

The fact that the above-mentioned uncertainty and changes impact all market participants at the same time across Europe further increases the challenge financial institutions are facing.

A recent PwC study commissioned by the Association for Financial Markets in Europe on the 'Operational impacts on wholesale banking and capital markets in Europe' therefore comes to the conclusion that "a transition period of 3 years would help ease the transformation to a post-Brexit trading environment in an orderly manner."10)

"The task before us is momentous but it should not be beyond us."11)

Europe will look different following Brexit, if it does not already. Considering the complexity that market participants need to master in the coming years, it seems hard to imagine a Brexit scenario without some sort of a transition period. Clarity regarding the timeframe and details regarding future relationships will hopefully remove current uncertainty, sooner rather than later.

We can only urge politicians and regulators to provide necessary leadership and foresight in the coming debates, that the agreement provides clarity as quickly as possible for all parties involved, and ensures a level playing field for strengthening Europe, including the UK.

1. Prime Minister's letter to European Council President Donald Tusk, 29 March 2017
2. Theresa May's speech, Lancaster House, 17 January 2017
3. European Council (Art. 50) (29 April 2017) Draft guidelines following the United Kingdom's notification under Article 50 TEU, 31 March 2017
4. Prime Minister's letter to European Council President Donald Tusk, 29 March 2017
5. European Council (Art. 50) (29 April 2017) Draft guidelines following the United Kingdom's notification under Article 50 TEU, 31 March 2017
6. European Council (Art. 50) (29 April 2017) Draft guidelines following the United Kingdom's notification under Article 50 TEU, 31 March 2017
7. TheCityUK, 'Key Facts about the UK as an International Financial Centre,' October 2016. Calculations based on data reported by UNCTAD in USD, conversions to GBP have been made at the average 2015 exchange rate of $1 to £0.654.
8. 'Planning for Brexit, Operational impacts on wholesale banking and capital markets', a PwC study commissioned by the Association for Financial Markets in Europe, January 2017
9. 'Planning for Brexit, Operational impacts on wholesale banking and capital markets', a PwC study commissioned by the Association for Financial Markets in Europe, January 2017

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