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Brexit Impact on Financial Services

What to expect from March 2019

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EU-UK relationship status: it's complicated

Unity and expertise favors the EU on the negotiating table:
The EU has shown its ability to come together in times of stress and has a strong expertise in trade agreement, whereas the conservative party is weakened in the UK.

No separate status for the financial sector in the negotiation:
Both sides want to negotiate a global agreement encompassing trade, security and citizens' rights. An approach that could favor the UK at the margin but weakens the City's lobbying power in our view.

A newly designed partnership without EU passporting rights:
The UK is not seeking to copy another state's status, nor to remain in the single market under EU passporting.

Banks and clearing to be the most impacted

Clearing activities likely to partly relocate:
Their systemic nature is key for the EU regulator who naturally wants to retain some control.

No easy way for banks, some front office relocation likely:
The EU regulator wants banks operating in the EU to have enough local independent power and skills to ensure adequate supervision. Some banks have already put estimates on the number of relocations.

Asset managers to face incremental regulatory costs:
The end of the UCITS framework for the UK will lead to some changes, but no deep transformation in our view. Asset managers will probably need local branches and more regulatory approvals to go through.

Operational, regulatory and capital challenges for insurers:
EU insurers may incur charges depending on how they currently operate in the UK, with new regulations and capital constraints potentially driving additional costs.

> *Any bank that operates in the euro area must be a "real" bank. And a "real" bank has adequate local risk management, sufficient local staff and operational independence.*
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> ECB Supervisory board, 4 May 2017, Technical workshop for banks considering relocation in the context of Brexit

EU-UK relationship status: it's complicated

On the 29th March 2017, Theresa May triggered the now famous "Article 50" of the Lisbon treaty, less than a year after the Brexit referendum vote. Technically, this means that the EU treaties will no longer be applicable to the UK on March 2019, unless there is a unanimous agreement from the EU member states to extend that deadline.

Unity and expertise favors the EU on the negotiating table

There are major uncertainties around the negotiations and their outcomes, making any forecast rather difficult. Both sides have tried to appear united in order to assert their position on the negotiating table. This show of unity does not necessarily resist the recent facts though. On the EU side, we have experienced in past decisions (e.g. Greek bailouts or migrants' crisis) that individual members can try and push their own agenda which could create divisions. On the UK side, the loss of majority from the conservative party was a clear sign of division in the country, and does weaken Theresa May's position.

On balance, we would think the EU still has an advantage regarding the unity of their approach at least from an economic perspective, as the Eurozone events in the last few years did test the ability of the union to come together in times of stress. We could also expect the recent election of Mr. Macron in France to further strengthen the ties between France and Germany, which could act as leaders for the rest of the EU.

Another advantage to the EU comes from the competencies and expertise it has built over the years to deal with a variety of treaty. The UK on the other hand has been outsourcing most of this expertise to the EU institutions since the 70s and therefore has a steep learning curve ahead.

No separate status for the financial sector in the negotiation

Regarding the financial sector, it does seem like there is a consensus on both sides to negotiate its status as part of a global set of treaties, which would also include commercial or security agreements, rather than as a separate case. This does seem to favor the UK's bargaining power overall, as they would be able to use their strength in terms of security and military power to negotiate in other sectors. Within the EU, France and the UK are indeed military leaders and the only ones to have access to nuclear military power.

Ultimately, the status of the financial sector should therefore be negotiated as part of a broader agreement which would try to preserve financial stability, fair market concurrence, and the rights of citizens on both sides. To some extent, this does appear to reduce the impact of a potential lobbying from the City though, as their requests would have to be considered alongside all other issues.

The United Kingdom wants to agree with the European Union a deep and special partnership that takes in both economic and security cooperation.
Theresa May, 29th March 2017, Letter to EU triggering article 50

Negotiations under Article 50 TEU will be conducted in transparency and as a single package. (…) nothing is agreed until everything is agreed, individual items cannot be settled separately.
Eu council, 29th April 2017, guidelines on Brexit negotiations

A newly designed partnership without EU passporting rights

Concerning the status of the UK post-Brexit, Theresa May did mention that the UK would not necessarily seek to align it to other countries like Switzerland or the Nordics. It would seek to build a different agreement, as none of the existing status seem to fill all the criteria in terms of accessing the single market while keeping enough sovereignty. This does create uncertainty as to which regime will exactly be in place and makes comparison to other countries' status somewhat irrelevant.

We seek a new and equal partnership (…) We do not seek to adopt a model already enjoyed by other countries.
Theresa May, 17th January 2017, Brexit speech

Given the change of status of the UK post-Brexit, the continuity of "European passporting rights" - which broadly gives the right for an entity authorized in one EU member state to conduct business in another EU member state - seems to be very much in play. Despite the current lobbying from the City to keep most of its terms, it does seem like there is consensus on both sides that passporting cannot continue to exist in its current form.

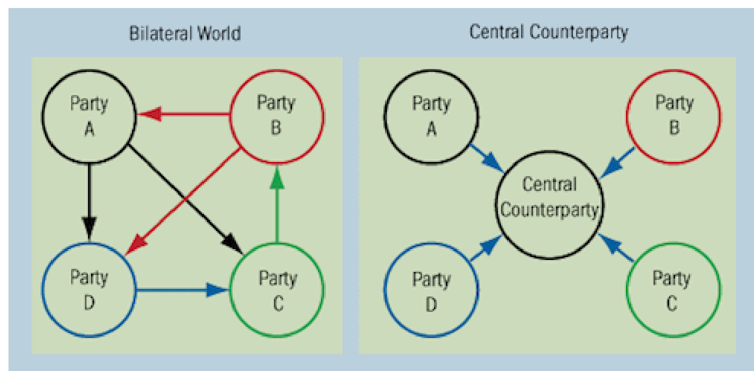
The United Kingdom does not seek membership of the single market: we understand (…) that the four freedoms of the single market are indivisible and there can be no "cherry picking".
Theresa May, 29th March 2017, Letter to EU triggering article 50

[Any free trade agreement] cannot, however, amount to participation in the Single Market (…), as this would undermine its integrity and proper functioning.
Eu council, 29th April 2017, guidelines on Brexit negotiations

Banks and Clearing to be the most impacted

Clearing activities likely to partly relocate

Clearing has become one of the major feature of the derivatives market since the Lehman crisis. It has contributed to vastly reduce systemic risk and to bring transparency by replacing bilateral risks between banks with trades facing the clearing house. It is therefore isolating banks in case of defaults and creates a framework to centrally manage counterparty risk. As an order of magnitude, the notional of derivatives cleared in a day can approach $1Trn.



Source: The Economist

As of today, and in line with the underlying derivatives market, the major clearing houses are UK or US based. Given their systemic nature, it is understandable that the EU wants to keep some control over the clearing houses. Indeed, in the event of a bank default there could be a potential for contagion to other banks via a weakened clearing house. The regulator therefore needs to make sure that it can address issues rapidly in times of stress and with full control. Ahead of that, it needs to be able to monitor and audit the clearing house as it wishes. These issues have been outlined in a recent European regulation proposal.

It intends on giving the EU the right to relocate an external clearing house within the union if it is deemed necessary from a systemic risk perspective. Whether this right is likely to get used or not, we estimate that it does create the need to build an EU-based clearing house to be prepared to the relocation scenario if it does get used. We would therefore ultimately expect clearing houses to relocate some of their business to continental Europe.

The cost of that relocation to the banks is mostly driven by the additional capital they would need to set aside due to the new regulatory regime of the CCP. The estimates vary massively depending on who is doing the analysis. Deutsche Börse, the marketplace organizer based in Germany, estimates this additional relocation-driven capital to be +10% (~$10bn), while LCH, one of the Clearing House based in London, has an estimate of +92% (~$90bn). Banks have come up with their own analysis of about +20% (~$20bn), which should be manageable.

Where ESMA and the relevant central bank(s) of issue conclude that a third-country CCP is of such systemic importance that additional requirements will not ensure the financial stability of the Union (…) The Commission should be able to adopt an implementing act declaring that the third country CCP should be established in the Union (…)
European commission, 13th June 2017, proposal on amendments to CCP regime

No easy way for banks: some front office relocation likely

The impact on banks has been a key question since the Brexit vote. The likely loss of passporting rights means that banks will have to adjust to a new partnership, and we believe that some businesses will have to relocate to continental Europe to fall under the scrutiny of EU regulators. EU regulators have mentioned several times that they want to keep some control on banks' risks, and do not wish to inherit systemic risks from activities that are outside their supervision.

The ECB has issued some guidelines[1] about relocating. Firstly, groups will have to be licensed to make business in the EU, which should already be the case for the major companies. The ECB also expects a continental European entity to have some books, some risks, some compliance and some management for adequate supervision. The regulator wants to make sure that it would be able to monitor a business in depth, and with enough local independent power to make necessary adjustments. Intra-group exposures will be deeply scrutinized to avoid regulatory arbitrage, and there would be no grand-fathering of models approved by the UK regulators to another EU local entity.

Based upon these recommendations, we do believe that some front office staff will have to relocate, along with some risks and compliance functions. The activities generating big systemic risks, balance sheet exposures, or with the most reliance on internal models would probably be the most impacted. Market-making of Government bonds or Euro funding desks could be examples of those. There is obviously no ECB guideline on a destination country itself, but from an infrastructure and competency perspective we think France and Germany should attract most of the business. It is not clear whether a specific local regulator in the EU would be beneficial for banks, but in any case, the ECB is also looking at harmonizing practices at national levels to avoid intra-EU regulatory arbitrage.

Some banks have already put estimates on the number of jobs to relocate, e.g. HSBC at 1000, UBS at 1000, Goldman Sachs at 3000, JPM at a few hundreds, although not all those jobs might necessarily relocate to the EU. Consultancy firms have also provided numbers with recent reports suggesting 75 000 jobs to relocate for the UK financial service industry, and 200 000 for the UK globally. These are still tentative numbers but it does show an order of magnitude and the necessity to relocate part of the activity.

Any bank that operates in the Euro area must be a "real" bank. And a "real" bank has adequate local risk management, sufficient local staff and operational independence.
ECB Supervisory board, 4th May 2017, Technical workshop for banks considering relocation in the context of Brexit

[1] ECB supervisory board, 4 May 2017, Some supervisory expectations for banks relocating to the euro area and Relocating to the euro area

Asset managers to face incremental regulatory costs

The impact on the Asset Management industry seems to be more mitigated. Unlike the banking sector which is vastly in the UK, the AM industry is more balanced as Asset Managers from Continental Europe will continue to seek to distribute their funds in the UK and vice-versa. Currently, the UCITS framework in the EU typically allows a fund to be based in Luxembourg, managed in the UK and sold in Italy for instance.

The end of the UCITS framework for the UK will lead to some changes, but we think that they can be managed without a substantial transformation in business model. Indeed, most Asset Managers are currently set-up to distribute from Luxembourg for example. Regarding relocations, the ESMA has recently published guidelines[2] on relocations for Asset Managers. UK Funds without UCITS will have no automatic approval and would need to get local regulatory approval in the country of distribution. Local entities do need to have “substance”, and according to broad guidelines from the regulator, 20 to 50 people are enough to provide substance to an entity. This would not be an issue for the major asset managers but could be costly for small and medium ones. We understand that funds could potentially be managed from the UK under strict conditions, with some sort of regulatory validation coming from the EU to authorize a person in a third country to manage the funds.

Overall there does not seem to be a need for a drastic change in business model, except **having incrementally more staff within the EU and probably more regulatory approvals and reporting to go through.**

The opinion sets out nine principles (…):

- *Outsourcing and delegation to third countries is only possible under strict conditions;*
- *NCAs should ensure that substance requirements are met;*
- *NCAs should ensure sound governance of EU entities;*
- *NCAs must be in a position to effectively supervise and enforce Union law (…)*

ESMA, 31 May 2017, ESMA issues principles on supervisory approach to relocations from the UK

[2] ESMA, 31 May 2017, ESMA issues principles on supervisory approach to relocations from the UK

Operational, regulatory and capital challenges for insurers

London is not a major hub for insurance companies, unlike banks and asset managers. The impacts should therefore be more limited on the insurance industry, albeit still important for the companies concerned. We have identified three main issues at stake for European insurers looking to operate in the UK: operations, regulation and capital.

From an operational point of view, insurers could face meaningful charges depending on how they operate in the UK. Under the hypothesis that there is no EU Passport (or equivalent to be invented) for UK, they typically fall under one of the following three cases:

1. The insurer (European or not) is operating in the UK from continental Europe through a registered company in the UK: it should face no operational changes
2. The insurer (European or not) is operating in the UK from continental Europe thanks to the European Insurance Passport: it will have to double its activities in the UK by creating ex nihilo an insurance company
3. A European insurer is operating in the UK through a branch: the situation is similar as in case 2.

The second and third case mean doubling most of the teams and therefore the costs. Alternative solutions could be to sell the UK insurance portfolio or to create a joint-venture with a UK insurance company for example. In terms of entities, circa 750 passports have been delivered and or branches opened in the UK.

A change in regulation could potentially be another cost introduced by Brexit. The question is whether the UK will diverge from Solvency II and the scale of this divergence. Given the current stances of the PRA and the FSA on Solvency II, it would be advisable to insurers in the cases 2 and 3 above to analyze differences between UK and "non-UK" application of Solvency II which will serve as the starting basis for a potential new regime.

Lastly, some capital may have to be locked in the UK post-Brexit, particularly in cases 2 and 3 above. As of today, operations in the UK are capitalized alongside European operations and capital can move freely between the UK and continental Europe. It might not be the case in the post Brexit world, with some fiscal impacts and an additional series of elements to anticipate:

- Locking some capital in the UK will create some new fungibility issues at the group level and have a negative impact on the insurance own funds
- The effectiveness of the capital support from the group to the UK insurance company might impact the rating of the UK entity
- Reviewing profitability targets for UK insurance companies. Operating within a post Brexit European insurance group may be costlier but there is a need to remain competitive in front of the "pure" UK insurance players

Regarding UK based insurer operating in continental Europe, we note that this article can be read symmetrically, with similar issues to be faced by the insurer.