

Banks' 2017 Brexit challenge: Cool heads must prevail

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At a glance:

- Regulatory arbitrage may re-emerge as politicians respond to upheaval
- Banks should resist the urge to react hastily to Brexit developments in 2017
- Financial institutions must still address four vital Brexit questions
- Diminishing London as a financial centre would have consequences for all of Europe

Financial institutions are hoping 2017 brings a little more certainty as they grapple with the challenge of Brexit. They may not get it. Donald Trump's victory in November and Matteo Renzi's fall less than a month later, show how social and political change is challenging the established order. Elections in the Netherlands and France next year could further shake the consensus.

The backdrop as Brexit talks begin in the spring of 2017, is one in which emotions threaten to crowd out business logic. And this mood has implications for banking and capital markets. In the wake of the 2008 financial crisis, regulators coordinated globally to frame new rules on conduct, transparency and liquidity. One of the benefits was that banks no longer lived globally but then died locally – dumping the costs of failure on individual markets. By and large, that system has worked till now.

But 2017 may be the year in which that global regulatory consensus cracks under the weight of these social and political pressures. The most obvious example is the potential repeal of parts of the Dodd-Frank Act – the main US leg of today's global regulatory consensus – by incoming President Trump.

Suddenly regulatory arbitrage is back on the scene and that is bound to add more complexity to any bank's Brexit strategy.





The disincentive to destroy

There's a related problem for the Brexit negotiators thinking about European and global capital markets, and that is its complexity.

We've heard much about the interconnectedness of supply chains in industries such as automotive. The supply chains weaving through the financial services sector are every bit as complex when you consider the legal and regulatory structures also involved. Right now, it isn't clear that all stakeholders in the Brexit process understand the intricacy of this ecosystem.

And we should be clear: a 'hard Brexit' would severely rupture the financial services supply chain. That means higher costs, and, inevitably, financial institutions having to pass on a significant part of those costs to consumers and corporates.

The UK, and London in particular, is a critical part of the supply chain. Over the 30 years since Big Bang, London has acquired a critical mass in the provision of financial services: sucking up the talent and the infrastructure to manufacture, wrap, distribute and service all these products.

Buyers and sellers value the protections English common law affords, especially around episodes of default or insolvency – and a common language in which global counterparties converse.

But this is really about scale and efficiency. London's clearing houses give the whole supply chain massive benefits in terms of off-setting, netting and capital efficiency. Duplicating this effect across different markets will not only be complex for banks, but also require more capital in aggregate to achieve the same effect. This may particularly affect some European banks that are already grappling with capital adequacy requirements.

The search for answers

It's not surprising, then, that we are seeing pressure from major EU banks – as well as those in the US, Japan and Australia – to create some kind of capital markets union across the continent in order to preserve that supply chain for the common good.

Banking executives we speak to in the UK fear that the negotiators – on both sides of Brexit talks – could become trapped by ideology or hijacked by emotion, especially if Europe experiences further social and political upheaval in 2017. Even if that doesn't happen, many in the EU are firm in their opposition to the UK picking and choosing the elements of Europe that it likes - 'à la carte'.

All of this uncertainty leaves bank customers with a huge number of questions. At a summit we hosted for a banking client recently, corporate treasurers were raising basic issues such as 'where will I be able to raise debt? Where should we list? How should we engage with our investors if the playing field tilts? What might be the impact of a rise in euro-denominated debt? What about the cost of hedging as currencies diverge?

"Reflection and consideration are the watchwords for 2017"



For many of these corporates, a splintering of the financial supply chain into smaller banking counterparties (each with lower credit ratings) creates new and costly counterparty risk.

Many of prominent voices debating Brexit today don't understand these knock-on effects properly. Newspapers are quick to cover news that thousands of car manufacturing jobs have been saved or US tech giants are hiring new staff. But rapid change to the financial supply chain would have a far more significant impact on people's jobs and cost of living in the UK, across the EU and even globally. The finance industry is not helped by the reputational baggage that banking continues to carry.

No first-mover advantage

So how should banks and other financial institutions view some of the big political unknowns next year? Even after Article 50 is triggered and negotiations start, there are good reasons why financial institutions should resist acting too hastily. Reflection and consideration are the watchwords for 2017.

For a start, everyone gains if the two sides can agree a long transitional period for any changes to the banking landscape. Whatever the broader implications of Brexit, measures that sustain existing finance supply chains are the best outcome for the real economy. Hopefully negotiators on both sides show as much emotional intelligence as IQ, when it comes to convincing their counterparties and own political masters of that undeniable logic.

What then are the motivations for EU politicians preparing to enter Brexit negotiations around finance? Our sense, formed from high-level conversations with European institutions, is that the last line of defence for many policymakers less 'the future of the EU27' and more 'the robustness of the Eurozone' – the core 19.

In that regard, instability in the banking system would damage the Eurozone's robustness and EU politicians won't want to exacerbate that at a time of potentially growing nationalism. If that means compromises on the 'four freedoms' in key areas like banking, don't bet against it – particularly if the UK continues to pay into the EU in some way.

Based on the work we've been doing with several large institutions, there are other, operational, reasons to take time to reflect in 2017.

Firstly, the options for moving out of the UK are limited. Capacity is a big problem. For example, from a regulatory and political perspective, some jurisdictions may lack the appetite for domiciling another major bank.

Secondly, most of these institutions are collecting revenue in US dollars and euros. Paying staff and other costs in sterling while the pound is weak creates valuable labour cost efficiencies. Rushing to move even back-office functions to the Continent doesn't look like the right move just yet.

Thirdly, the money is still in London. The signals from the investment community suggest it will continue to be core and even remain a bridge into Europe for the foreseeable future. Softbank and the Saudi sovereign wealth fund, for example, are basing their brand new fund – which could top \$100 billion – in London.

Brexit preparation still vital

The good news – for now – is that markets businesses are thriving on fluctuations in currencies and fixed income securities. Stock markets have been doing well, and the VIX index of volatility is trading at a level where investors are risk-on/risk-off creating beneficial levels of turnover and liquidity. Profits are up this quarter – and we think will they will continue to be well into Q1 2017.

But although we don't see any first-mover advantage around decisions on domiciling, banks do have to engage with some Brexit challenges in 2017 – aside from those huge considerations around the EU electoral calendar:

1. Gravitational pull of the US

Trump is a factor. If US investment banks in London feel a need to move post-Brexit, the US might be their best option – especially if the regulatory environment becomes more open.

We think most banks would be well advised to beef up their US operations in any case. If there are questions about liquidity in Europe, enhanced access to the US will be valuable.

2. Strategic review for a post-split scenario

The London clearing houses cannot be moved easily – so losing passporting rights into and out of the UK has massive consequences for EU banks as well as those in the UK. That's why equivalence has become such an important concept.

But passporting has a legal status and future certainty – equivalence might not. Banks may be advised to build a split platform by March 2019 as the ultimate hedge against hard Brexit. They need to work through which businesses, based on that split, are uneconomical and should be sold or re-domiciled. Their US and Asian businesses must be part of that process.

3. Client engagement

It's important banks have a deep appreciation of the effects of different Brexit options on clients and not just on the financial services industry. We know politicians on both sides of Brexit talks will be listening to corporates and consumers. Understanding these positions will not only help connect with customers but boost the weight of their arguments too.

4. Tailoring their approach

Every financial institution has different operations, legal footprints and jurisdictional licences so every firm needs a tailored plan once Article 50 is triggered. Work through the options, analyse the implications and then map out an execution plan. Speed is not the critical factor. Strategy is.

The bottom line

The capital markets supply chains that underpin everything from payments and corporate treasury to credit cards and mortgages are well established, complex and would be extremely hard to unpick.

The finance industry must hammer home an important truth as it responds to Brexit in 2017: banking serves the real economy – and the real economy is fragile right now.

This is not a time for emotional or hasty decisions – it is a time for realising our shared interest, and the need for goodwill.

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