It's not all about Brexit

But banks could use the UK's exit as a catalyst for change

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- Despite the need for EU banks to passport into the UK, political posturing may outweigh common sense for much of 2017
- Banks must be much more vigilant to the changing geopolitical landscape and the effect that could have on regulation
- Brexit and regulatory upheaval make now the time to address longstanding structural and commercial concerns

Over the next 12 months, banks will be watching the Brexit process, elections across Europe and the 'Trump effect' to understand just how geo-politics will impact their futures. Most immediately, banks in London are focused on the timing of Brexit: after all, once Article 50 is triggered they will have just two years to prepare for whatever comes next.

But none of these geo-political factors are as important to banks as the long term structural and commercial decisions that their own executives will have been mulling over for some time. Their focus must rightly remain on the cost/income ratio, and any decision to mitigate the effects of Brexit – whether that be duplicating back-office costs or coping with new regulations – must be viewed in that light.

In truth, the changes we are likely to see over the next couple of years around Brexit, regulation and competition are already undermining banks' business-as-usual model. Investing in brand new approaches rather than spending money to fix obsolete models sounds more sensible. Fortunately, the need to insure against the worst-case scenarios is as much an opportunity as it is a burden. It gives banks a good excuse to examine business models, structure and technological questions that might have festered until now for fear of damaging operations.

So how is the landscape shifting and what does that mean for banks' strategic choices?

First, the tone and direction of debate around Brexit means banks must plan for the worst-case scenario. Will financial services get some special access? Will there be no deal, and a default to WTO? At this point we simply don't know. And while we welcome the concept of a phased implementation to any deal, the possibility of 'no deal' (and therefore a cliff-edge Brexit) means 'wait-and-see' isn't a credible approach.

Bank executives are asking themselves whether they need to act immediately to have everything in place before Britain's likely exit in March 2019. Our view is that there is no first-mover advantage to leaving the City. However, they will need a considerable period. It takes time to get authorisation from overseas regulators and install new management teams ahead of shifting operations. Then there are the practical implications such as finding homes and schools for teams and their families.

HSBC has already said it will move 1,000 people to Paris and Japanese institutions have told the government they will begin moving functions from London within six months unless they receive some clarity over Brexit. We expect further announcements later this month when banks start to publish preliminary results. Historically, nothing this big has been attempted in such a short timeframe.

Politics before passporting in 2017

So how rapidly will banks have to act as they face an end to passporting as we know it today? Whether it's two years, or a gentler transitionary period, will depend on competing impulses on the Continent.

On one hand, there are still reasons to be hopeful as European bankers and politicians take on board the City's importance to their financial systems and economies. As Mark Carney told the Treasury Select Committee in January, 'there are greater short-term risks on the Continent in the transition than there are in the UK'.

For example, London accounts for 85% of the EU's hedge fund assets, 78% of its foreign exchange turnover, 74% of over-the-counter interest rate derivatives, 64% of private equity assets and 59% of its international insurance premiums[1]. Financial Conduct Authority data shows around 5,500 UK firms rely on passporting to do business in Europe. More than 8,000 European firms rely on passporting to do business in the UK, and privately EU politicians and bankers admit a cliff-edge break would not only harm their own financial systems but also drive US and Asian banks back to New York or Singapore rather than across the Channel.

> "For those with the greatest strategic nous, the fact that these old certainties are being ripped up is not a threat. It is an opportunity"

[1]https://www.thecityuk.com/assets/2016/Reports-PDF/The-UK-Europes-financial-centre.pdf

On the other hand, while both sides have a strong incentive to reach a deal that maintains the free flow of financial services, both sides are talking tough as politics trumps economic self-interest in the short term. The UK has red lines on immigration and the control of our laws; the EU needs unity among the 27 and is resolute on the indivisibility of the four freedoms. While the Dutch, French and German elections are playing out through to October, political posturing is likely to outweigh common sense and progress is unlikely. Eventually however, I believe the harsh realities of unpicking a complex financial network will force long transitional periods on to the politicians' negotiating agenda.

What seems beyond doubt is that passporting - as the bedrock of continental, and even global, financial services since 1993 – is over. Theresa May has prioritised immigration control over membership of the Single Market. Regulatory equivalence, often hailed as the solution, is currently viewed by banks as too uncertain to rely on, and only offers a partial solution – deposit-taking and asset management, for example, are excluded. Hence the real fears of a hard Brexit.

There are other important changes to the landscape. Borders are back in style – and not just in Europe (as President Trump will tell you¬¬). The cost of doing business across national boundaries looks set to increase, and we can expect to see a move towards a more "balkanised" approach to regulation in 2017 – starting with President Trump's signalled repeal of Dodd Frank.

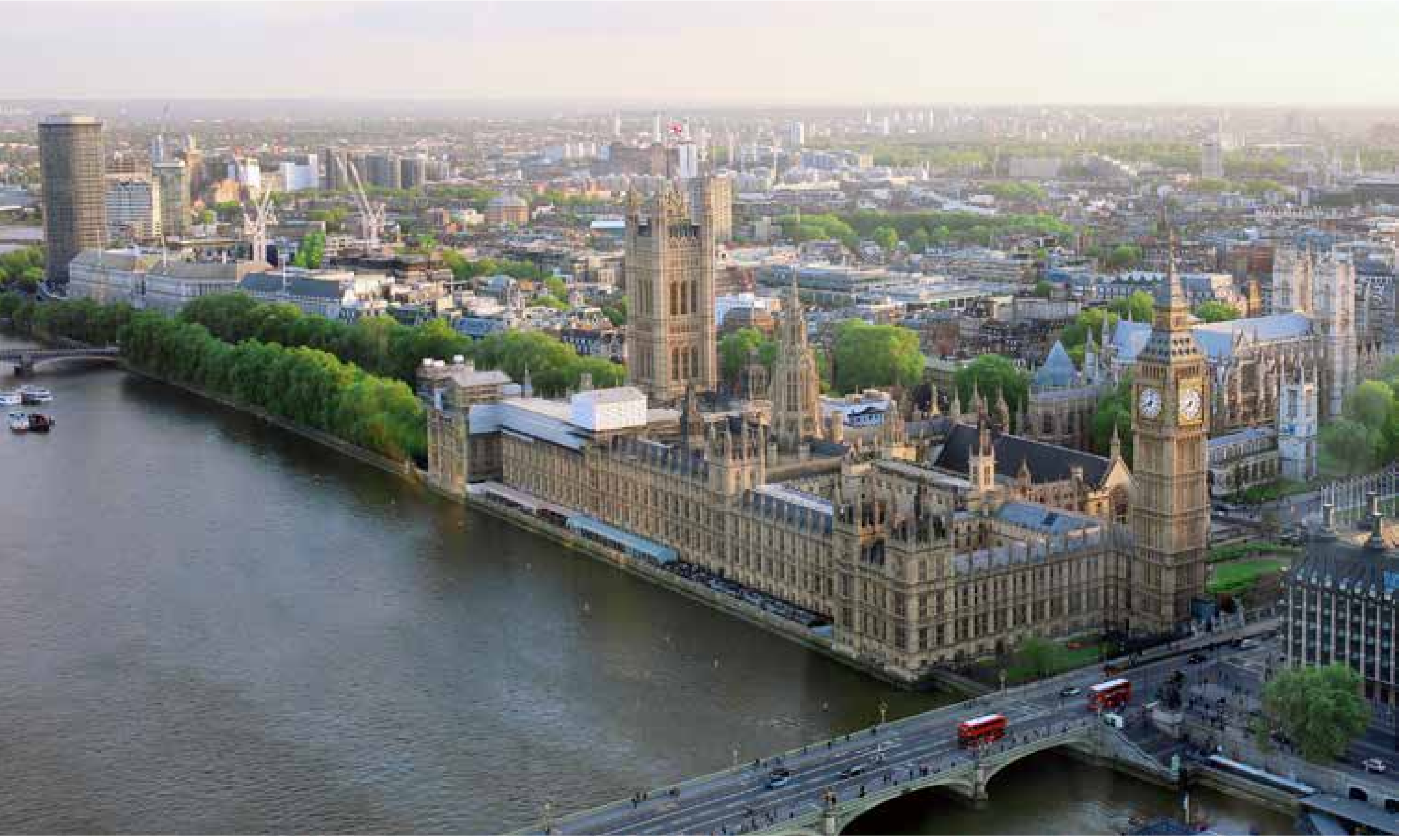
This is another trend that's long in the making, but which Brexit will catalyse in 2017 and beyond. Its drivers look set to stay, too: lower for-even-longer interest rates; slow macro growth; competition from new entrants and technological innovation; higher capital and liquidity standards; IFRS9; CRD IV; ongoing conduct issues; higher capital and implementation costs from Basel IV – the list goes on.

Getting to the heart of it

It is because Brexit, together with new geographic or regulatory realities, throws so many pieces into the air that now is the moment to address longstanding concerns on cost/income ratios, business models and a host of structural questions. What makes for a core business? What new shared services opportunities are there? How will regulatory arbitrage affect models and domiciles?

We knew that many banks had already been planning to restructure, before the referendum vote even happened. But now the two-year deadline on negotiations means those long-term decisions on headcount, back-office locations and technology investment will need to be accelerated.

The pressures from Brexit and beyond will mount. Without continued 'passporting' rights, entities in the EU and UK will face higher capital requirements as new regulated subsidiaries demand



separate capital reserves. US rules on intermediate holding companies for foreign banks will trap capital there for many banks with more than $50 billion of assets in the country.

And the EU has unveiled its own proposal for intermediate holding company requirements for foreign banks operating in Europe. This throws a major spanner in the works for some banks as they work through their already complex preparations for Brexit and splitting non-ringfenced operations from their ringfenced Bank.

This might well lead banks to de-globalise as the benefits of international scale are diminished. It might also lead them to reconsider what is core and what is non-core. What is sub-scale or uneconomic under new, less efficient operating structures?

Banks will have to be much more vigilant to the changing geopolitical landscape and the competing pressures this brings into the regulatory sphere. The conventional wisdoms of the past will be increasingly challenged as borders are re-drawn.

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