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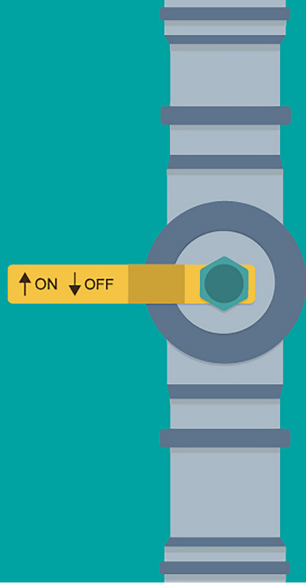
Keep the finance flowing



Exposing global corporates' Brexit funding issues

21 March 2018

Conditional agreement on a Brexit transition period gives global companies vital breathing space. Corporates have more time to adapt operations and to assess what Brexit means for the way they finance and hedge themselves inside a more fragmented financial system, post Brexit.

Yet with transition not fully guaranteed until a withdrawal agreement is signed at the end of the year, 'no-deal' still remains a very live possibility. **Joe Cassidy**, KPMG's Brexit lead for Financial Services, says corporates must continue to consider actions to protect themselves against the possibility of a sudden UK exit next March.

Treasury and Finance functions inside corporates around the world continue to plan for the possibility that Brexit will arrive next year, despite welcome news that a 21-month transition – or implementation period – should start in March 2019. These are 'no regrets' activities that will be needed at the end of transition anyway.

However are they taking a wide enough view? Talking to clients, banks and regulators, the plans put in place by non-financial corporates are tending to capture the visible and immediate consequences of 'no transition', such as the need for extra inventory around borders. In our view, too few are examining the potential knock on for their financial operations in both the UK and further afield.

To reduce risk and keep finance flowing through a period of potential instability, we are advising corporate clients to pay particular attention in two areas:

Look again at your banking and financial relationships.

Make sure your regulated financial businesses can continue to operate cross border.

… and to focus on establishing four certainties:

- Certainty of counterparty
- Certainty of data
- Certainty of contract
- Certainty of market access

In numbers: The UK's role in financing EU corporates

Two-thirds

Proportion of EU corporate debt and equity capital arranged by UK-based banks[1]

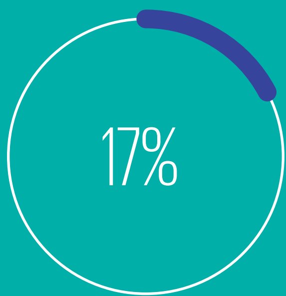
£2.6 trillion

Value of assets managed for overseas clients (£1.4 trillion from EEA countries)[5]

£19 billion

The size of Britain's trade surplus in financial services with other European Economic Area countries[2]

London's share of the global euro-denominated OTC derivatives markets[2]



Share of international bank lending by UK based institutions[4]

1. The Chancellor of the Exchequer, Philip Hammond's speech on financial services at HSBC, 7 March, 2018
2. Implications of Brexit on EU Financial Services - European Parliament, June 2017
3. Letter from Financial Conduct Authority to Chairman of the House of Commons Treasury Select Committee, August 2016
4. Key facts about the UK as an international financial centre 2016, TheCityUK
5. UK Asset Management Industry: A Global Centre, The Investment Association

Look again at your banking and financial relationships

Warnings about the potential consequences of Brexit to Europe's financial services sector have been widely reported. Nevertheless there is a danger that, in focusing on their core business response, corporates will fail to address fundamental issues around banking relationships. They might presume their banks can resolve a number of issues, only to find those banks can't.

1. Have a plan if markets / financial lending freezes up

All sides might agree that a chaotic no-deal Brexit is a lose-lose situation, but that doesn't mean it won't happen by accident, despite the transition deal. In such a scenario, banks' lending appetite could be seriously affected, both to the real economy and even to each other in an echo of the Global Financial Crisis.

Potential impact

Banks switch to 'risk off' mode

If talks start to sour and a final withdrawal agreement looks shaky, jumpy financial markets participants will quickly liquidate riskier positions and move into safe assets such as government bonds.

Banks could follow suit: holding cash and cutting lending risk… particularly to customers whose businesses are most exposed to Brexit, most notably importers and exporters.

Ironically banks' appetite to lend would be waning just as companies sought more credit, for example more working capital to increase inventory in case borders seize up.

Contractual uncertainty = market uncertainty

A failure to reach a political agreement would place a massive question mark over the validity and enforceability of financial contracts already in place, as well as the ability of your counterparty to fulfil contracts.

And in that scenario, it's plausible to imagine banks saying: "I'm not doing anything until I understand the legal basis on which everything stands".

Economic crisis ensues

People's worst fears become reality: talks fail late in the day and we face a chaotic Brexit. In such a scenario, fears over others' exposures could lead to a near-complete freeze in bank lending in a re-run of 2007-8.

Actions

Review your financing and who it's with

Look at what you might need through the next year and a half and assess how you could secure that financing – if there was a tightening of your usual facilities – both before Brexit and in its immediate aftermath.

Those companies which need money the most will, paradoxically, be those least able to secure it.

Engage with banks providing derivatives

Look at ways of minimising risk in derivative portfolios and potentially even exposure to clearing houses.

Plan early

Be aware of the wider financing dynamic and minimise your short-term funding exposure ahead of any reduction in lending.

Look out for opportunities

Not every lender will be 'risk off': Some banks will see others reducing their risk appetite as an opportunity to expand their loan portfolios.

2. Check your bank footprint

The cost and regulatory impacts of Brexit are forcing banks to re-examine their global operating models and ask which locations best fit with their medium-term strategy. As a result, we are already seeing staff, systems and capital moving in and out of London, to and from the EU27 and – in some cases – out of Europe altogether.

But contrary to much of the narrative around banks moving away from the UK, we believe the short term risk to corporates is actually that there is a dislocation of banking services in EU27 countries immediately after a 'no deal' Brexit.

Banking clients need to guard against three risk scenarios:

Potential impact

You bank with a branch located inside the *EU27*, but whose parent is in the *UK*

In most cases, British, American, Japanese and other non-European banks are authorised in London through Prudential Regulatory Authority (PRA) and then use their 'passporting rights' to provide services through a branch structure in other EU countries.

Post Brexit, those banks will have to re-authorise with a national regulator in an EU country to convert those branches into a completely separate subsidiary. That means getting a new licence, being fully capitalised and completing all other tasks such as staffing, IT systems and signing new contracts, all by March 2019.

There is a good chance at least some of these banks will not be ready for Brexit Day +1 which (worst case) would see branches inside the EU27 declining to take on new business until they were ready.

You bank with a branch located inside the *UK*, but whose parent is in the *EU27*

Again, has the parent bank had that branch re-authorised and are deposits secured and backed by the parent bank?

Your bank retrenches from London, the EU, or the whole of Europe

We see no evidence that London will lose its status as one of the world's pre-eminent banking centres. However we are seeing some smaller banks retrenching here as extra costs make operations uneconomic.

Some international banks might withdraw some services from Europe altogether as slim margins become slimmer still. Equally, some UK banks with a presence in the EU27 may pull some credit, services or branches from the Continent. UK-incorporated banks today account for around 4% of total loans outstanding to EU27 large corporates and SMEs[6].

Actions

Access your banks' Brexit plans

Companies and individuals inside the EU will continue to borrow from banks in London after Brexit.

However the situation could raise serious issues for corporates if they had, say, revolving credit facilities with the branch of a non-European bank in Spain, Germany or Poland, because rearranging that facility with the head office in London will take time and resources – both of which may be in short supply as Brexit approaches.

Speak to your relationship bankers and get a better understanding of all their contingency plans… and their progress against those plans.

Engage with your bank early and know your alternatives

Engage with your bank. Understand their long-term strategy and therefore commitment to a particular market or jurisdiction.

Seek independent advice for a deeper understanding of likely bank relocations and what your alternative options might be.

6. Bridging to Brexit: Insights from European SMEs, Corporates and Investors - AFME 2017

3. Study your counterparty risk on deposits

Companies seeking credit are primarily interested in how much they can borrow and at what rate. Companies depositing their cash care far more about the robustness of the bank holding their unsecured assets. If Brexit impacts a bank's operating or business model then its corporate treasury departments have a responsibility to look at the potential risks posed by that counterparty.

Potential impact

Banks are downgraded

Unless there is a deal to avoid the fragmentation of Europe's banking system, banks will be forced to split their capital between jurisdictions. That will make some of them less creditworthy counterparties and lead to ratings downgrades.

Bank failure

In the worst case scenario, the market's 'risk off' fears are realised as Brexit triggers a wider economic crisis and a partial repeat of the financial crisis that brought down banks a decade ago.

Today, banks are better capitalised and better regulated, meaning the risk is lower. However, at this point we lack true visibility on just how severe or benign the effects of Brexit will be.

Actions

Review your exposure

Any good corporate treasury will multi-bank to hedge their risk. Take a fresh look at your banks' exposures and how concentrated their risk may be, by geography, market and lending profile.

For example, examine capital ratios or how they performed in European Banking Authority (EBA) stress tests. This is basic counterparty risk management to protect your unsecured cash assets.

Look for a better return

If a ratings downgrade reflects the increased risk of placing your money there, then customers should be compensated for that extra risk with a higher earned rate on deposits.

Set up your own bank?!

That is the step several large corporates including Airbus and Siemens took during the credit crisis, as they sought somewhere safe to place large cash piles[7]. Owning a banking licence would allow these companies to deposit funds with the European Central Bank and to tap the central bank's low-interest programme[8].

7. Airbus buys German lender to create company bank - Reuters, February 2014
8. Siemens Bank: report on French deposit is incorrect, Reuters, September 2011

4. Prepare for frictional costs to rise

The physical disruption at border crossings – and the costs that might entail – is the most tangible example of Brexit's impact on business. Clients should expect similar frictional costs in the provision of cross-border banking. Banks will have to staff new subsidiaries, re-write contracts, establish new compliance departments, build IT systems and so on.

Your existing banks will try to replicate everything they do today, but it will cost them more.

A report commissioned by the Association for Financial Markets in Europe (AFME) has estimated the cost of restructuring and establishing subsidiaries in EU27 jurisdictions could be as much as 15 billion euros, plus an additional 40 billion euros in regulatory capital[9].

Potential impact

Banks face increased pressures

Banks will try to preserve their existing offering and pricing structure as long as possible, but commercial pressures may, in time, prove them to be sub-scale and uneconomic.

They will either have to accept the hit to margins, cut costs or pass those higher costs on to clients. Something has to give.

Prepare for the cost of your banking service to rise.

Actions

Analyse the impact early, then engage

Banks will absorb some of these costs, but they will pass on a proportion. Gain an understanding of the likely impact on your banks.

Others will be less affected by the way they are constituted and therefore have a cost advantage they should pass on to customers.

9. Bridging to Brexit: Insights from European SMEs, Corporates and Investors - AFME 2017

Make sure your regulated financial businesses can continue to operate

It's not just conventional banks that face the passporting challenge. Thousands of non-financial companies carry out regulated activities such as selling consumer credit, securitising debt or trading derivatives across the European Economic Area, and the overwhelming centre of that activity is London.

Multiple non-financial corporates currently do that using authorisation granted by an EEA member state outside the UK. Based on the stance of UK regulators up to this point, we believe it would be unwise to assume the UK would accept a 'grandfathering' of existing authorisations. Therefore, just like banks, inbound corporates should work on the assumption they will lose this right to passport services from 29 March 2019, if a transition period is not ratified.

Companies therefore have a choice: re-authorise foreign branches to maintain access or choose to withdraw to their home market. The only certainty is that corporates cannot delay this decision, given the time needed to plan and for the regulator to carry out a re-authorisation.

This is effectively the first time the regulator is going to be looking at you, as they would a non-EU firm. It's vital to understand how long it's going to take and the complexity of the task.

Who is affected?

Profile 1: The corporate with a bank

These include global household names: major automotive or aircraft makers and other global manufacturers with separate banking divisions to securitise debt, hedge currency, borrow at cheaper rates or extending credit to corporate customers and consumers.

Many are already authorised by both EEA and the Bank of England's PRA – which safeguards the fundamental safety and soundness of financial institutions in the UK. However, a number do not yet have the necessary local authorisation.

In essence, any company in this situation will have to go through the same rigorous authorisation process as a fully-fledged bank.

Profile 2: The corporate conducting commodities or energy trading

Agriculture, metals and energy businesses, trading on forums such as the London Metal Exchange, fall under the jurisdiction of the Financial Conduct Authority (FCA) and gaining UK re-authorisation for foreign registered firms would require substantial work.

The same task faces businesses currently domiciled in the UK: Europe's energy markets are highly integrated and most participants have significant cross-border activities, whether hedging UK power on French exchanges or Rotterdam-bound gasoline on US exchanges domiciled in the UK.

Profile 3: The corporate with a consumer finance and securitisation business

Whether they are a car maker, a credit card lender or a phone equipment provider, all these types of business require authorisation to finance purchases or lease to customers. A failure to re-authorise locally would mean the firm could no longer offer finance to customers and then use that same entity to securitise debt. In 2016, EU28 auto manufacturers raised 27 billion euros through asset backed securities – 10% of Europe's securitisation market[10].

10. AFME: European Structured Finance, Q4: 2014

To keep the finance flowing during Brexit, look to create certainties

Certainty of counterparty

Greater systemic risk within financial markets inevitably reveals those who are weakest and least well prepared in the end.

Make sure your counterparties are not compromised.

Certainty of data

Multinationals would virtually grind to a halt without the ability to transfer customer and employee data cross-border. Brexit combined with GDPR will challenge this assumed right. Don't rely on the expectation of a political agreement.

Understand your own risks and take action to create certainties on the ground.

Certainty of contract

Right now, there is little clarity as to the status of a vast number of cross-border contracts on which financial services are based after Brexit.

Review your stock of cross border contracts and assess which might need repapering.

Certainty of market access

Banks, insurers and others financial market actors are addressing the passporting challenge to preserve access in and out of London. Corporates with a regulated financial business need to do likewise.

Establish what your regulatory status is and what you need to do to stay compliant in both the EU27 and UK.

Our experts' views

Joe Cassidy
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Brexit Financial Services Lead

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"Banks are working hard on Brexit but the truth is they have no clearer idea of what the world will look like in 12 months' time than you do. Be proactive: don't wait for your financial counterparties to come to you; don't assume your bank relationship will remain unaffected; and don't assume this will be a cost-free exercise. We are in a moment of significant flux."

Dan Thomas
UK Head of Corporates
KPMG Executive Board

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"CFOs and Treasury need to get this on their radar. The issue isn't about where you're based or where you bank. It's about keeping the money flowing, regardless of any upheaval to the world's most important financial centre"

Mark Raddan
Partner
UK Head of Working Capital

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"Some companies are already signalling a need for more inventory to manage the supply chain impacts of Brexit. That requires a broader look at potential working capital improvements, particularly if banks become more reluctant to provide credit."

Justin Benson
Director
UK Head of Automotive

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"Many Heads of Treasury I talk to seem confident their banks will offer the help they need through Brexit. That shouldn't disguise the fact that they face potentially increased costs and delays to supply chains - so corporates will need to work closer than ever with their banks to optimise cash and working capital."

Andy Cox
Partner
UK Head of Energy

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"Many firms are correctly working to understand the impact of Brexit on their own trading arrangements, but they also need to focus on the impact of a hard Brexit on their counterparties' credit, the wider supply chain and liquidity in their markets. Disruption of supply, distribution or market liquidity could prompt significant price volatility and counterparty distress."

kpmg.com/uk/brexitnavigator

Produced by Create | March 2018 | CRT095740