Grant Thornton
An instinct for growth™

The impact of ‘Brexit’ on the financial services sector

APRIL 2016

Grant Thornton’s Financial Services Group explore the various merits for and against our continued membership of the European Union and discuss measures businesses should take to prepare for any eventuality.

With the EU referendum fast approaching, the debate is hotting up with perhaps more rhetoric than fact emanating from both sides of the argument. This is perhaps unsurprising as the timing of the vote coincides with a bewildering and complex set of tensions and challenges faced by Europe as a whole. From an EU perspective, ‘Brexit’ comes on top of a pressing agenda; geopolitical challenges with Russia, an unreformed Euro, the Schengen Agreement (eliminating passport control between the 26 parties to the Agreement) under threat from the migrant crisis and a perceived democratic deficit within EU institutions. For the UK’s part, although it is the world’s 5th largest economy, markets are waking up to the impact ‘Brexit’ may have on the current account deficit, foreign direct investment into the UK, the inflow of talented individuals and the value of sterling and its status as a safe haven currency.

The importance of financial services to the UK economy

Financial and related professional services in the UK - facts and figures

2 MILLION + jobs in the UK, of which **two thirds** are employed outside London

UK'S LARGEST TAX PAYING SECTOR paying **£66bn** in 2015/16

UK’S BIGGEST EXPORTING INDUSTRY with a **£67bn** contribution to the balance of trade

In 2014, exports of **FINANCIAL SERVICES** to the EU generated an **£18.5bn** trade surplus

Source: TheCityUK

With much at stake, Grant Thornton has conducted a series of surveys with our clients, along with research to look beyond the rhetoric, to understand how ‘Brexit’ will impact key sectors and provide practical information to help firms prepare. Our most recent survey found that few companies have considered the practical implications of a ‘Brexit’ and are unprepared for a potential vote to leave. Perhaps a surprising result, given the proximity of the vote.

Ewen Fleming
Practice Leader, Financial Services Group
T +44 (0)131 6598 538
M +44 (0)7733 236 559
E ewen.a.fleming@uk.gt.com

David W Young
Associate Director, Financial Services Group
T +44 (0)131 6598 542
M +44 (0)7717 433 296
E david.w.young@uk.gt.com

How will ‘Brexit’ impact the financial services sector?

The financial services sector is of key importance to the UK economy, while the continued success of the City as Europe’s principle financial services hub is a central theme in the ‘Brexit’ debate. We have looked at the pros and cons of ‘Brexit’ from three perspectives in order to assess how it might influence the regulatory landscape, economic fortunes of the sector and implications for cross border trade.

Regulatory impact

The regulatory picture is complex. Many financial and banking rules are set by global regulators while in some areas it could be argued that UK regulatory standards are higher than those set by the EU, suggesting any immediate impact may be limited. Conversely, a ‘Brexit’ could reduce overall banking stability as any crisis may be met with divergent responses from UK and EU regulators. It could also pose a thorny legislative challenge, with over 40 years of regulation not formally enshrined in UK law.

A rapid solution to continued passporting arrangements between the UK and the single market will be a high priority in ‘Brexit’ negotiations. A favourable outcome is highly relevant to the ability of UK based institutions to export financial services into the EU and may impact future decisions by global institutions on where best to locate.

Whatever the outcome, there will likely be an on-going need to comply with new EU regulation in order to continue to conduct business across the EU. Indeed, even if the UK were to exit, it is probable that firms wishing to conduct business across the EU would face increasing regulatory demands and, in all probability, still be required to comply with MIFID II rules when they are introduced in January 2018.

Economic impact on the City

It could be argued that the City is unlikely to be challenged by ‘Brexit’ in the short term as it enjoys considerable competitive advantages and a highly developed ecosystem of capabilities and support services that would be hard to quickly unwind or replicate elsewhere. However over time, competing European financial centres may renew attempts to attract key Euro related activities and infrastructure, using the argument that these are better conducted from within the Eurozone under EU supervision. The UK may find it harder to resist such attacks after losing the protection of the European Court of Justice.

One impact that may be immediately felt could be a slowdown in EU talent that currently comes to work in UK Financial Services. A requirement for visas and work permits may create a barrier that could weaken the UK, whilst strengthening other more welcoming financial centres.

Implications for cross border trade

One of the largest identifiable risks to the sector is the potential loss of passporting rights for firms based in the UK, looking to sell services into the EU. Firms could adopt the Swiss Banking model by operating through subsidiaries without passporting rights. Many firms already have distribution or servicing hubs within the EU, such as Luxembourg or Dublin. These take advantage of local knowledge and expertise, or deal with indirect obstacles to trade within the single market for services, such as tax.

Many businesses may wish to look at their footprint to re-determine if all their cross border operations are required given that greater complexity usually comes with greater cost. Despite the alternative options, some commentators have estimated that ‘Brexit’ could still see a significant reduction in exports of financial services into the EU.

Over the longer term, there could be an opportunity to compensate any potential loss by concluding bilateral trade agreements with emerging financial centres, such as Hong Kong and Singapore, with which the UK has considerable historical and cultural ties.

Remain or leave?

Weighing up both sides of the Brexit argument

ARGUMENTS FOR LEAVING

Regulatory impact

- Higher UK regulatory standards lead EU regulation in several areas. Examples include Retail Distribution Review (RDR) implementation in 2013, tougher Bank of England stress tests in 2014 and ring fencing of retail banks from their commercial arms from 2019.
- Many financial and banking rules are set by global regulators, such as the Basel Committee and Financial Stability Board.
- UK institutions already comply with existing EU legislation, facilitating participation in the European Economic Area (EEA).
- UK based institutions could benefit from lower capital requirements set by the PRA.
- UK firms could potentially avoid burdensome EU legislation, such as the bonus cap, restrictive employment rights and proposals for a financial transaction tax, improving the City's competitive position with Asian and US financial centres.

Economic sector impact

- The UK has the strongest Financial Services sector in the EU by reason of history, timezone, language, legal system, critical mass of skillsets, expertise in professional services and London's cultural appeal. This lead is likely to continue with the UK outside the EU.
- Market forces will continue to prevail. Strong and innovative UK firms should have every reason to believe that discerning European customers will still do business with them.

Cross border trade impact

- Switzerland operates a successful banking industry outside the EU without passporting rights. Swiss banks operate their European investment banking businesses via London subsidiaries.
- The single market in services is imperfect. Global financial services firms are adept at dealing with local market variations and hidden barriers to trade, such as competing Regulatory and Tax regimes.
- Brexit could provide a longer term opportunity to develop bi-lateral trade agreements with emerging financial centres, such as Hong Kong and Singapore, with which the UK has considerable historical ties.

ARGUMENTS FOR STAYING

Regulatory impact

- Brexit could pose a set back with over 40 years of regulation not formally enshrined in UK law.
- It could arguably reduce banking stability, as a banking crisis would be managed by UK authorities with limited EBA input.
- Potential loss of passporting rights for UK based firms. While the UK could preserve these rights by remaining in the EEA, it would still have to adopt EU regulations while losing the ability to influence or block damaging ones.
- Non-EEA institutions providing financial services within the EU may face higher barriers with the introduction of MIFID II rules in January 2018.

Economic sector impact

- Brexit poses short term risk to financial stability given the UK's high current account deficit. A period of prolonged uncertainty could increase sterling volatility, the risk-premia on assets, cost and availability of financing.
- The UK leads Europe in euro-denominated wholesale banking, FX and derivatives trading. Eurozone countries have historically pushed to have key euro related activities and infrastructure relocated within the Eurozone and overseen by the ECB. Brexit could make such outcomes more likely as the UK would lose protection from ECJ enforcement of single market rules.
- Brexit could restrict the free movement of banking professionals between Europe and the UK.
- Over time, Brexit might inhibit growth in the sector, impacting on long term investment decisions, job creation and the length of time required for new businesses to establish themselves across Europe.

Cross border trade impact

- Given the disparity in financial services trade, the sector is arguably one part of the economy where negotiations stand the smallest chance of success. Loss of passporting rights could potentially see exports of financial services to the EU halve to around £10bn.[1]
- Brexit could impact cross border M&A activity aimed at EU firms by London based investment banks.

[1]The economic impact of 'Brexit'. Woodford Investment Management LLP and Capital Economics 2016

So what can firms do to prepare?

With some big issues at stake for the sector and a large number of risks and unknowns, it is important that companies use the remaining time before the referendum to prepare. Grant Thornton has compiled a list of questions across five areas, that our clients can use to assess the likely consequence of 'Brexit' on their businesses. First, firms need to understand their degree of exposure, not just directly, but also that of their counter-parties, customers and suppliers. Secondly, firms must gauge the impact to their businesses under the most likely 'Brexit' scenarios. Finally, firms should complete the appropriate contingency planning, with identification of resources and support in order to cover off the largest risks and most likely outcomes.

Thinking about the impact of 'Brexit'

Some questions to help you explore the possible impact of 'Brexit' on your firm.

Regulation and strategy

How would an adverse outcome on passporting **impact location strategy?**
For subsidiaries of **European parents**, how is the parent likely to respond and how can decisions be influenced?
How essential is the need to comply with **new EU regulation**, e.g. MiFID II?

Finance

How will short term £ volatility impact the firm and what measures are in place to **manage exchange rate risk**?
How will Brexit impact **investment decisions** and the ability to **raise capital** from EU investors?
What is the likely impact on **capital requirements**?
What impact will Brexit have on the firms **cost base and cost-income ratio**?

Communication

What will the **firms response** to a Brexit be to clients, shareholders, suppliers and key staff from the EU?
Do you have a Brexit communication **plan and resources** in place?

Distribution

What is your **market access exposure** and likely impact of loss of passporting arrangements?
What adjustments to **pricing strategies** will be required?

Operations

What impact would Brexit have on **existing legal contracts and mandates**?
What **documentation** will need to be changed. What measures and **resourcing** have been put in place to do this?
Review counter-party risk, direct and indirect **impact on suppliers**. How do impacted suppliers plan to respond?
What are the implications for **cross border data management**?
What is your **key man risk and level of reliance** on talent from the EU? How are key individuals likely to respond?

Conclusion

One prediction that we are confident to make, is of a sustained period of business uncertainty in the run up to a 'Brexit' vote and beyond. By understanding their level of exposure to the most probable outcomes and putting strong plans in place to handle them, firms can ensure that they are well placed to mitigate any immediate risks and also capitalise on longer term opportunities ahead of the competition. For our part, Grant Thornton's Financial Services Group is well placed to support our clients through a 'Brexit' with relevant regulatory, business planning and risk services.