The City plans for a tough Brexit divorce

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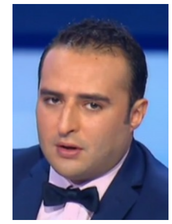
The upcoming exit of the United Kingdom from the European Union risks further weakening an economy already hampered by low interest rates and raises questions concerning the ongoing profitability of the British financial sector. ***Nader Haddad*** *writes that Brexit will not only impact goods trading inside the EU, but it will have a direct impact on financial markets, especially the City of London.*



The UK economy is comprised of 80 per cent services, 10 per cent industry and less than 1 per cent agriculture. This results in a need for foreign trade to compensate for domestic shortages and supply basic needs, to include food and industrial supplies. In the automotive industry, for example, half of all cars manufactured are destined for export to the European Union. At the same time, assembly lines remain dependent on the supply of parts from abroad.

This concern about trade is noted in Theresa May's letter to Brussels, in which she demands that discussions on future trade relations be conducted in parallel with the discussion of the separation itself. The Europeans, however, refuse this parallelism and want to settle the divorce before talking about the future. Meanwhile, scepticism exists concerning the feasibility of signing a free trade agreement within the two years allowed for negotiations by Article 50.

In considering the nature of post-Brexit trade, the City's great fear is the loss of "European Passporting rights". Passporting is an agreement between the 28 EU member states that allows an establishment to do business in one member state of the EU and to trade across the regions without having to be separately authorised in each country, within the framework of the Single Market. Should the UK continue its current position of seeking a "Hard Brexit" (e.g., through its refusal to apply the four fundamental freedoms of the European Union, including free movement), it risks loosing Single Market access. Indeed, Theresa May's government considers it "unlikely" that access will be retained.

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"Whether it's a hard or soft Brexit, we should be ready for any eventuality", Jim Cowles, EMEA Head of Citigroup said last month. "We are forced to expect the worst case scenario." In the eventuality of loss of "EU Passporting", non-European financial institutions (and the UK's highly active international banks such as HSBC and Barclays) will be forced to establish an entity in an EU country outside of the UK, or strengthen it, if they already have one. This is the only way they will be able to avoid being cut off from the Single Market and all that this entails (access to big corporate clients issuing shares or bond loans, states, large fortunes, millions of savers).

Marc Perrone, director of the Banking and Financial Regulation Department of the law firm Linklaters, reports that foreign, particularly U.S. Banks, have intensified their activities in the British capital in the 15 years since full Passporting was granted, often making London their hub. Continental branches have subsequently been closed or severely reduced in size and number. As an example, Goldman Sachs is said to employ approximately 6,000 people in Europe, including 5,500 in London. According to a report by the Bruegel Institute, the top five US investment banks have more than 80 per cent of their workforce in the UK. Consequently, the Bank of England (BoE) recommends that British banks take necessary measures to minimise the risk of credit contraction in the event that the Brexit unfolds in a disorderly manner.

The Financial Policy Committee, BoE, has asked banks to clarify how they will avoid a sudden break in their relations with their continental clients after Brexit, suggesting that "A sudden adjustment could disrupt the liquidity market supply as well as investment banking services." Longer-term changes in the banks' business model post-Brexit, as well as the anticipated increase in complexity in legal structures, could weaken the soundness of the UK financial system. As part of their plan to manage risks, the Financial Policy Committee has presented a scenario for stress testing of the UK's top tier banks. For the first time, Tier One banks will be subject to an "exploratory" test. This is planned to take place every two years and will assess their ability to cope with latent risks that are independent of the usual financial cycle. While cyclical tests cover a period of five years, these "exploratory" versions will run for seven years. The Committee has also set a Tier 1 capital ratio requirement of 13.5 per cent for banks, compared with the current 15.1 per cent, to be reviewed in line with changing international rules.

As the City plans for post-Brexit upheaval, governmental entities develop their negotiating positions. While Britain seeks to retain access to the European market that has been its primary trading partner and the largest money maker for several British industries for the last 15 years, Europe wants a solution based on the premise that "out is out", with no opportunity for special access, preferential deals or benefits. While the outcome is unknown, what is certain is that the UK's choice to pursue a hard Brexit will only harden the tone for future negotiations.

This article gives the views of its author, not the position of LSE Brexit or the London School of Economics.

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