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Brexit and the financial sector:
Time is already running out

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Brexit negotiations have just started but the UK's financial services industry is already running short of time to adjust to the worst case of a 'hard Brexit'. An assurance for a transition arrangement would be necessary to avoid expensive contingency measures. This blog post reviews the current state of relocation plans and asks whether negotiation parties could settle on a transition arrangement soon enough to avoid exaggerated worst-case planning.

1 Hard Brexit has become the default scenario

Brexit will take effect in about 20 months. Since the European Commission wants to settle the divorce principles before any talks about the future relationship between the UK and the EU27 can start, the fog around the effect of Brexit on financial services will probably only start to clear in 2018. Industry representatives claim that banks would need three years to implement the final agreement of the Brexit negotiations. The bumpy start of the negotiations, however, has given little reliable hint towards such a transition arrangement.

The key challenge is that the pressing need of the industry for a reliable assurance about the length and nature of a transition is at odds with the logic of a package deal in which no legal certainty exists until the very end. According to Michel Barnier, the chief negotiator of the European Union, the final deal including a transition arrangement should be completed by October 2018. Afterwards it would still have to be ratified by the member states, the European Council and the European Parliament. Thus, even in an ideal scenario where the UK and the EU stick to the timeline without delay, settle on divorce terms in 2017 and agree in early 2018 on a transition period, there is still a chance for a messy home stretch at the point of ratification.

As a consequence it seems almost unavoidable that UK's financial sector will start to prepare for a so-called 'hard Brexit', meaning that UK leaves the EU without a proper trade deal. This would force the financial industry to relocate those services that depend on Single Market passports to an EU member state before March 2019.

According to numerous assessments banks and other financial services providers should not wait any longer than September 2017 to start making arrangements if they want to continue business without disruption on day one after Brexit. In April, the Bank of England ordered the financial services industry to submit contingency plans for a hard Brexit by 14 July. This call and the increasing time pressure led many of the major financial players to make public announcements about their preparatory work. This blog post reviews the recent developments and asks whether negotiation parties could settle on a transition arrangement soon enough to avoid exaggerated worst-case planning.

2 What does relocation imply?

The main economic loss of Brexit for the European financial system is less efficient and more fragmented markets, which will result in higher costs for financial services. The current set-up allows significant economies of scale due to a clustering of all industries and related services in

the City of London. Most firms will now split their operations between a London-based business and potentially multiple European businesses. This is costly for at least two reasons:

First, firms need to duplicate numerous functions. While investment banks will continue to operate a trading room in London, they will now also establish one in Dublin, Frankfurt or elsewhere in the EU. The same holds for risk management and compliance. Second, firms need to provide their new subsidiaries with additional capital. Having all operations in one place has the benefit that one large diversified portfolio needs less regulatory capital than multiple smaller and less diversified portfolios. According to estimates of the consultancy Oliver Wyman, wholesale banks will have to increase their capital base in Europe by 15 to 30%, which is equivalent to 30 to 50 billion USD. On a positive note smaller subsidiaries are also less significant if they get into trouble and are presumably easier to resolve. And a larger capital base may also serve as a better buffer in a potential future financial crisis.

3 The beauty contest continues

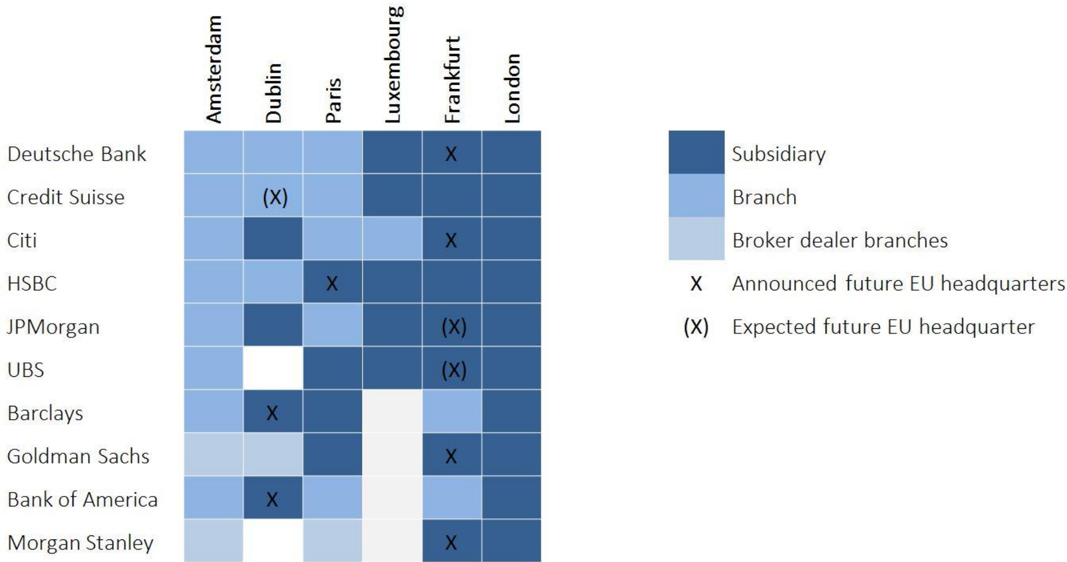
Financial centres in the rest of Europe have been trying hard to poach London-based businesses. Determinants in this beauty contest are the regulatory environment (reliability and quality of financial regulation, proximity to European supervisors as well as the labour code), and living standards such as the cultural attractiveness and infrastructure.

So far Frankfurt and Dublin seem to be the preferred destinations in particular for investment banks. According to Ernst & Young's Brexit tracker 19 out of 222 tracked financial institutions have announced to move operations to the Irish capital while 18 firms named Frankfurt their preferred destination. Most of the firms (63% or 151 institutions) remained silent, at least publicly, about their post-Brexit plans. Despite Dublin being in the lead, Frankfurt is likely to attract 6 out of the 10 largest investment banks in Europe, while only 3 are expected to choose Dublin (see Figure 1).

But banks are not the only show in town. Luxembourg is expected to attract the bulk of asset management firms. Amsterdam has managed to attract two major US trading venues and is already home to a number of high-frequency trading platforms. Furthermore, Warsaw could see another boost in back-office jobs.

All in all Brexit might push 31,000 to 35,000 jobs out of London (estimates by Oliver Wyman). Nevertheless, not all of these jobs will move to cities in the EU27, as some non-European firms might also choose to downscale their business in Europe and move staff to New York or financial centres in Asia. And as the described pattern indicates, the London ecosystem will migrate to multiple European cities which will make it harder to replicate a financial system as efficient as the UK's today.

Figure 1: Post-Brexit future headquarters of 10 top investment banks in Europe.



Notes: Presence of banks based on figure "Brexit banking matrix" (Financial Times, Germany well-placed for post-Brexit migration of London business, 9 October 2016). Announcements based on newspaper article compiled in early August 2017. Sources: FT Research, FT, Bloomberg.

4 Preparations will quickly become more costly

The longer the uncertainty around the post-Brexit EU-UK relationship prevails and especially whether there will be some time to adapt to this new regime after March 2019, the more costly will contingency measures of the financial industry become. So far banks were able to restrict themselves to "no regrets" moves, like applying for licenses in other EU member states. Those actions cost little and increase options. It is advisable to submit such licence applications at latest in autumn 2017 as their approval may take several months and subsequent steps have to follow swiftly.

To avoid a disruption in a no-deal scenario banks will have to build up their subsidiaries over the coming 12 months. This includes much more expensive steps such as renting office space, building up the infrastructure for trading rooms, injecting capital and of course moving staff (including senior management) and their families as well as recruiting new staff.

5 Negotiations are not a zero-sum game

The questions now are: What could each of the negotiation parties do to provide legal certainty as early as possible? And what are each side's interests to do so? The UK has a strong interest to negotiate a transition period as early as possible but its government has limited its room for manoeuvre by declaring multiple red lines. In theory, the UK could soften its demands on issues such as the Brexit bill or the applicability of EU law after Brexit and in exchange demand a binding assurance by EU member states in early 2018 for a three-year transition. This would however weaken Prime Minister Theresa May because her opponents in the UK would claim she did not negotiate the best divorce deal possible.

The EU itself could ease the time pressure in two ways: First, it could lay out some options for potential transition periods and state its demands on what it wants in exchange. Second, it could work on a clear and comprehensive third-country regime in its multiple financial service regulations. To date parameters for the equivalence assessments are not always sufficiently specified, which makes a preparation for UK firms difficult. In contrast to the UK, the EU has however few incentives to bring up the question of transition proactively, as the uncertainty about day one after Brexit is a strong bargaining chip.

The best way the UK could weaken the EU's position on this issue would be to appear as the better prepared and more compromising negotiation party. The EU negotiation team could probably not afford to appear playing on time as this might alienate some governments and business associations that are worried about the economic consequences and therefore risk unity of member states. The infightings in the Conservative Party and the lack of clarity about the UK's negotiation position on important divorce principles display, however, just the opposite.

Nevertheless, the EU and its member states should be careful not to become complacent with their seemingly strong position. The European financial system as a whole has already become less attractive due to the Brexit decision and is likely to lose attractiveness as long as uncertainty about the future relationship of the EU and the UK prevails. This will result in more expensive financial services and hamper the growth of alternative financing sources for enterprises, just the opposite of what the European Commission hopes to achieve with its Capital Markets Union project as I have argued in a recent policy paper.

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