OLIVER WYMAN

ONE YEAR ON FROM THE BREXIT VOTE

A BRIEFING FOR WHOLESALE BANKS

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A year has passed since the UK voted to leave the European Union. With the political situation in flux, we still know relatively little about the likely future arrangements between the EU and the UK. However, we have learned more about how wholesale banking might be affected as management teams have pored over their options and worked through detailed contingency plans.

In this note, we take a look at where wholesale banks stand and what their priorities should be now and in the future.

THE SHIFT AWAY FROM LONDON

Banks have been working hard to design "Day 1" operating models to ensure continuity of client service in the event of a hard Brexit. Although some banks may take the opportunity to restructure their European footprint more broadly, most are looking to minimize expense and disruption by relocating as little as possible in the first instance.

For these banks, expect to see their EU presence increase primarily in EU client-facing roles and in local entity risk management and governance. As part of this, banks may seek to use remote booking and back-to-back risk management models for some activities to allow trading and associated risk management roles to remain in the UK, at least on an interim basis. National supervisors are showing signs of flexibility in their approach to these kinds of "Day 1" models, in part to help ensure smooth functioning of banking and financial markets come March 2019 and avoid a "cliff edge".

Over the medium term, however, pressures are likely to grow for banks to move beyond their initial "Day 1" operating models. The European Central Bank is seeking tougher banking supervision across the Eurozone as part of their ongoing work to strengthen the financial system. This means new requirements for the operations of multi-national banks to demonstrate that they are economically self-sufficient, resolvable, and have strong local control and governance will all likely build over time. It may also mean booking and risk management has to take place locally, raising questions over the use of back-to-back booking models. These pressures are likely to lead wholesale banks to increase their presence inside the EU over time.

Last year, working with TheCityUK, Oliver Wyman estimated that a hard Brexit in which UK-based banks lost privileged access to the EU would drive 31,000–35,000 jobs out of the UK across all financial services. Of these, 12,000–17,000 would be in wholesale banking. Based on banks' subsequent disclosures and our engagement across the industry, we believe this remains a sound estimate of the impact in the medium-term.

However, as we also found in our prior work, the movement of jobs from the UK could ultimately be greater. Management teams may find commercial reasons to relocate more activity to the EU over time, for example to encourage collaboration among salespeople, traders, and risk managers, while maintaining close proximity to clients.

More fundamentally, the EU faces a number of broader policy questions about the future structure of the Euro financial system and whether elements of it, such as clearing, can continue to be provided from London. We continue to estimate that such a long-term shift in the wider financial markets ecosystem towards the EU could move around 35,000–40,000 jobs from the UK to the EU in wholesale banking alone.

FRAGMENTATION, INCREASING COSTS, AND REDUCED RETURNS ON EQUITY

Despite plans to relocate jobs out of London, at present none of the other European banking centres seem set to replace London as a pre-eminent global financial services hub.

Frankfurt and Dublin are emerging as the main destinations for potential new sales and trading entities, along with Paris, Luxembourg, and Amsterdam. In their planning, banks have found each jurisdiction to have particular advantages and disadvantages. Frankfurt is seen as attractive on supervisory stability and influence. Dublin's tax advantages are being weighed up against a less convenient location and potential issues around relocating large and complex balance sheets. Paris and Amsterdam are considered attractive and convenient locations and are already home to several major wholesale banks.

This picture may change over time as all these locations work on attracting financial services by putting in place solutions to the local challenges, for instance revised tax codes or labour laws. More broadly, the future landscape of European financial and capital markets remains uncertain and will not be shaped by banks' location decisions alone. The approach taken by the EU to market infrastructure will also play a role, as will the reactions of the banks' clients – such as asset managers – who are heavily hubbed in London today.

Should a new EU hub emerge, banks would be quick to re-orient their operations towards that location. But, for now, the industry is moving towards a less centralized structure, as each bank chooses their preferred location based on their existing legal entity structures and their own business profiles and priorities. Some are likely to spread their operations across a number of countries using a combination of branches and subsidiaries.

A hard Brexit can therefore be expected to fragment the European wholesale banking market. It will also make it significantly less profitable. We estimate that the wholesale banking industry would need to find USD 30–50 billion of extra capital to support new European entities, equivalent to 15–30 percent of the capital currently committed to the region by wholesale banks.

There is a risk that banks' capital needs could be higher still, for example if they fail to achieve sought-after regulatory treatment on issues such as internal model approvals and the treatment of large inter-company exposures. Depending on their ability to partially offset these increases in capital, we estimate banks could see two percentage points knocked off their returns on equity of their wholesale banking operations in the region.

Banks also expect operating costs to increase, as some functions previously centralized in London are duplicated in their EU subsidiary. The functions most likely to be replicated are control areas such as risk, compliance, and finance. We estimate that such changes could add 2–4 percent to the annual cost base, equivalent to around USD 1 billion across the industry.

Given that returns on equity in European wholesale banking are already below hurdle for many players, these new challenges from Brexit will raise difficult questions about the viability of some activities over the medium term. Some banks may even choose to withdraw capacity from the European market as a whole and redeploy to other regions, such as Asia or the US.

UNCERTAINTY AND OPTIONALITY

We find uncertainty about the outcome of the Brexit negotiations means wholesale banks are trying to restrict their initial responses to "no regrets" moves: actions that increase their options but cost relatively little, such as applying for licences in EU jurisdictions. Over the next six to 12 months, however, actions will be needed that are more costly and harder to reverse – such as injecting new capital into EU entities, moving employees, appointing senior management, and building dealing room infrastructure.

The immediate challenge is to coordinate the vast amount of work to ensure the bank is ready for a range of "Day 1" scenarios. This is a daunting task. The issues raised by Brexit cut across all areas of the business and the possibilities that must be considered in planning are wide ranging. As such, Brexit programmes need to provide a strong hand from the centre to challenge and coordinate the work across the bank. Banks must also build as much flexibility as possible into the approach.

The longer-term risk is that a bank will take a series of steps, each seemingly sensible in itself, which draw it into a structurally unprofitable position. Managers should guard against this by making sure their plans take a broader, longer-term view. Strategic options, such as shifts in client or product mix, need to be evaluated as part of the response to a hard Brexit outcome. This needs to be underpinned by facts and analytics that show how the economics of the business adjust to a range of future scenarios.

Constructing such a fact-based model is not easy: it requires a myriad of assumptions, on everything from revenue potential to the likely incremental financial resource needs over time. In particular, this requires thinking through alternative scenarios for the future supervisory landscape and the associated regulations requirements. Yet, with major cost and capital commitments looming, it is a necessary step to inform senior management discussions and decision making.

SMOOTHING THE TRANSITION

So long as the outcomes of the Brexit negotiations remain unpredictable, banks must act as if a hard Brexit is coming. This is driven by natural prudence and also regulators' demands. As a consequence, some of the fragmentation and inefficiency that would result from a hard Brexit will likely occur even if a closer relationship between the UK and EU is ultimately negotiated.

Job losses in London and reduced tax revenues mean the UK has a clear interest in avoiding this outcome. Reflecting similar concerns across the economy, the UK government has signalled a clear commitment to a transition period. Yet the agreed timetable for Brexit negotiations will initially prioritize the divorce bill, the Irish border, and the status of expats. Until an implementation period is formally agreed with the EU, banks will not be able to rely on this in their planning.

In the meantime the onus will pass to regulators to help ensure a smooth transition in financial services. There are many technical areas where such additional regulatory guidance could significantly reduce the degree of upheaval felt by the industry. Some of the most important areas include: the approach to the "back book" of existing client trades; the treatment of "third country" branches (such as UK branches of EU entities); policies on internal model approvals; and clarity around the timing of any decisions regarding regulatory equivalence.

CONCLUDING REMARKS

Banks are reaching a critical stage in their Brexit response work. As they move into implementation, management teams have complex change programmes to deliver in an environment that is likely to remain highly fluid. With the European market set to become more fragmented and less profitable, banks will have difficult strategic trade-offs to make. Nonetheless, the primary focus must be to avoid a post-Brexit "cliff edge" and this will require banks, policymakers, and regulators to all play a role.

FURTHER READING

Commissioned by TheCityUK in October 2016, this report provided a range of information about financial services in the UK and Europe, and analysed what different regulatory and access outcomes from Brexit could mean for the industry.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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