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Brexit: Potential effects on financial institutions

Implications in ASEAN

What happened exactly?

On 23 June 2016, the British people voted in a referendum for the United Kingdom (UK) to leave the European Union (EU), after having been a part of it for almost half a century (Since 1973). While the impact on the financial markets was felt almost immediately, the exit process is expected be a long one - at least 2 years until an effective actual 'Brexit'.

What are the possible implications for the UK-EU relationship?

There are 3 possible scenarios:

Scenario 1:

The UK joins the European Economic Area[1] (EEA) and the European Free Trade Association[2] (EFTA). This is also known as the 'Norwegian' model. This scenario is somewhat unlikely as it would not change significantly from the current regime.

Scenario 2:

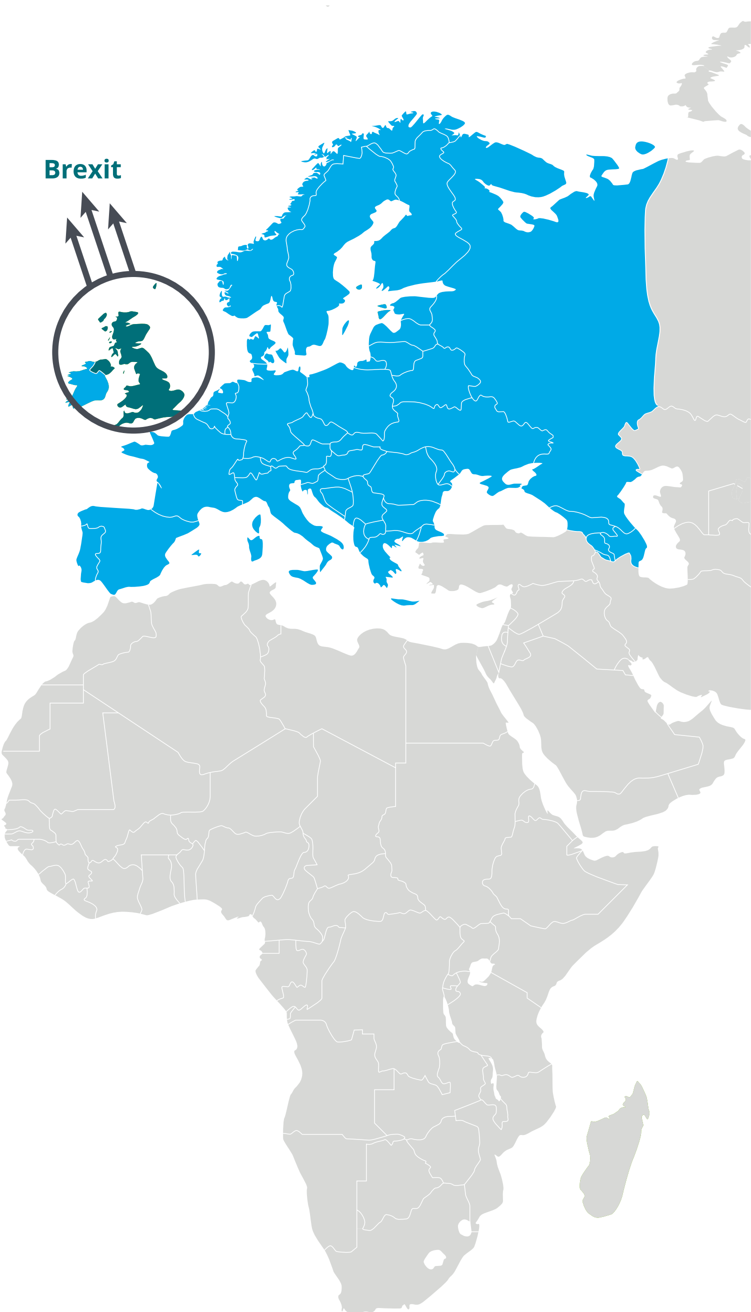
The UK does not join the EEA but only the EFTA. This is also known as the 'Swiss' model. This scenario would offer more flexibility to the UK when they negotiate and tailor their new relationship with the EU.

Scenario 3:

The UK opts for a third country status, entirely outside the EEA and EFTA. This scenario is the one offering maximum independence to the UK vis-à-vis the EU, although they would still have to align on EU regulations in order to gain access to the EU's Single Market. This can be a lengthy and cumbersome process for the UK.

1 The Agreement on the European Economic Area, which entered into force on 1 January 1994, brings together the EU Member States and the three EEA EFTA States — Iceland, Liechtenstein and Norway — in a single market, referred to as the "Internal Market".
Source: http://www.efta.int/eea/eea-agreement

2 The European Free Trade Association (EFTA) is an intergovernmental organisation set up for the promotion of free trade and economic integration to the benefit of its four Member States: Iceland, Liechtenstein, Norway, Switzerland.
Source: http://www.efta.int/



What are the key regulatory implications for UK and European financial institutions?

Fundamentally, the financial institutions that are active in the UK, whether headquartered or having significant presence there, will have to analyse the potential implications of the three possible scenarios mentioned above. It will be especially crucial to observe the strategic direction that the UK will be taking during the next two years of the negotiations around its exit conditions, in particular in relation to Scenarios 2 and 3 – the most probable scenarios.

From a regulatory standpoint, there are two different ways this can translate:

- The UK desires to preserve its full access to the EU's Single Market, and hence, it needs to demonstrate consistent alignment with and application of the EU rules in terms of capital adequacy, liquidity requirements, derivatives reforms, structural reforms, and so on. This access would also include the 'four freedoms' agreement (free movement of goods, services, persons and capitals) the UK has with its counterpart EU members. This desire may significantly reduce the influence of the UK on the regulatory environment – an influence the UK has enjoyed up till now.

  Depending on the outcomes of the negotiations between the UK and the EU, this may constitute a less disruptive scenario whereby the financial institutions may still have full access to the EU markets and regulations fully/mostly aligned with the EU framework even if they are based in London.

- The UK decides to compete directly with the EU by becoming a fully independent financial centre offering financial, tax and regulatory incentives to financial institutions that choose to stay/settle in London. This option would obviously be far more disruptive and a delicate play for the UK, as it would be taking the risk of completely isolating its financial institutions from the rest of the EU's Single Market.

  The arbitrage for the financial institutions would have to be between local flexibility and enjoying incentives on the one hand, and limited growth opportunities due to restricted access to the EU markets on the other. If the situation moves in this direction, it will lead to an important shift of big financial institutions towards the continental EU and a shrinkage of the UK financial centre, which will be progressively replaced by another European city such as Amsterdam, Frankfurt or Paris.

How will Asian banks be affected, especially in the ASEAN region?

In Singapore so far, there has been several different reactions to the Brexit among the local financial institutions. UOB has decided to suspend new loans for the purchase of London properties, citing potential foreign exchange and sovereign risks as reasons, whereas DBS and OCBC announced that they would continue to grant such loans but with heightened care. This shows that even though the risk appetite may differ from one financial institution to another, Brexit is not neutral in terms of risk management and decision-making process.

Where ASEAN financial institutions are concerned, the implications of Brexit can be classified under the following 3 main, potentially inter-related, areas:

Regulatory implications

In an environment where uncertainty has become the norm, where digital transformation and financial technologies ('FinTech') poses as much a threat as an opportunity, and where profitability has become a survival game, the Brexit risks may eventually lead the international regulator (the Basel Committee) to review its ambitions in terms of regulatory pressure imposed on the financial institutions. In particular, further resistance may be observed from the banks vis-à-vis the new layer of so-called Basel IV rules, arguing that they now need to focus and prepare for the post-Brexit new world order.

Although this is a fair enough statement, the international regulator could counter-argue by stating that the recent regulatory requirements have actually been efficient in preventing any big bank from collapsing following the Brexit shock, and thus their current regulatory orientation is the right one.

Therefore, it is very difficult to predict how the Brexit will affect the approach of the regulator globally and in the ASEAN region.

Systemic implications

Although the Brexit is a shock for most observers, it is fair to say that the bigger risk still lies ahead. Indeed, this move by the UK could trigger a politically contagious effect in other EU countries – they can and may propose similar referendum to their population. Some newspapers recently even mentioned the possibility of 'Frexit', which could see France leaving the EU.

In Italy, a critical constitutional referendum is expected to take place in October 2016 that affects structural reforms crucial for the future economic and political stability of the country. A rejection of this referendum, combined with gloomy economic indicators and a banking sector currently in great difficulty, would plunge Italy into a crisis which could eventually threaten the fragile ecosystem of the Eurozone even more.

While Brexit may still present a lot of volatility and uncertainty going forward, it would be nothing compared to the worst case scenario - a collapse of the entire Eurozone due to the exit of more of its members. If this happens, all financial institutions across the globe, including in the ASEAN region, would be hit.

Financial institutions globally and even in ASEAN should perform robust scenario analysis and contingency planning in order to anticipate a potential contagion effect and strategise what would be the key decisions to be made in order to weather through such a crisis should it arise. Financial institutions need to review and revise their risk appetite framework in the light of the recent events.

Eco-political implications

The EU has been often mentioned as a role model for the AEC (ASEAN Economic Community), but recently, it has been showing ASEAN what not to do instead. What happened in the EU over the past few years, from the Grexit threat tragedy to the Brexit Shakespearian act, poses several poignant 'education' and 'learning' points as ASEAN moves towards more integration in the years to come.

The intricacy of political, economic and regulatory dimensions is a real challenge when it comes to agreeing on a common strategy. Also, Brexit will certainly trigger structural reforms in the way the EU will be governed going forward, and this may influence some of the decisions the AEC will make to achieve its own goals. Eventually this will have implications for the financial institutions in the region, where economic integration is a chance, but also where potential political divergences may alter harmonisation objectives. ASEAN banks will need to analyse accordingly the potential scenarios and consider the implications when performing their strategic planning.

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