CloserLook

Brexit: What now for US banks and capital markets firms?

The world turned upside down?

The decision by voters in the United Kingdom to exit the European Union, known as "Brexit," was a surprising one: prognosticators in the days leading up to the vote assigned a fairly low probability for the "leave" vote to come out on top.[1] Uncertainty related to the potential for other EU member nations to seek an exit, or even for constituencies within the UK to seek their own path with respect to the EU, has the potential to further complicate an already challenging situation.

Financial institutions in the UK and Europe will bear the brunt of this event over both the short and long term, as the timetable for full separation is two years following the invocation of Article 50 of the Lisbon Treaty. What about their counterparts in the United States? Some very large US firms operate globally, with a meaningful presence in the UK and Europe. For them, the impacts are more direct and immediate. But many more US financial institutions are purely domestic, so the impacts of Brexit will be part of larger regulatory and economic forces that may emerge as the UK executes its departure.

In the remainder of this document, one of a series of reports spanning financial services, we will explore the implications of Brexit for banking and capital markets in the United States, looking at financial, regulatory, operational, and strategic considerations for US banking and capital markets executives. Those interested in understanding the impact of Brexit on other financial industry sectors are encouraged to review our companion pieces in this series.

[1] Justin Wolfers, "Brexit Hits U.S. Stock Market Harder Than an Election," *New York Times*, June 24, 2016.

Recalibration post-Brexit

The US banking industry's mood shifted from self-congratulation—all large US banks exceeded regulatory capital minimums in the Dodd-Frank Act Stress Tests (DFAST) for the second consecutive year—to one of heightened anxiety about fallout from the Brexit vote. Even banks that do not have a presence in the UK or the EU now have to consider myriad implications.

Many banks have begun executing contingency plans designed ahead of the vote. But more will obviously need to be done as the drama unfolds. Final outcomes are, of course, unclear at this time, but our hypothetical base case assumes some fundamental conditions going forward:

- A prolonged and complicated negotiation process that fuels political and economic uncertainty.
- A higher degree of trade friction between the UK and the EU post-separation.
- Less free movement of people between the EU and UK due to immigration restrictions.
- A more complex and uncertain regulatory environment during the transition period as some EU rules are modified, replaced, or eliminated for UK specific regulations.

Our analysis does not account for the worst case—such as a disorderly exit and further disintegration of the EU itself.

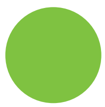
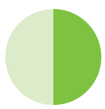
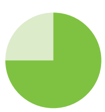
As Sir Winston Churchill said, "It is a mistake to look too far ahead. Only one link of the chain of destiny can be handled at a time."[2] In the coming weeks and months, US banks will face the following critical issues as the sense of urgency to execute the separation process gains steam.

1. Continuing political and economic uncertainty will hobble attempts to reliably reassess returns on equity (RoE) from UK and EU operations, potentially forcing a scaling back of investment commitments in the region.
2. The likely absence of a flexible "passporting" arrangement for transactions means business scale in each region will need to be resized for the new reality.
3. The costs and barriers of erecting and running a dual UK and EU business model will force a reevaluation of transaction booking models and the distribution of asset and wealth management products.
4. Earnings impact on US banks, even those solely focused on the domestic market, could be negative. US-based banks with meaningful revenues from and exposure to the UK and the EU will obviously see a direct negative impact. More broadly, the general dip in business sentiment and potential weakening of global growth could cause domestic loan demand to sputter. Margins may also be pressured further by continuing low interest rates and a flatter yield curve as long-dated Treasury yields decline.
5. US banks will have to balance the cost and speed of operational restructuring depending on how separation occurs (i.e., orderly or disorderly, immediate or gradual). Correspondent banking partnerships and vendor relationships with firms in the UK, and possibly even in the EU, will demand close attention through the coming transition.
6. Regulatory standards in the UK could diverge and possibly become less stringent than those in the EU, as London attempts to retain its status as a leading global financial center. Beyond impacting US banks that have a UK presence, this divergence may influence future investment decisions of domestic banks with international ambitions.
7. Resolution ("living will") plans mandated by the Dodd-Frank Act will now need to account for impediments to resolvability that have emerged due to Brexit. These include legal and operational frictions to bankruptcy and operational continuity in resolution across jurisdictions.

At a fundamental level, capital and liquidity improvements, alongside frequent stress-testing exercises, have raised US banks' resilience to geopolitical shocks such as Brexit. Going forward, this very resilience may enable them to maintain and possibly even improve their competitive positioning.

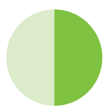
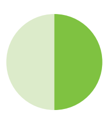
[2] Simon Paige, "The Very Best of Winston Churchill—Quotes from a British Legend," 2014.

Areas of focus

Strategy and business model		
Implications	**Scale of impact**	**Likely impact on US banks and capital markets firms**
Economic and political uncertainty in the UK and the EU, further weakening global growth		• Continuing uncertainty will hobble US institutions' attempts to reassess RoE expectations from the UK and EU markets. This, in turn, will force US banks to scale back investment commitments in the UK—and possibly in the EU. • Pressure on performance in the US domestic market will intensify.
Market strategies and product portfolios		• As the UK market splits from the EU, US banks will need to reassess their commitments to individual markets and segments. This exercise will likely include a reconfiguration of product portfolios, especially in trading, transaction banking, and fund management. • Pricing strategies will also be redesigned as cost of capital and funding in the UK and the EU diverge. • Passporting arrangement changes may affect distribution networks and create new regulatory costs.
Competitive structure		• As UK and EU banks are preoccupied with separation-related adjustments, large US banks have an opportunity to improve their competitive positioning. • If UK and EU banks scale back their US ambitions, domestic banks may benefit from reduced competition. • US banks looking to expand their international reach may find this an opportune time to acquire UK/EU franchises—leveraging the strength of the US dollar and suppressed asset prices in the UK and EU.

Key: No impact Minimal Moderate Material High

Areas of focus

Financial		
Implications	**Scale of impact**	**Likely impact on US banks and capital markets firms**
Pound sterling and euro weakness; persistent foreign exchange (FX) volatility		• Clear short-term negative earnings implications for US firms exposed to GBP- and EUR-denominated assets. • More active hedging strategies will be needed to optimally allocate capital amidst heightened volatility.
Shifting revenue profile		• Overall revenue impact for US banks could be somewhat negative for the foreseeable future. • Global US-based banks with meaningful revenues from UK and EU markets will obviously experience a more significant impact. • Core lending margins will be squeezed as interest rates remain low or are further reduced in response to slowing global growth. A flatter yield curve in the US due to declining long-term Treasury yields will add to the pressure. • Trading revenues for global US banks could get a short-term boost due to heightened volatility and greater client hedging activity. • M&A activity is likely to pick up in the medium term as separation-related corporate restructuring ensues. • UK and EU IPO-related revenues for US banks will be suppressed for a while.
Balance sheet		• Funding will become cheaper for US financial institutions with increased global appetite for USD assets. • US banks—and their global peers—will begin to hold more liquid assets to withstand separation-related market shocks. • Loan growth in the US market may remain low due to reduced business confidence, thereby diluting US banks' incentive to chase retail deposits. • Drop in securities prices and potential rating downgrades in the UK/EU will lead to marginal declines in capital ratios. • Brexit repercussions may impair the ability of various EU countries to service sovereign debt obligations—a significant consideration for sovereign risk exposure and capital management.

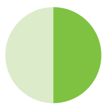
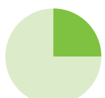
Key: No impact  Minimal  Moderate  Material  High

Areas of focus

Operations		
Implications	**Scale of impact**	**Likely impact on US banks and capital markets firms**
Restructuring and governance		• US banks will need to balance the scale and speed of operational restructuring as the manner of separation is uncertain (i.e., orderly or disorderly, immediate or gradual). • Friction in passporting banking and capital market services and infrastructure from the UK could force relocation. • Relocation decisions—where, when, and what—will need to be made with attention to local infrastructure, tax regimes, talent pools, and ease of resolvability. • As separation ensues, banks will have to reconsider data storage and access procedures due to potentially different standards around data protection in the UK and the EU. • In all likelihood, a bifurcated and more complex operating model (one in the UK and one in some other location in the EU) will emerge through the transition. • This model may also demand separate boards and governance structures.
Counterparties and vendors		• US institutions will need to reassess relationships with counterparties and correspondent banking partners in the UK, and possibly even in the EU. • Collateral agreements may also have to be revisited as banking systems readjust. • Vendor relations will be reconfigured; for example, agreements governing data and intellectual property between the UK and the US parties.
Talent		• The war for talent in the legal and compliance arena will sharply intensify as banks begin planning and executing their restructuring initiatives. • Job losses within UK operations may be inevitable as some business activities shift out of the UK. • Cross-border transfer of talent may become more challenging.

Key: No impact Minimal Moderate Material High

Areas of focus

Regulatory factors		
Implications	**Scale of impact**	**Likely impact on US banks and capital markets firms**
Regulatory divergence		• Regulatory standards in the UK may diverge from and possibly become less stringent than in the EU as London attempts to retain its status as a leading global financial center. • Likelihood of regulatory arbitrage may increase as the UK regulatory regime diverges from that in the EU.
Stress testing and resolution planning		• US regulators may encourage explicit modeling of extreme geopolitical risks for DFAST and CCAR (Comprehensive Capital Allocation and Review). • Resolution planning for US banks will likely become more complex due to legal entity restructuring. • Current expectations regarding simpler operating models will be harder to meet due to the bifurcated operating models in the UK and the EU.
Regulatory strategy		• Proactive engagement with EU and UK regulators/legislators as the separation process unfolds and trade agreements are reconstructed.

Key: No impact, Minimal, Moderate, Material, High

Contacts

Industry leadership

Kenny Smith
Vice Chairman
US Financial Services Leader
Deloitte LLP
+1 415 783 6148
kesmith@deloitte.com

Deloitte Center for Financial Services

Jim Eckenrode
Managing Director
Deloitte Center for Financial Services
Deloitte Services LP
+1 617 585 4877
jeckenrode@deloitte.com

Author

Val Srinivas, Ph.D.
Research Leader, Banking & Securities
Deloitte Center for Financial Services
Deloitte Services LP
+1 212 436 3384

Urval Goradia
Senior Market Insights Analyst, Banking & Securities
Deloitte Center for Financial Services
Deloitte Services LP

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Scott Baret, Advisory Partner, Deloitte & Touche LLP
James O'Riordan, Partner, Deloitte UK
Alok Sinha, Advisory Principal, Deloitte & Touche LLP
James Sohigian, Principal, Deloitte Consulting LLP
Christopher J. Spoth, Managing Director, Center for Regulatory Strategy, Deloitte & Touche LLP
Tom Robinson, Partner, Deloitte & Touche LLP
David Wright, Advisory Managing Director, Deloitte & Touche LLP

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Michelle Chodosh, Marketing Manager, Deloitte Services LP
Steve Fromhart, Manager, Deloitte Center for Financial Services, Deloitte Services LP
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Seth Raskin, Marketing Manager, Deloitte Services LP
Lauren Wallace, Lead Marketing Specialist, Deloitte Services LP

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