A note on the implications of Brexit for the delivery of financial services to corporates across Europe

Introduction and summary

Most of the analysis of the impact of Brexit on financial services has focussed on the consequences for the providers of financial services rather than the end-users, the customers. There will be a major impact on both the availability and cost of financial services for users since providers of financial services from the EU to UK customers or vice versa will no longer have the benefits of free access through the single market arrangements and will likely have only very limited access through the third country equivalence regime.

At the same time, the commercial impact of new, post-Brexit, cross-border trade arrangements – presently uncertain - will mean that the financial needs of corporates in both the EU and UK will also change.

It is not possible to say just what the consequences will be for individual customers, as this will depend on the complex interplay between financial firms within wholesale markets and between financial firms and their customers in a significantly changed and more costly legal environment for which there is no precedent.

The impact will vary by sector as well as size and business model. Even corporates who have only UK-UK or EU-EU business models may still see an impact in availability and/or cost of banking services. In addition, it is not possible to know what further action might be taken by regulators beyond the simple removal of market access in certain areas, which will also have an impact on corporates. Even if an agreement can be reached on a Free Trade Agreement (FTA), this is not envisaged as providing market access for financial services, which is likely to depend upon the EU and UK's general third country regimes such as equivalence.

In the event of a political agreement on an FTA, this might provide the political context for a more cooperative relationship on financial services and potentially equivalence which could reduce fragmentation in some areas. However, the European Commission has stated that it does not intend to grant equivalence for UK-based firms to provide MiFID investment services to EU clients in the short or medium term. If no political agreement can be reached, then a less cooperative relationship is likely similar to the no-deal scenario which was contemplated prior to the ratification of the Withdrawal Agreement. However, in either scenario European financial markets are likely to be increasingly fragmented, impacting liquidity and costs for financial services providers and their clients.

The increase in market fragmentation that will result could reduce choice for corporates and increase costs – both in terms of increase in cost of supply but also extra resources required to navigate multiple sets of regulation and, in some cases, book business in a fresh location. It is also likely to reduce market stability as smaller pools of liquidity could see greater volatility. Greater risk concentration could increase risk to everyone bar the most diversified player. Operational burdens are likely to be significant for some users of financial services as well as suppliers.

This note considers in detail the consequences for corporates in both the UK and EU member states of curtailment of the range of different activities provided by banking counterparties.

Given the deep uncertainty about how all the changes, introduced on a single day, namely 1 January 2021, will play out, there is risk of short-term market disruption while firms and their customers seek to establish new patterns of relationships.

The note concludes with a **check list** of some of the actions corporate customers of financial services firms may wish to consider undertaking.

Detail

Most of the various assessments which have been made of the impact of Brexit on financial services have looked at the question from the point of view of the financial institutions and markets themselves. Many of these have in turn focussed on the legal and regulatory position rather than the impact on the volume or price or complexity of doing business, or how much business might have to be transferred to other vehicles or in what way.

The aim of this note (which was finalised in early -November 2020) is to see what can be said about the impact on corporates and end users in the near term. It does not explore how future regulatory change may subsequently improve (or worsen) the position of final users, for example, whether through potential regulatory simplification in the UK or the implementation of CMU measures in the EU.

It does not cover insurance or pension funds – although many corporates are sponsors of defined benefit pension plans (and a few multinationals have captive insurers). Nor does it address issues of cross-border data transfer or movement of staff, which are of much wider applicability, but also impinge on the deliverability of financial services.

More importantly, it does not explore in any detail the impact which Brexit will have on the financial services requirements of corporates. It only considers potential consequences resulting from the impact of Brexit on the availability and cost of financial products, but clearly the needs of end users will be affected greatly by the impact of Brexit on their core business; the extent that their supply chains and hence trade finance needs are impacted by tariffs or by administrative friction, or indeed whether their commercial activities can continue at all, will affect overall financial services requirements, such as additional guarantees, for ongoing trading and for investment.

In addition, corporates with a UK footprint may encounter regulatory complexity once the transition period ends. To take an example, under EMIR Refit, it is stated in Recital 16 that OTC derivatives transactions between counterparties within a group, where at least one of the counterparties is a non-financial counterparty, should be exempted from the reporting obligation, regardless of the place of establishment of the non-financial counterparty. However, in practice EU NCAs are applying a territorial restriction when interpreting this exemption. Furthermore, in the absence of equivalence determinations, there may be divergence in regulatory requirements between the UK and EU which may create future complexity for corporates' Treasury Management Systems and processes (in addition to the financial sector impacts).

Leaving aside the interaction between supply and demand consequences, one of the reasons why such analysis is challenging is because outcomes in practice will depend on how both firms and customers behave, and how the markets in which they interact develop in an environment which is outside any prior experience and is still not certain in key respects. In particular, the very nature of wholesale financial markets and the participation of intermediaries as principals mean that there is little or no direct connection between non-financial customers so that it is very difficult to determine the incidence of the increased costs of friction arising from new fragmentation.

It is also not known what further measures regulators might take in response to the changed legal circumstances, particularly in response to the ending of a common legal framework. This will mean that it will become more problematic for supervisors to rely on each other because there will no longer be a common rulebook or recourse to the ECJ in the event of difficulties. Any further measures are also likely to have an impact on end users.

It is difficult to generalise about the impact on individual customers, whether in the UK, EU or multinational and whether served by an EU or UK financial services provider, as each customer, whether corporate, asset manager or individual will have requirements for a different mix of products. The impact will depend in part on the corporate and geographical structure of both the customer and the providing firm, and on the ease with which services can be provided through different jurisdictions. A UK customer should have continued access to the pools of capital in UK markets, assuming they remain available, whereas the position of EU customers may depend on the status and development of EU capital markets.

A certain amount is known about the restructuring of financial services firms to deal with Brexit, but corporate customers may also restructure in order to access financial services. For certain large multinational customers, this may apply to services within their organisations if they have, for example, a regulated entity within an otherwise non-financial group.

Moving to a 3rd country status will directly impact regulated firms in both the UK and the EU, and hence also their customers. The UK FCA has adopted a "Temporary Permission Regime" for EU firms to continue servicing their UK clients, but this has not been reciprocated by most countries in the EU for UK firms to service their EU customers. What is definite at present is that passporting as we know it will come to an end, which will mean that certain activities will no longer be legal on a cross-border basis. The main legal issue remaining is the extent to which any equivalence regimes will be put in place in a timely fashion and whether they will cover the full suite of activities that may be covered by such equivalence regimes. The outlook on this is at present not promising, aside from the temporary (18 months) equivalence recognition for clearing activities of the UK CCPs and a few temporary and qualified permanent exemptions available at a national level. The UK has unilaterally announced some equivalence decisions which are not time-limited, but are limited in scope. It remains to be seen whether the EU with reciprocate.

The remainder of this note explores the impact of loss of passporting as well as the difference between the establishment of functioning equivalence regimes and none, or no deal in other words.

At its most basic, the ending of passporting is in itself bound to lead to fragmentation and cost increases as certain business which could previously be done directly or through passported branches, if it is to be undertaken at all, has to be undertaken on the books of separately capitalised subsidiaries in other jurisdictions. Of itself this will increase costs, but the extent to which these will be passed on to different categories of customer is not possible to determine. The interplay with large exposure limits may also have an impact on the ability of financial firms to provide the same level of services to their customers because financial entities, now separately capitalised for Brexit purposes, will have to operate with lower absolute levels of capital. This is because capital will be fragmented between existing London-based operations and new or expanded EU entities. Many international banks will be challenged with additionally fragmented capital at a time when they are under pressure from the macroeconomic environment, including Covid-19 demands and the acceleration of the ESG/sustainable finance agenda.

The direct challenges for bank customers of an end to passporting and lack of equivalence are outlined below and applicable in varying degrees to all parts of the financial services industry.

- **The cross-border sale of investment services** will be limited so achieving the same activity will need some elements to be conducted elsewhere. This may involve the transfer (or 'novation') of the customer business to legal entities where such activity is permitted, in some cases involving the financial firm upscaling existing legal entities and recapitalising them as necessary, or in some cases the establishment of new legal entities. The customer may choose to act through another route, perhaps using a competitor financial firm. This could involve higher cross-border investment costs or other barriers for both UK and EU companies. This could include, for example, less equity coverage by EU firms of UK companies and vice versa.
- **The transfer of legacy** business may be problematic where, for example, the customer needs first to assess whether such transfers may give rise to any tax, accounting or even regulatory/legal implications. Given the experience of preparation for prior "cliff-edge" risks of Brexit, it is probable that by now larger corporates and their banks should have completed the majority of these transfers, but the situation is arguably less clear for combinations of smaller corporates and smaller banks, both in relation to legacy business as well as new business.
- **M&A, debt and equity fund raising** for EU issuers is currently centred in London. London provides the expertise, knowledge but also currently access to global investors for the functioning of risk distribution. Fragmentation will affect this role, including if there are also restrictions on the ability of EU banks who currently rely heavily on their London-based operations to provide critical debt and equity financing services. London also plays an important role in supporting EU governments to issue debt, of particular importance with record levels of issuance post-Covid. For Germany, 11 out of the 29 primary dealers are currently London based. For France this is 11 out of 19 and for Italy 14 out of 20. This support for government issuance will need to be diverted from London to banks in the EU. London also plays an important role for corporate Equity Capital Markets and Debt Capital Markets. In Germany about three quarters of all ECM issuance included at least one UK book runner and for corporate DCM this is similar. This will no longer be possible after the 31st of December 2020. For M&A, the largest transactions included at least one UK-based advisor. This represents the majority of total deal volume, implying the larger, international deals, whether carried out in the UK or EU, require international expertise currently available from firms in the UK. The urgency of the CMU discussions is a reflection of the fact that development of onshore capital markets capability in the EU to enable customers to regain a level of services equal to today is a major project which needs time to develop expertise, infrastructure, legal harmonisation and sufficiently open markets. A shift to 3rd country status for the UK, even if already flagged in advance, will have profound impacts on the functioning of these EU markets and have consequences for EU-based issuers until onshore capabilities are fully developed. The speed with which this might take place is uncertain, but there could be some disruption in the immediate term and an impact for some period ahead.
- **Cross-border lending and deposit activity** would become constrained by the ending of passporting, depending on the precise legal position in individual EU Member States. This would impact UK corporates who require financing for operations in the EU or to manage EU-based cash and liquidity positions. The same could be the case for EU corporates needing finance in the UK, depending on the position of their current suppliers. Corporates in each area could become much more reliant on local banks to support their growth, trade financing and investments in the respective areas, and signs of this retrenchment are already visible. Banks may need to turn to their local subsidiaries, where they exist, to support customers. Depending on the prior position, these subsidiaries will likely operate with much smaller capital bases and be required to operate increasingly standalone from their parent group, reducing their total lending capacity and increasing cost to serve. This amplifies the retrenchment of credit provision to the EU and vice versa, and particularly restricts the effectiveness of large exposure and loan underwriting of larger corporate transactions and acquisitions. It is important to understand that, as lending under the CRR does not include the option of an equivalence determination, these factors would hold true whatever is agreed about cross-border equivalence and would also depend on variation in local laws and regulations. For instance, in some cases retail business will be prohibited by national legislation and retail customers will need to find alternatives to their now 3rd country provider. Similarly, taking and holding deposits from EU customers in the UK and vice versa will be restricted and will not benefit from a cross-border equivalence determination. Some EU jurisdictions have recently suggested that UK banks must close accounts held by EU customers or move them from London to an EU subsidiary or branch.
- **Payments services** provided by banks in the UK to the EU or vice versa could potentially be restricted, driven by CRD and PSD access requirements, fragmenting payment services for corporates who trade between the UK and the EU. However, this is unlikely unless at some point the UK is found to be no longer equivalent for SEPA purposes. A different uncertainty relates to Correspondent Banking which is provided through a number of constituent products some of which may be subject to local licencing restrictions after Brexit. In the absence of services passports to facilitate seamless delivery, the market will need to calibrate an operating model that continues to allow the movement of capital and for interbank operations. There is a risk that any change of interpretation by national regulators or by the EU could hamper movement of funds between banks, with consequent knock-on effects on cost and availability of finance for customers. Any divergence in sanctions lists could affect the application of AML rules.
- **FX translation** is a core activity for banks in the UK to serve EU corporates and for banks in the EU to serve UK corporates; this activity could become heavily restricted because derivatives are regulated under MiFID (which could be addressed by the yet-to-materialise equivalence determinations) and the treatment of spot is less clear. The fragmentation of underlying FX markets could result in wider prices due to reduced competition and thinner liquidity and could play through to overall cost to end users of FX services. For reference, nearly 40% of total EUR spot FX is currently traded out of London.
- **Interest rate and FX hedging** activity is operated through the UK as a global hub for FX markets. The market in London is well served by the UK, EU, RoW and non-bank players. Banks in the EU could be prevented from distributing to UK clients if MiFID and CRD restrictions are replicated by the UK. Banks in the EU would have less access to London as global hub and divert to onshore trading with less liquidity available. This could restrict banks in the EU in providing risk and hedging services to their EU client base as competitively as they are used to.

- **Financial market infrastructure –** including clearing, venues, custody, etc - could all be affected, though temporary equivalence for clearing has been granted until 2022 by the EU. Changes to the regulation of financial market infrastructure may add additional costs and risks, fragmenting pools of liquidity. Both UK and EU corporates will have to operate through more fragmented FMI. Part of any of these costs will be borne by the banks and they may attempt to pass these on to end users, but the extent to which this takes place is currently unclear.
- **Intra-group** transactions within financial services groups will be affected by the loss of waivers, making movement of funds and capital more difficult and expensive, with the potential of stranded or inefficient capital and liquidity positions within global operating FS Groups. This will affect the attractiveness of doing particular kinds of business in particular locations and may affect both the availability and the cost of services to final customers.
- Amended **capital treatment**, for example for EU and UK sovereign exposures, could affect trading models and hence bond market spreads. This would affect conditions for both issuers and investors.
- The use of **financial benchmarks** administered in the UK may become restricted/prohibited in the EU (in the absence of equivalence, under the third country provisions of the Benchmarks Regulation (BMR), unless the deferment period to December 2021 is again prolonged). Although this would not apply to LIBOR, there is potential risk of divergence on application of LIBOR statutory fallback solutions (revised BMR currently pending finalisation).
- There is also the direct cost of **regulatory divergence through** duplication of requirements, which might at the same time also differ, making it more complex and expensive for both UK and EU-based banks to provide harmonised banking services to clients across the UK and EU, some of the cost of which may be borne by customers. Multinationals should be able to manage with increased and divergent regulatory requirements in their interaction with financial services providers, but this could at the margins prove a potential barrier to investment. Internationally operating SMEs and MidCaps could face more substantial challenges. For example, **meeting regulatory obligations** could become more difficult for corporates under EU MiFID versus UK MiFID. Whilst smaller banks and corporates have relied on their larger bank counterparties to carry out post trade transparency reporting for them, this will not be possible going forward as UK banks will no longer be able to carry out this activity for EU corporates under EU MiFID and EU banks will not be able to do this for UK firms under UK MiFID. Similarly, to meet the derivatives trading obligation (DTO) requirements under MiFID, entities from the UK trading with entities from the EU will need to meet on trading venues deemed equivalent by both the EU and the UK (and currently only US SEFs qualify).

In short, the exact impact for the real economy of not achieving an enduring form of equivalence or consistency of approach for CRR lending activities is difficult to measure as the impacts are mostly indirect. Frictional costs and regulatory barriers are likely to increase operating costs and introduce restrictions into **wholesale markets**, markets that are currently highly integrated and operate to a large extent on a cross-border basis, including across the EU/UK boundary. The impacts may manifest themselves through less deep or less liquid markets and through the higher operating cost of less efficient markets, with the most immediate effect likely to be a retrenchment of lending out of the UK into EU corporates and vice versa.   All these issues will be especially pertinent for large corporate customers that tend to be pan-European or multinational in nature, with operations in multiple countries accessing single syndicated financing structures or with single integrated European Treasury functions. Depending on how restrictions evolve, some corporates may decide to change their issuance practices.

There could also be **market instability** for a period as players try to work out the possible availability and price of transactions in a steady state which will depend on their assessments of the likely actions of other financial market players and their views as to how Brexit itself affects the creditworthiness as well as behaviour of final users. In the immediate term there may be unexpected secondary impacts; for example, as seen in COVID-19 crisis, disruption of expected commercial flows of goods and services may mean that some corporates have over-hedged their anticipated trading positions, and these hedges may need to be reversed. There may be volatility in GBP FX rates, not only against EUR but also USD.

The fragmentation of banking capital may affect end-user perceptions of banks' credit worthiness too. Although there will have been a certain amount of time to prepare, the change in legal arrangements will come as a cliff edge so there could be some disorder for customers as they re-assess their banking relationships and replace elsewhere services which are no longer available from their current provider and whose pricing might be quite volatile.

Conclusion

The needs for financial services of corporates in both the EU and UK, including for cross-border trade flow between the EU and the UK, are supported by banks on both sides that are currently providing a seamless service to finance client needs. A more restrictive financial services deal will make it more difficult and costly for banks to support corporates selling into the EU and vice versa. UK companies, for instance, will need to rely more on banks in the EU, of whatever ownership, to support them. In addition, there may be impacts for international banks such as Asian or US banks who will be confronted with fragmentation of their European business model which may further dilute the services they provide across the UK and EU markets. This could involve a further rationalisation of business and legal entity models and a less rich international banking offering for customers than is currently available. This could be particularly relevant to the extent that EU banks refocus for whatever reason on their own domestic markets and there could be less overseas support for UK corporates as they need to manage through the economic downturn and repair balance sheets. Similar effects would apply in the opposite direction, depending on the detail of the UK's own post-Brexit regime.

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Some matters that corporate customers may want to focus on before 31 December include:

1. Establish they have a comprehensive list of the financial services they use, and which banks provide them to them.
2. Determine they can distinguish which financial services are provided across the UK/EU border in either direction.
3. Where such services are provided cross border, check with the provider whether they will be affected by changes at the end of the Transition Period.
4. Where they are affected, check with the provider whether the provider will still legally be able to provide them from the same legal entity.
5. Where they are not able to, establish whether the provider can provide them from a different legal entity.
6. Where the provider either cannot or does not intend to provide them from a different legal entity, explore how else they can be provided.
7. Where provision continues to be possible, explore whether its cost is likely to change.

NatWest Markets Plc
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This note has benefitted from input from the staff of the Association of Corporate Treasurers (ACT), the Association for Financial Markets in Europe (AFME) and the Confederation of British Industry (CBI).

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