

## Box 1

Preparing for Brexit to secure the smooth provision of financial services to the euro area economy

---

**The decision of the United Kingdom to withdraw from the European Union (EU) contributes to prevailing political uncertainties, but should not have significant financial stability implications, especially if adequate preparations are made.** On 29 March 2017 the United Kingdom notified the European Council, in accordance with Article 50(2) of the Treaty on European Union, of the United Kingdom's intention to withdraw from the EU. While it adds to the prevailing political uncertainty, the Brexit process itself is currently not one of the main concerns for euro area financial stability. At the same time, depending on the nature of the agreement on withdrawal, the new relationship and any possible transitional arrangements, Brexit will affect how financial services are provided to euro area customers.<sup>6</sup>

**The United Kingdom runs a significant trade surplus in financial services vis-à-vis the rest of the EU.** In particular, the City of London is a key global hub for wholesale financial services, such

---

<sup>6</sup> This box focuses on a "hard Brexit" scenario in which there is no agreement on the future EU27-UK relationship at the end of the two-year period following the triggering of Article 50(2). As a consequence, UK-domiciled institutions would lose their passporting rights to the Single Market and would not receive any preferential treatment compared with institutions in other third countries.

as trading and clearing of derivatives, foreign exchange transactions, repurchase agreements (repos), securities issuance and financial advisory services. With regard to financial services provided to the euro area economy (e.g. to firms and households), the role of the United Kingdom varies across activity types:

(i) **Direct provision of credit by UK-domiciled banks to the euro area non-financial private sector represents only 1-2% of the sector's total external financing.** Loans by UK-domiciled banks to the euro area non-financial corporate and household sectors, totalling €67 billion and €150 billion, respectively, as at the end of 2016, represent only 1% and 2%, respectively, of the overall loan financing of the two sectors.<sup>7</sup> UK banks' holdings of euro area non-financial corporate debt are also relatively small at €26 billion.

(ii) **Around 10% of all syndicated loans granted to euro area non-financial corporations involve UK banks.**<sup>8</sup> In addition, another 30-40% involve banks from the United States, Japan or Switzerland. Among the latter, it is not possible to precisely identify the degree to which those banks are operating out of London, but often their European syndicated loan units are based in London.<sup>9</sup> While being part of a loan syndicate catering to a euro area company does not necessarily require EU passporting rights, the lead banks are often expected to provide ancillary services (e.g. treasury management, corporate finance, advisory and underwriting services)<sup>10</sup> that do require a passport. While the majority of lead banks in deals catering to euro area companies are from the euro area, in recent years around 20-25% of lead banks have come from the United States or the United Kingdom or, to a somewhat lesser extent, Japan or Switzerland.

(iii) **Owing to the size and depth of UK capital markets, some euro area firms issue securities on UK securities exchanges.** The share of total debt and equity issued by euro area firms listed on UK exchanges has ranged between 5% and 15% over the last decade (based on Dealogic data).<sup>11</sup>

(iv) **Some advisory services related to securities underwriting are currently provided from London.** Regarding underwriting of debt securities issued by euro area firms, in 2016 UK-domiciled banks or subsidiaries acting as bookrunner accounted for around 40% of the top 40 bookrunners (based on Dealogic data). For euro area firms' IPOs and secondary public offerings, the share of UK-based bookrunners amounted to around 35%.

(v) **Derivatives transactions conducted in London amount to around one-fifth of the euro area real economy's total hedging activities.** The share of UK-domiciled institutions in the provision of hedging services to euro area non-financial counterparties for all types of over-the-counter (OTC) derivative classes combined is estimated to be between 16% and 22% of outstanding transactions. For trades with all counterparty types (i.e. including financials) the UK

---

<sup>7</sup> According to ECB MFI balance sheet items statistics.

<sup>8</sup> According to Dealogic. Many of the syndicated loans are granted for the purpose of financing merger and acquisition (M&A) transactions. The share of UK banks in total M&A loan-financed deals has been declining and amounted to around 15% in 2016.

<sup>9</sup> It may be the case that many of the arranging units of euro area banks participating in syndicated loan deals with euro area companies are also based in London.

<sup>10</sup> See, for example, Gadanez, B., "The syndicated loan market: structure, development and implications", *BIS Quarterly Review*, December 2004.

<sup>11</sup> These figures, however, include double listings where shares or debt securities are issued on both UK and EU27 stock exchanges.

share increases to 20-25%.<sup>12</sup> UK-domiciled subsidiaries of US (and to a lesser extent Swiss and Japanese) broker-dealers play a major role in trades with euro area non-financial counterparties.

(iv) **UK-domiciled central counterparties (CCPs) play an important role in clearing euro-denominated transactions.** The role of UK CCPs is most important for the clearing of euro-denominated OTC derivatives and repos. Furthermore, money market transactions cleared through UK CCPs represent a significant share of the total business conducted by euro area counterparties in several key money market instruments, such as secured transactions and overnight index swaps. However, non-financial counterparties do not clear trades directly with CCPs, but use the services of clearing members.

**While it is difficult to make a definitive assessment of all financial stability implications of Brexit, on the whole, the risk that the euro area economy would be excluded from access to wholesale and retail financial services appears limited.** Although a number of crucial financial services for the euro area economy are currently provided from London, euro area entities will probably retain sufficient access to financial services post-Brexit, as some (unregulated) services can continue to be provided from the United Kingdom, some will be provided by EU-domiciled entities instead, and/or some of the entities currently providing such services will relocate from the United Kingdom to the remaining EU Member States (the EU27).

**The impact of the loss of EU passporting rights for UK-domiciled institutions and the implied need to relocate to the EU27 differs across types of activities.** For services partly covered by a third-country equivalence, the outcome will depend on negotiations. For unregulated services (e.g. FX trading), the impact of Brexit may be limited, as it would not result in restrictions on the continued provision of such services. For other services, including banking, firms would be compelled to relocate to the EU in order to continue to benefit from EU passporting rights and to service EU markets. In principle, certain banking services (such as large corporate loans) could still be provided to euro area customers by entities outside the EU.<sup>13,14</sup> However, those entities would not be taking deposits within the EU, which may limit their ability to provide loans to EU companies. In addition, for many non-EU banks catering to EU companies, the provision of loans is only one part of their business, as it is often accompanied by a range of ancillary services.

**Preparations will, however, need to be properly managed to avoid “cliff-edge” effects.**

Therefore, it is important that banks engage in proper and timely planning to reduce the risks of a

---

<sup>12</sup> According to ECB transaction-level EMIR data from five trade repositories and ECB calculations. Sources of aggregate data on derivatives – such as BIS OTC derivatives surveys – indicate much higher figures for UK-based transactions. For instance, according to the 2016 Triennial Survey, UK-based sales desks account for 82% of European activity in OTC interest rate derivatives. However, these sources do not allow the singling out of UK trades with euro area (non-financial) counterparties only.

<sup>13</sup> The provision of loans per se is not regulated in the Capital Requirements Directive (CRD IV), but is regulated in Union law at least with regard to consumer and mortgage credit. Thus, the possibility to provide loans to households would be limited by such legislation. Other activities covered under the CRD IV for credit institutions include financial leasing, payment services, guarantees and commitments, trading for own account or for the account of customers, participation in securities issues and the provision of services related to such issues, advice to undertakings on capital structure, industrial strategy and M&As, money broking, portfolio management, custody services and investment services provided for in the Markets in Financial Instruments Directive (MiFID II).

<sup>14</sup> It may be that pan-European syndicated loan agreements and revolving credit facilities will need to be split into a UK part and an EU part, which could potentially lead to a tightening of the credit terms and conditions; see, for example, *Implementing Brexit: practical challenges for wholesale banking in adapting to the new environment*, Association for Financial Markets in Europe, April 2017.

cliff-edge effect, especially if no transitional agreement is reached. Generally, risks appear to be contained, provided that affected entities adequately plan for a “worst case” scenario.

**In the longer term, a new equilibrium may even be beneficial for some euro area institutions looking to take advantage of the business opportunities created by Brexit.** While a tremendous depth and breadth of financial services capacity – including skilled personnel, capital, institutions and infrastructure – currently resides in the United Kingdom, the beneficiaries of relocations are likely to be existing EU financial centres that already have infrastructure in place that can be scaled up, which should also limit concerns over possible shortfalls in capacity.

**The impact of Brexit on financial services is likely to be mainly reflected in the cost of external finance rather than in a reduction in available services.** Moving from a centralised wholesale banking market based in London towards a potentially more fragmented landscape, and thereby forgoing synergies reaped from the economies of scale and scope of the City of London, could increase the cost of capital for households and non-financial corporations.<sup>15</sup> While such financing cost increases are likely to be modest and are very difficult to quantify at this point, the prospect of a less deep capital market within the EU adds more incentive to make swift progress on an ambitious capital markets union.

---

<sup>15</sup> See Sapir, A., Schoemaker, D. and Veron, N., “Making the best of Brexit for the EU27 financial system”, *Policy Brief*, Issue 1, Bruegel, February 2017.