

Brexit Impact on Sell Side Firms in the UK

Abstract

The UK's decision to leave the European Union (EU) has far-reaching impact on the financial services sector in both the EU and the UK. The impact of Brexit will be felt across the industry spanning firms offering services in retail banking, lending, insurance, capital markets and so on. This paper covers the possible Brexit scenarios, and specifically focuses on the impact of a hard Brexit scenario on sell side firms.

What Brexit Means for UK's Financial Services Industry

The UK government triggered Article 50 to initiate formal withdrawal of the UK from the European Union (EU) following UK's vote to leave the EU in a referendum. The EU and the UK have concluded the first stage of negotiations covering the exit principles. The EU and the UK have concluded the second stage of negotiations with a draft withdrawal agreement that clearly states that the transition period will end on December 31, 2020, thereby avoiding a cliff-edge situation. The next stage of negotiations will cover the future relationship between the EU and the UK.

Brexit, as the event is popularly known, will have significant impact on the capital market participants including sell side firms, buy side firms, and market infrastructure firms operating in both the EU and the UK. Given the uncertainty on the outcome of the negotiations and the future relationship between the EU and the UK, firms are evaluating possible Brexit scenarios and putting in place contingency plans to prepare for the worst.

Many firms based in the UK use passporting rights to offer services to EU-based clients and counter parties. Similarly, EU-based firms use passporting rights to offer services in the UK. Let us examine the three possible Brexit scenarios.

Scenario 1: EEA membership (Soft Brexit)

The UK becomes member of the European Economic Area (EEA), which enables the UK to retain EU passporting rights and single market access. This scenario is unlikely as the Government of UK has stated that it will not seek EEA membership.¹

Scenario 2: Third country with equivalence

Equivalence will enable UK-based investment banks to continue to offer cross-border services to EU institutional clients and eligible counterparties. The European Commission (EC) grants equivalence after ensuring that the UK has an equivalent regulatory regime. The UK grants similar equivalence to the EU on a reciprocal basis. However, since equivalence determination is a discretionary exercise, it will most likely be time-consuming and subject to withdrawal at short notice, which makes this scenario a relatively risky proposition.

Scenario 3: Third country without equivalence (Hard Brexit)

The UK becomes a third country and no equivalence is granted. UK firms lose passporting rights and single market access, necessitating business model changes. This scenario will require UK firms to establish subsidiaries in the EU and obtain authorization to provide services to EU clients. Alternatively, they may choose to restructure their business model and cease services to EU clients.

How a Hard Brexit will Impact the Region's Sell Side firms

The objective of sell side firms is to continue to service their existing clients in compliance with appropriate regulations and with as little disruption as possible post Brexit. Banks are putting in place contingency plans based on the assumption that Scenario 3 (Hard Brexit) will apply. Legal entity restructuring and relocation of the business to the EU will result in increased liquidity requirements and regulatory complexity, besides necessitating technology and infrastructure changes to accommodate operating model changes leading to higher costs.

The impact of Brexit on cross-border services varies across banks, and depends on individual banks' legal entity structure, geographic footprint, and the services offered to the clients. UK-based banks can be categorized into three based on their current legal entity structure and operating model. The impact would be pretty much similar for EU-based banks providing services to UK clients.

UK-based banks with no branches in the EU

UK-based banks that do not have a branch in the EU, but offer cross-border services to clients using passporting rights must evaluate the nature of the cross-border services offered, and the financial viability of continuing the practice. Banks with sustainable business models will have to set up a subsidiary in the EU and obtain authorization to continue to provide cross-border services.

UK-based banks having branches in the EU

UK-based banks that have branches in the EU, and offer cross-border services to clients using passporting rights must define a target operating model with clear delineation of target

markets between the UK and EU based entities. In this case, banks have two options:

- Set up a new subsidiary in EU and obtain authorization to get passporting rights.
- Obtain the authorization for the branches in the EU, and take other remedial steps for the loss of passporting rights.

UK-based banks with EU subsidiaries

UK-based banks with subsidiaries in the EU can leverage the passporting rights of their EU subsidiary to continue to offer cross-border services. These banks have to relocate the client-facing functions to the EU and may also have to transfer assets, business, and people from the UK to the EU subsidiary incurring significant cost. Moreover, these banks will be required to define target operating model with clear delineation of target markets between the UK and the EU based entities.

What Must Banks Do to Deal with the Impact

Banks would do well to plan well in advance for potential Brexit outcomes. Waiting until the two-year Article 50 process gets completed could adversely impact business. Let us look at some of the operational changes that a Hard Brexit scenario will entail.

Accessing market infrastructure in EU markets

Currently, most global investment banks access market infrastructure in the UK and the EU through a single UK-based entity with passporting rights. Post Brexit, banks will access the market infrastructure in EU markets through a newly established subsidiary or an existing subsidiary in the EU. The existing UK-based entity will continue to access market infrastructure in the UK and other non-EU countries.

The new entity will need to obtain membership at trading venues in EU markets, make suitable arrangements to participate in clearing houses across the EU, and open custody and cash accounts with suitable entities as applicable. In addition, banks' internal systems, associated reference data setups, and business processes must be appropriately modified. Banks will also need to migrate customer accounts, reference data, and contracts from the old entity to the new entity and realign security positions at the CSD or settlement agent.

Changes in market infrastructure firms and impact on investment banks

Legal entity restructuring and relocation of the business to the EU will significantly impact the operating model and necessitate technology and infrastructure changes leading to higher costs for banks. Brexit will impact the market infrastructure firms that operate in the UK and provide services for Euro denominated products. These firms may have to relocate to the EU or set up subsidiaries in the EU to continue to provide services; banks will have to enter into membership agreements with the relocated entities or subsidiaries. Post Brexit, EU regulators are looking at moving the clearing of Euro derivatives to the EU, which will require UK-based market infrastructure firms to make changes.

The impact on IT

IT applications supporting compliance and those interfacing with market infrastructure firms will be significantly impacted. Even if IT applications are configurable with minimal entity hardcoding, several functions of investment banks will be impacted by a Hard Brexit scenario (see Figure 1), necessitating considerable changes to IT systems and processes. However, the impact of Brexit will be much more where applications have a greater degree of entity hardcoding and a lower degree of flexibility and configurability.

High-level changes to IT systems include inserting new entity code or name across applications, connectivity with new entities of market infrastructure firms, changes in the applications that interface with market infrastructure firms, and risk management model definition and EU regulatory compliance requirements for the new entity. End-to-end

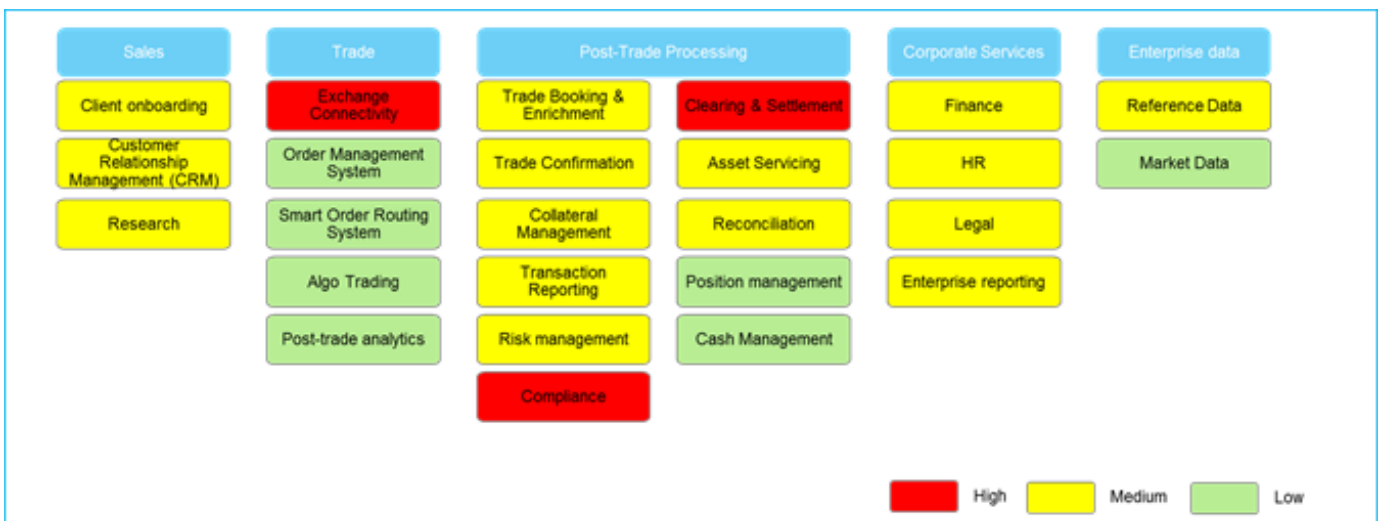


Figure 1: Hard Brexit Impact on the Various Functions of Sell Side Firms

testing, and migration of clients' obligations, reference data, and banks' positions from the old to the new entity will also have to be done.

Looking Ahead

Although the outcome of Brexit negotiations remains unpredictable, banks are preparing for a Hard Brexit scenario to ensure business continuity post Brexit. With the submission of contingency plans to regulatory agencies, focus has shifted to execution. But the plans will require tweaking to align with the outcomes of the Brexit negotiations. Post Brexit, the emergence of alternative financial hubs could fragment the investment banking business. This would result in increased costs and operational inefficiencies necessitating further modifications to banks' post Brexit strategies.

References

- 1 Statement on a New Partnership with the EU, Oral Statement to UK Parliament, Jan 2017. <https://www.gov.uk/government/speeches/statement-on-a-new-partnership-with-the-eu>

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