United Kingdom

UK banks facing the Brexit test

- Against all expectations, the 23 June referendum produced a majority in favour of the UK leaving the European Union.
- Brexit is likely to damage the UK's growth in 2016 and even more so in 2017, mainly because of increased uncertainty, the negative impact on trade and, despite the expected fall in interest rates and sterling, tighter monetary and financial conditions resulting from higher risk premiums.
- Stormclouds are gathering above UK banks, which are being penalised by a short-term fall in share prices, the deterioration in the medium-term macroeconomic outlook – i.e. slower growth and a fall in real-estate prices – and regulatory uncertainty relating to negotiations between the UK and EU, which will begin in the next few months and are likely to take a relatively long time to complete.

Contrary to general expectations in the markets, which assumed that Remain would win, the British people voted in favour of the UK leaving the European Union in the 23 June referendum. Looking beyond the immediate adverse market reaction and the sharp fall in bank share prices on the morning of 24 June (see figure 1), Brexit is also likely to have adverse economic consequences over the medium and long term. More broadly, the UK's exit from the EU would affect banks' solvency, to varying extents depending on their geographical diversification.

In this note, we will briefly review how Brexit might affect the UK banking sector. However, not all of the consequences arising from Brexit can be assessed at the moment, because they will depend on future political decisions.

Adverse economic consequences

Brexit is likely to affect the UK economy in four main ways[1]: i) increased uncertainty and lower confidence, ii) a negative impact on financial markets, iii) a reduction in foreign direct investment and other capital flows and iv) lower trade flows.

In those circumstances, we are revising down our growth forecasts by 0.3 points in 2016 and almost 1.5 points in 2017. That would mean GDP growth of 1.4% in 2016 and 0.6% in 2017, versus 1.7% and 2.1% respectively under our previous scenario.

In our scenario, the deterioration in the economic environment would prompt the Bank of England to loosen monetary policy by cutting its base rate 50 basis points to zero, and by increasing quantitative easing GBP 100 bn. UK banks bid for GBP 6.3 bn of funding from the BoE on 28 June 2016, in return for collateral. That figure was higher than the levels seen in previous auctions, although it remains modest given the major turbulence that followed the referendum result. The BoE granted GBP 3.1 bn of funding, in line with the average seen in monthly auctions in 2016.

Daily share prices

Base: 1 January 2016 = 100 (latest figures: 6 July 2016)

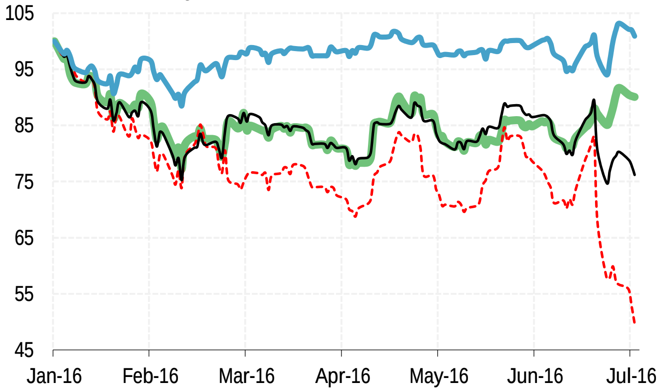

Figure 1 Source: Datastream

In early July 2016, the BoE's Financial Policy Committee (FPC) – in charge of monitoring systemic risk and financial stability – decided to reduce its countercyclical capital buffer rate (set in March 2016 and theoretically due to take effect in March 2017) from 0.5% to 0% of risk-weighted bank assets, and announced that it would keep it there at least until June 2017. To justify this reduction in capital requirements, the FPC argued that Brexit would probably have a recessionary effect on the UK economy. Our scenario factors in these monetary and macroprudential loosening measures, which are likely to cushion the blow of Brexit but not eliminate it altogether.

Various effects on the banking sector

The UK leaving the EU would affect UK banks in three main ways: i) lower profitability, ii) less favourable treatment of covered bonds and iii) the impact on the banking landscape.

– Likely reduction in bank earnings

Brexit is expected to affect all UK banks, regardless of their business model or size, by sharply increase funding costs for their wholesale financing operations[2]. The UK leaving the EU would mean greater uncertainty for a longer period of time, and that would increase the risk premiums demanded by investors for a wide range of UK assets, including securitised debt issued by banks. Given the increase in economic, political and regulatory uncertainty, premiums on bank credit default swaps (CDSs) have increased sharply (see figure 2),

[1] EcoFlash of 24 June 2016 by William De Vijlder, "UK and Brexit: the economic implications"

[2] However, as a proportion of total assets, wholesale financing only fell 3 points between its peak in September 2009 and April 2016.

while share prices fell significantly in the immediate aftermath of the referendum result. At the moment, it is too early to predict how far the decline in share prices will go or how long it will last. International bank stocks have already rallied since 29 June 2016. Bank debt seems to have held out better against market turbulence than equities.

In the short and medium term, investment banking returns will also be damaged if share prices continue falling, i.e. through lower fee income caused by a decline in IPOs and M&A activity. Further out, Brexit could prevent UK banks from carrying out euro-denominated clearing operations. According to the European Court of Justice's decision, such clearing does not necessarily have to take place in the eurozone, but it does have to take place in an EU country. Currently, the European passport allows UK banks, including investment banks, to operate throughout the EU. Brexit would affect UK banks' trading activities if the UK were unable to negotiate a bilateral agreement with the EU quickly. It could therefore encourage them to shift operations to EU countries so that they can continue accessing euro-denominated clearing and markets in which euro-denominated securities are traded.

Finally, Brexit would have repercussions on the retail banking segment. At a time when low interest rates are already dragging down banks' margins, the fact that most UK mortgages are variable-rate means that the expected 50bp rate cut, and the resulting fall in yields at the long end of the curve, would push down margins a little further. More generally, slower growth and falling real-estate prices – caused by lower foreign investment and a decline in domestic incomes – could be accompanied by a deterioration in the quality of bank assets and lower profitability for commercial banks.

– Tougher prudential treatment of covered bonds

Brexit could mean that covered bonds [3] lose their preferential treatment when calculating capital and liquidity ratios, conferred upon them by European banking regulations, i.e. the Capital Requirements Regulation (CRR) of 26 June 2013 and the Delegated Act of 10 October 2014. It would therefore reduce demand for these UK debt securities, which are mainly issued by Santander UK, Lloyds and Nationwide, from European bank investors located outside the UK[4].

In terms of solvency ratios, these securities currently have a minimum risk weighting of 10%, as opposed to 20% for unsecured bank debt. If UK covered bonds were to lose that preferential treatment, their risk weightings would increase, making them much less attractive for banks and insurance companies in European Economic Area countries (outside the UK).

Regarding the calculation of the Liquidity Coverage Ratio (LCR), covered bonds were previously considered – subject to certain conditions – as among the most liquid after government bonds. If the UK remained a member of the European Economic Area, or if a reciprocal agreement were negotiated with the EU, they would retain their favourable treatment, like Norwegian covered bonds. If not, UK

Daily credit default swap spreads

Spreads in basis points (latest figures: 6 July 2016)

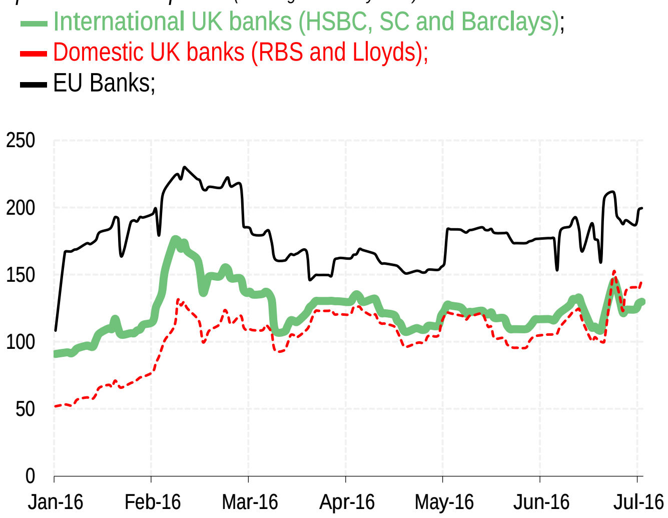

Figure 2 Sources: Credit Market Analysis / Datastream

covered bonds would become like Canadian or Australian bonds, for example, i.e. still assets eligible for the LCR but with a larger haircut in the numerator than that applied to covered bonds issued by European Economic Area institutions[5].

– Brexit's impact on the banking landscape

Shortly after the financial crisis, the UK government announced its intention to encourage new banks and non-banks to enter the retail market[6], although that has not yet threatened the dominant positions of the big five incumbents (HSBC, Barclays, RBS, Lloyds and Standard Chartered). However, the UK leaving the EU could cause that increase in competition to come to a halt. New challenger banks, and particularly the smallest ones, saw their stockmarket value fall sharply on the morning the referendum result was announced, making it less certain that they will be able to bolster their capital bases by issuing new shares. In addition, their focus on the domestic UK market makes them more exposed to the domestic economic cycle and/or a possible correction in the residential real-estate market than the large, geographically diversified banks (HSBC, Standard Chartered and to a lesser extent Barclays).

In addition, the Treasury has now decided to delay until 2017 the reprivatisation of RBS, which was bailed out by the government post-crisis, because current conditions are not favourable. Before the referendum result, the government was still confident of quickly completing the sale of its RBS stake (73% at end-December 2015), but such a sale would now fail to create value for taxpayers, which

[3] A covered bond is a debt instrument issued by a credit institution, the reimbursement of which is covered by a portfolio of mortgages and/or loans to the public sector.

[4] Credit institutions are the main issuers of covered bonds, but also the main buyers of these securities in Europe after insurance companies and mutual funds.

[5] According to the Delegated Act of 10 October 2014, covered bonds issued by a credit institution in the European Economic Area are eligible for the LCR with a haircut in the numerator of at least 7%. Those issued by a bank in a non-EEA country are eligible for the LCR with a haircut in the numerator of at least 15%.

[6] One of the recommendations of the report by the Independent Commission on Banking (ICB) led by Sir John Vickers in September 2011 aimed to stimulate competition: i) by enabling customers to change banks quickly and at low cost and ii) by making it easier for new players to enter the market by reducing administrative formalities and cutting the time taken to deliver licences.

was its initial aim. RBS' current share price (around 15p at 6 July 2016) remains well below the 50p at which the government bought the shares, and so the Treasury would realise a big loss if it sold them at the moment.

Brexit will undeniably have major repercussions on the UK's banking and financial industry. Given the many uncertainties surrounding the shockwave triggered when the referendum result was announced on the morning of 24 June 2016, it is still too early to assess their extent. As a result, this note is in no way exhaustive, and further comment will be required as events unfold and as the authorities take decisions.