Brexit Risk For The U.K. And Its Financial Services Sector: It's Complicated

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Brexit Risk For The U.K. And Its Financial Services Sector: It's Complicated

On June 12, 2015, we revised our outlook on the long-term sovereign credit rating on the United Kingdom to negative from stable because we believe the plan to hold a referendum on EU membership indicates that economic policymaking in the U.K. could be at risk of being more exposed to party politics than we had previously anticipated. A potential exit of the U.K. from the EU—known as a Brexit—poses a risk to growth prospects for the U.K.’s financial services and export sectors, in our view. We believe it could significantly dent the U.K.’s current net trade surplus in insurance and financial services of more than 3% of GDP. This is one of the stronger points of the U.K.’s relatively vulnerable balance of payments performance since the 2008-2009 global financial crisis.

Our base-case scenario is that the U.K. will remain in the EU after the referendum, which is to be held by the end of 2017. Even if a Brexit did occur, we think it likely that some of the negative economic implications would be ameliorated by alternative arrangements, such as bilateral free trade agreements or membership of the European Free Trade Association (EFTA). We nevertheless see a risk of more adverse outcomes in the event of an "out" vote if the U.K. failed to negotiate alternative arrangements successfully.

Overview

- By end-2017, the U.K. will hold a referendum on whether to leave the EU.
- If the U.K. leaves, we believe this could have significant negative economic implications due to the effect on the U.K. financial services industry.
- However, the impact depends crucially on what alternative free trade arrangements the U.K. government could agree with its European partners.
- While we think London would maintain its status as a global financial center, global banks could ultimately consider other locations as bases for their European operations.
- The impact for domestically orientated U.K. banks would likely be modest, mainly related to the knock-on effect on the vitality of the U.K. economy and the creditworthiness and activity of its actors.
- For insurers, a Brexit would likely entail additional costs of doing business in Europe, although we do not expect their operations would be significantly curtailed.

Despite the financial crisis, the financial services sector is still a major contributor to the U.K. economy, providing an estimated 1.4 million jobs, 12% of income tax and national insurance receipts to the U.K. Treasury, and more than 3% of GDP in net export receipts to the U.K. A Brexit would likely lessen foreign direct investment (FDI) inflows to the U.K., particularly to the financial services sector, and entail additional costs to doing business. A potential U.K. departure from the EU therefore poses a business risk for this sector, in our view.

The EU Contributes Nearly Half Of U.K. Financial Services' Inward FDI

A Brexit is likely to be detrimental to FDI into the U.K., particularly into the financial services sector, in our view.
Although the City of London has been a major financial center for centuries, it has grown ever more rapidly over the past few decades. The U.K. financial system's total assets have grown from less than 1x GDP in the 1960s to more than 4.5x GDP today, with most of that increase taking place between 1979 and 2006. The initial spur for U.K. banking services was U.S. regulation and tax policy in the 1960s and 1970s and the genesis of the Eurobond market. But the second wave of growth coincided with the U.K.’s accession into the European Economic Community in 1973 and the Big Bang deregulation of financial markets in 1986.

The rapid increase of inward investment into the U.K. economy follows a similar exponential pattern. At an estimated $1.6 trillion, the stock of inbound FDI (excluding special purpose entities) to the U.K. is the third-highest in the world. It represents 6.3% of the global total, well above the U.K.’s 4% share of global GDP. High FDI inflows into the U.K. have increased the capital stock in an economy that stands out for low investment. The proportion of capital expenditure to total expenditure in the U.K. is low, at an estimated at 17% of GDP. This lags all OECD peers with the exception of Luxembourg, Italy, Ireland, Portugal and Greece (see Sovereign Risk Indicators, a free interactive version is available at spratings.com/SRI).

The U.K. furthermore attracts the highest financial services-related FDI among rich countries (see chart 1). At 30% of total inward FDI into the U.K. (based on OECD data), this is equivalent to 17% of GDP. Nearly one half of the FDI into the U.K. financial services sector comes from EU investors (see chart 2).

In our view, a Brexit would put at risk this FDI to the financial services. If such an exit resulted in large-scale disinvestment from the City of London it would undermine the enormous success of the U.K.’s financial services industry.
Chart 1

Inward FDI By Sector (% Of GDP)

- Financial intermediation excl. insurance*
- Mining and quarrying
- Construction and real estate
- Insurace
- Manufacturing
- Other services plus agriculture

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A Brexit Could Shift Europe’s Banking Center Of Gravity From London

While global banks may have a greater incentive to tilt away from London in the event of the U.K. leaving the EU, the effect on the domestic banking system would be less harsh, in our view, and would depend on the wider economic fallout from a Brexit.

London is the principal global hub for banking and financial markets, and non-EU banks typically make it their springboard for conducting operations in the EU. At present, almost one-fifth of global banking activity is booked in the U.K. There are now 150 deposit-taking foreign branches and 98 deposit-taking foreign subsidiaries in the U.K. from 56 different countries. Foreign banks make up about half of U.K. banking assets on a residency basis. Foreign branches account for about 30% of total U.K. resident banking assets and about one-third of U.K. interbank lending. This is approximately 225% of U.K. GDP. Most of these banks are based in London because other global financial institutions are also based there. This in turn reflects everything that makes London a financial sector cluster:

- The infrastructure of clearing houses and exchanges.
- A deep pool of international talent, and a historically welcoming attitude toward highly skilled immigrants.
- Legal and business services suppliers.
• A highly advantageous middle time zone with overlap in Asia and the Americas.
• A legal system that has a centuries-long track record in preserving property rights and creditors’ rights, and innovating legal structures for tradeable securities.

These strengths are unlikely to be changed were the U.K. to leave the EU.

Still, the U.K.’s EU membership is also a strength for its financial services industry because U.K.-domiciled banks make active use of their U.K. authorization to provide banking and trading services across the EU and European Economic Area (EEA), known as passporting rights. Without these rights, we see a risk that enough major global banks could choose to route their business through other financial centers in the EEA that retain those rights. Even assuming that an exited U.K. was prepared to enter the EEA or find a way to preserve passporting, the trend in global regulation is moving toward basing risk management functions inside their jurisdiction--be it Frankfurt, Paris, Madrid, Milan, or New York. A Brexit could accelerate this trend within Europe, in our view.

Therefore, while London would likely retain its global status as a leading financial center, post-Brexit the center of gravity in European financial markets could well move further toward Frankfurt, Paris, Dublin, or beyond. This trend would potentially accelerate if the U.K. was outside an EU free trade area or if free movement of labor were curtailed. In response, overseas banking groups could be expected to relocate some of their trading operations from London. Indeed, they may even take more wide-ranging action to center their European operations on subsidiaries inside the remaining EU.

Important pieces of the European financial sector infrastructure are hosted by London, including stock and derivatives exchanges, and clearinghouses. Earlier this year, the EU General Court overturned a European Central Bank (ECB) decision that would have forced clearinghouses clearing euro-denominated contracts to be domiciled within the eurozone. By ceasing to be an EU member, the likelihood of the U.K. being challenged again on the ECB’s location policy would rise.

That said, the history of global financial centers suggests that incumbents do not always prevail. Amsterdam in the early 18th century was a far more important financial hub than London. Over time, the importance of financial centers follows the trajectory of its host economy’s wealth and trading reach. This suggests that, whatever happens in the next few years in Europe, in the long-term Asia is more likely than continental Europe to pose greater competition to London.

**Domestic U.K. Banks Would Be Less Affected**

We see the effects of a Brexit on U.K. domestic banks, however, as somewhat indirect and modest, aside from initial transaction costs. These banks would suffer mainly from the secondary effect of any harm to the vitality of the U.K. economy, and so the creditworthiness and activity of its actors. This reflects the importance of the EU as a trading partner for the U.K., but also the relatively limited international operations of many domestic U.K. banks, many of which have retrenched significantly in recent years. However, if investors saw a Brexit as a retrograde or worrying development for the health of the U.K. or its banks, or if a U.K. departure reduced investor appetite for sterling-denominated assets, this could raise U.K. banks’ cost of funding, which is important because much of their
wholesale funding comes from abroad.

**For Insurers, A Brexit May Be Costly But Not Game-Changing**

While insurers may face additional costs from a U.K. exit from the EU, their business would likely continue largely unchanged, in our view. A key advantage of EU membership for insurance firms is their ability to write insurance business in any EU country without the need to establish subsidiaries in each country. If a Brexit were to put an end to these passporting rights, it would no longer be possible for EU firms to write business in the U.K. via branches or a life or non-life passport. Likewise, U.K. firms would not be able to use their U.K. regulatory approval to passport business to the rest of the EU. Currently, 562 non-life insurers and 177 life insurers from outside the U.K. write business in the U.K. via a passport. Although many of these EU companies are very small, they also include larger companies such as Zurich (based in Ireland). Conversely, AIG writes all of its European business from a U.K. entity.

In the absence of passporting rights these groups would have to set up U.K. subsidiaries. This would necessitate set-up costs, capitalization, and—probably more stringent—regulation by U.K. regulators, the Prudential Regulation Authority and Financial Conduct Authority. Equally, U.K. insurers would need to acquire licenses and regulation for operations in the rest of the EU. While inconvenient and expensive in the short term, these changes are unlikely to lead to any but the smallest and most marginal of businesses to cease writing in the U.K. The same goes for U.K. companies with continental operations. Importantly, a subsidiary would require its own rating, while a branch would not. And it is possible that a small overseas subsidiary might not share the rating of its parent, whereas a branch would.

Overall, however, we see the U.K.’s highly successful insurance sector as less exposed to any risk of a U.K. exit from the EU. While the EU represents about one-third of the U.K.’s very substantial financial services net export surplus, the insurance sector in the U.K. is far more reliant on trade with non-EU countries, especially the U.S., and is a very limited recipient of inward investment (see chart 1).

Our insurance industry country risk assessment (IICRA) includes consideration of regulatory barriers to entry. While it is possible that leaving the EU could improve our assessment of this factor, we expect that the overall barriers to entry assessment would remain unchanged.

**Future Trading Arrangements With The EU Would Be Key**

The extent of the effect of a Brexit on the U.K.’s financial services sector would in our view greatly depend on what arrangements, including free trade agreements, the U.K. could negotiate to replace EU membership. In a Brexit scenario, the U.K. could, and probably would, seek to retain access to the single EU market, the destination of 50% of U.K. exports. The most straightforward way to do so would be to apply to become a member of the European Free Trade Association (EFTA), which is an intergovernmental organization composed of four relatively small European economies: Iceland, Liechtenstein, Norway, and Switzerland. We see few impediments to the U.K. acceding to EFTA. The U.K. was a member of EFTA between 1962 and 1972, prior to entering the European Economic Community. To rejoin EFTA, the U.K. would be required to sign the Agreement on the European Economic Area to regain access to the single market.
This agreement provides for the automatic inclusion of all new EU internal market legislation on the free movement of goods, services, capital, and persons in the legal systems of EFTA member states, while also establishing common rules on competition and state aid. And this appears to be the political rub for an exited U.K.—other than no longer being subject to EU common policies on external trade, agriculture, fisheries, monetary union, or security and foreign affairs, EFTA membership wouldn’t look very different from EU membership. The U.K.’s net contribution to the EU budget would decline, but would remain positive. In short, the U.K. would have exchanged EU membership for something very much like EU membership without a seat at the negotiating table of key EU institutions.

One alternative would be for the U.K. to negotiate a series of bilateral agreements with the EU, anchored in a Free Trade Agreement, as Switzerland has done. However, the circumstances of a U.K. decision to leave Europe would make it unlikely that it could negotiate from a position of strength. The situation would not be comparable to bilateral negotiations between the EEC and Switzerland in the 1970s. While Switzerland negotiated with the background of moving eventually towards EU accession, the negotiation dynamics could be very different and more challenging for a nation that just left the club. There is no precedent for such an agreement post an EU exit. What’s more, we expect that talks would be drawn out and complex. Under such circumstances, there would be few positive incentives for EU member states to grant any carve-outs for the U.K.’s financial sector, such as passport rights for international banks and insurance companies operating in the U.K.

A Brexit would also have important implications for financial services companies in Scotland. A national vote to leave the EU would, for example, likely increase the probability of a Scottish exit from the U.K., given limited popular support in Scotland for the U.K. to leave the EU.

**A Brexit Poses Risks To The U.K.’s Balance Of Payments, Currency, And Economy**

If the referendum resulted in a vote for the U.K. to leave the EU, the U.K. government’s discussions to negotiate alternative arrangements could be protracted. As negotiations between the EU and the U.K. dragged on, one potential market consequence could be a possible sustained depreciation of the exchange rate in the face of the U.K.’s very large current account deficit (the world’s second-highest in absolute terms), and greater uncertainty over how to finance it. A sterling devaluation could in theory provide a source of adjustment to the economy by stimulating some activity in the U.K.’s manufacturing sector. However, in a worst case scenario, it might relegate sterling from a reserve currency to an actively traded currency status, as volumes and international issuance of sterling bonds by international entities might decline over time, and large central banks might start to reduce their sterling holdings. This might deprive the U.K. of what has been one of the key pillars of its creditworthiness.

The U.K. currently has a highly successful financial services sector. In 2014, its trade surplus in insurance and financial services totaled an estimated 3.3% of GDP. Trade with the EU accounts for more than 40% of net earnings of the financial services sector, excluding insurance. And this figure does not reflect third-party deals that ultimately depend upon the U.K.’s distribution arms in the rest of the EU. Given that the U.K. operates the second-largest current account deficit in the world, to put at risk one of the few net exporting sectors via a highly politically charged referendum would in our view pose substantial risks to the balance of payments, the currency, and the economy.
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