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Press release

New report outlines impact of Brexit on European SMEs, corporates & investors

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AFME, The Boston Consulting Group (BCG) and Clifford Chance have today published a new report, "**Bridging to Brexit: Insights from European SMEs, Corporates and Investors**" examining the impact of Brexit on SMEs, corporates and investors, in particular, on their use of wholesale banking and capital markets services.

To assess the potential effects, BCG interviewed end-users of wholesale banking services, including 62 CEOs and treasurers of SMEs, large corporates and investors, along with 10 industry associations representing a wide range of companies and sectors in multiple geographies, including a significant portion of SMEs, EU and UK equity market capitalisation, and assets under management. To illustrate the potential impact on businesses, the report also includes real life case studies and quotes from the interviews conducted.

Simon Lewis, Chief Executive at AFME, said: "*The clear message from our report is that our interviewees, especially small firms with customers or suppliers cross-border, believe that a hard Brexit could impact their business and growth. Large corporates, in particular, are concerned about loss of efficiency and fragmentation in conducting cross-border business. Both SMEs and large corporates also face potential disruption in the provision of wholesale financial services which in turn will lead to a higher cost of capital for businesses. That is why above all else business would like the status quo preserved.*"

Philippe Morel, Senior Partner at BCG, said: "*This is a unique study providing the end-user view for the first time. We interviewed businesses across the EU-27 and UK – across all sizes, sectors and segments, providing a strong representation across SMEs, large corporates and large investors. Their message was clear: they hope that the impact on their procurement of financial services is minimal. At the same time, we looked behind the front office curtain – what do banks have to do to maintain the same levels of service post-Brexit as they currently provide? We found that in aggregate the cost, in the event passporting is lost, would be significant, both in terms of transferring bank operations and capital to new entities, as well as re-structuring costs, and ongoing higher capital needs. Specifics will vary depending on individual business models.*"

The overarching findings are that:

- European businesses are not yet prepared for a change in the wholesale banking landscape.
- While measures can be taken to continue offering the same services through different structures, this will result in greater fragmentation of banks' use of capital, and a likelihood of reduced aggregate capacity for financing and other wholesale banking services.

Other key findings:

- **Businesses are primarily worried about the direct impacts of a hard Brexit**, such as trade barriers, movement of labour, increased compliance and customs costs.

- **Brexit-driven concerns relating to wholesale banking services are sector specific.** Both SMEs and large corporates are worried about access to credit and fear risk management will become more expensive.

- Investors are concerned that Brexit will induce a complex exercise of re-documenting existing derivatives and other trading relationships.

- **BCG's "supply side" analysis found that Brexit could lead to reduced capacity and more restricted access to wholesale banking services than our interviewees expect, with SMEs potentially hardest hit.** The cost and impact of making adjustments, such as forming new banking relationships, could also be significant for SMEs. Approximately 55% of our SME participants said they had made no plans so far for Brexit, compared with only 27% who have carried out some internal planning and around 18% who have executed plans.

- Of those who have started planning, interviewees are adapting their businesses and relationships to operate on both sides of the Channel, which increases their costs, risk level and cost of capital.

- Though they recognize potential challenges, **businesses generally expect banks to handle any post-Brexit wholesale banking-related difficulties and to support them through the Brexit journey.**

- **Continuity of service could be maintained if banks currently operating with UK banking licences create subsidiaries in EU27 jurisdictions. The process to do so, however, is likely to be costly due to additional capital and operational change required.** The cost of restructuring could be as much as €15 billion, with the cost for each individual bank depending on its current geographical footprint and client focus. Amortised over 3 to 5 years, this could reduce return on equity for affected banks by 0.5 to 0.8 percentage points, a material impact.

- **BCG's "supply side" analysis suggests that businesses may underestimate the banking-related effects of a hard Brexit.** In aggregate, approximately €1,280 billion of bank assets (loans, securities and derivatives) may need to be re-booked from UK to EU27 following a hard Brexit, unless alternative arrangements can be agreed. These assets are supported by €70 billion or approximately 9% of the (Tier 1) equity capital of the banks affected.

- **Securities and derivatives trading has largest potential for disruption** - trades with EU27 clients now booked in the UK are estimated to amount to €380 billion in risk-weighted assets (or €1,100 billion in trading assets) representing approximately 68% of UK-booked business to EU28 clients. This business is supported by €57 billion of bank equity capital which may need to be re-booked to the EU27 following Brexit.

- **Bank lending may also be affected, though to a lesser extent.** The total loan exposure of UK-incorporated banks to EU27 SME and large corporate clients is estimated to be €180 billion (4% of total loans outstanding to EU27 large corporates & SMEs). This lending is supported by about €13 billion of equity bank capital currently domiciled in the UK.

- **Any movement of EUR-clearing from UK to EU27 would impact banks & clients** - approximately €30-40 billion of additional initial margin would need to be posted by banks, an increase of 40-50%, the cost of which will need to be allocated between banks and clients on an individual basis.

- BCG estimates that the long-term inefficiencies of Brexit-related fragmentation could require banks to hold as much as €20 billion of additional equity capital.

Chris Bates, Partner at Clifford Chance, said: "*Much has been said about the challenges of a hard Brexit for banks, but that only tells half the story. The truth is that from SMEs to international businesses, companies that rely on those services are equally at risk. This research shines a light on some of the challenges that a hard Brexit* *would present business users of banking services, and how it would affect the real economy in both the UK and EU27. Measures to smooth the transition are critical. The costs of the cliff edge have never been so clear.*"

***Filip Geerts,* Director General at CECIMO**, a European machine tool industry association interviewed for the report, said*: "Our SME machine tool builders are focused on their businesses and do not want to lose time or resources on any possible political or institutional driven Brexit related obstacles. We would like to see uninterrupted lending and risk management services."*

Conclusions

The report concludes with some key recommendations from interviewees, including:

- **grandfathering of existing contracts** and a degree of patience with respect to re-documentation of contractual relationships, to minimize the legal and operational disruption to banks and their clients;
- **a transition period** to give users and providers time to adjust, as well as a period in which risk-transfer mechanisms are permitted;
- **gaps to be filled**: UK policy makers to consider replacing lost capacity from the European Investment Bank (EIB) and European Investment Fund (EIF) from which UK end users would suffer;

And most critically:

- **status quo preserved:** approximately 80% of our interview participants – EU27 and UK – hope Brexit negotiations will result in similar levels of access to and costs of wholesale banking services as they have today. Interviewees feel strongly that the political negotiations should keep in mind the impact of Brexit on real economy end users.

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