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First take

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Brexit: Five key points

The UK voters' decision to exit the EU came as a surprise to many observers, as well as the markets, with the "Leave" campaign even hinting at defeat as the polls closed. The Wall Street echo chamber view that it would make no sense in the end for the UK to leave was just that. The vote has unleashed political, economic, and financial uncertainty that will play out over the months ahead with attendant risk premia rising for affected currencies, equity and fixed income markets, sectors, and individual firms. Market values for banks, insurance companies, and asset managers dropped Friday in reaction to the vote from 5% to over 30%, with UK firms understandably hit the most and those less reliant on UK-based revenue sources impacted the least.

1. **Stepping up while stepping out.** Central banks and market makers stepped up to provide liquidity as the initial market reaction unfolded and regulators made it clear they were in close consultation with the industry. As a result, the immediate global asset price adjustment in response to the vote was generally orderly and markets functioned well. The prospect of economic slowdown spawned by political, economic, and investment uncertainty will necessitate a continuation of current monetary policy accommodation and vigilance by regulators for financial fragility due to credit risk migration, downgrades, and resultant collateral calls. In turn financial institutions, which are much better capitalized and more liquid than before the 2008-09 financial crisis, will be focusing in the days and weeks ahead on helping their clients adjust to the new reality.
2. **No macroeconomic relief in sight.** Financial institutions, especially banks, have been laboring for some time under zero/negative interest rates, low volatility, and currency and commodity imbalances (albeit in a benign credit environment). The macro picture has suddenly darkened, reducing the likelihood of rate relief, at least in the US, any time soon. At the same time credit costs seem poised to rise and investment spending poised to decline. Consequently, the earnings prospects for financial institutions of all stripes will continue to be challenged. We expect hyper focus on the expense line with concomitant pressure on staffing levels and technology spending.
3. **No speedy exit.** The formal exit of the UK from the EU will take time and is fraught with uncertainty over specifics. The rules governing cross-border business conduct, prudential requirements, and market operations are all to be negotiated once the UK has formally sought its exit. US banks, insurance companies, and asset managers are all heavily invested in the UK. While some firms have already indicated they are considering moving some staff or operations, they will be quite deliberate in making those decisions as clarity increases regarding Brexit's impact. In addition, they will need to weigh carefully the complications of differing regulatory regimes. Regulatory authorities will be watching the potential impacts to safety and soundness, especially how changes to global operating and legal structures will require reworking of resolution plans. Typically markets reward first movers, but there is considerable risk of regrettable decisions here without knowing to what extent the terms of UK engagement with the EU will change.

4. **How will US banks respond?** London's reputation as a global financial center is strong, but with relatively high operating costs and the uncertainty over the status of passporting rights, US banks (like many businesses) will consider looking elsewhere depending on the exit scenarios. Approximately 50% of trades booked in London are executed in Asia, so it will be natural for US banks to consider looking East to better align their client activity with their global and EMEA operating models, especially considering that UK regulators have been calling for better alignment of booking of trades with the location of execution. Furthermore, some smaller non-US players will likely begin to wind down UK operations altogether given their limited global revenue from EMEA (even the largest US banks derive at most 15% of their revenue from EMEA). In the end, Asian financial centers and banks could be surprise winners. Frankfurt, Paris and Dublin, however, stand to gain as financial centers as the Brexit details unfold. We expect this reality to factor into the negotiations with the UK (and each other) in the months ahead. Despite some short-term pain, US banks will likely turn their range of options into long-term gain.

5. **Who's next?** The emerging big concern over the Brexit vote is where will it end? With elections coming up in Europe over the next year and early indications that old decisions could be revisited (e.g., Scottish independence), it is possible that voters will continue to consider the benefits and costs of wider union. While the geo-political benefits of union are compelling to many, in a period of slow growth, fiscal imbalances and democratic challenges (e.g., aging and migration), it is clear that some will continue to question the economic and social benefits. Managing this period of uncertainty while planning for a variety of potential future outcomes presents challenges, but also opportunities.

Additional information

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