Beyond Brexit

The real impact of Brexit on Agency Brokers

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Introduction

Uncovering the real impact of Brexit on agency brokers.

As the dust settles after the anxiety-inducing Brexit transition period came to an end on 1 January 2021, the actual impact on the financial services industry of the UK's splintering from the EU is becoming more apparent.

Agency brokers on both sides of the English Channel and further afield will be measuring the effects on their business and evaluating how effective their mitigation plans were in protecting their post-Brexit bottom line.

Looming over 2021 are questions around the adequacy of those plans (most of which were made 'in the dark' as deal-or-no-deal talks dragged on), and what the short and long-term effects are likely to be on agency brokers in the UK, Europe and elsewhere.

This report is based on new research undertaken with 15 investment banks and brokers based in the UK, Europe and beyond. It examines the real impact that Brexit has had on their operations, revealing for the first time how different business for agency brokers in the post-Brexit world will be.

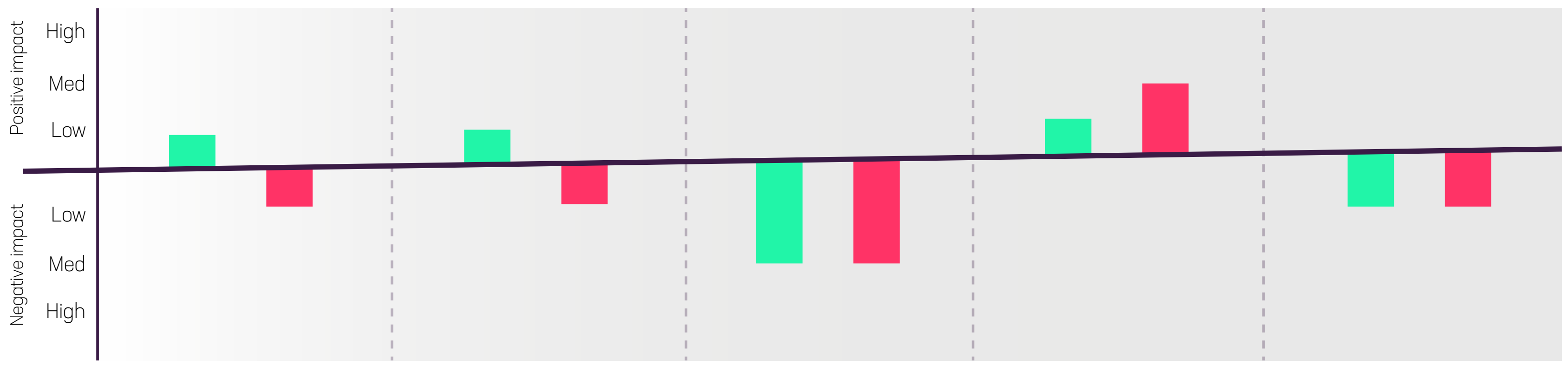
Contents

The Brexit effect

Since the UK cut ties with the EU, the impact on agency brokers has been messy and inconvenient but, for most, far less severe than might have been anticipated. While there have been operational headaches, the effect on business has been relatively minor. That said, quantifying the impact on trading volumes across the industry is not a trivial exercise.

There are many compounding factors, with Covid-19 the most significant by far, which mean that it could be a longtime before the impacts of Brexit can be fully untangled from those of other factors. However, a qualitative analysis of the experiences of agency brokers in the first post-Brexit quarter has provided some interesting insights, which broadly fall into five categories.

Short-term impacts of Brexit on agency brokers



Impact 1
Require a physical presence in Europe / UK to do business with Europe- / UK-based clients.

Impact 2
Asymmetry in the stance taken by regulators.

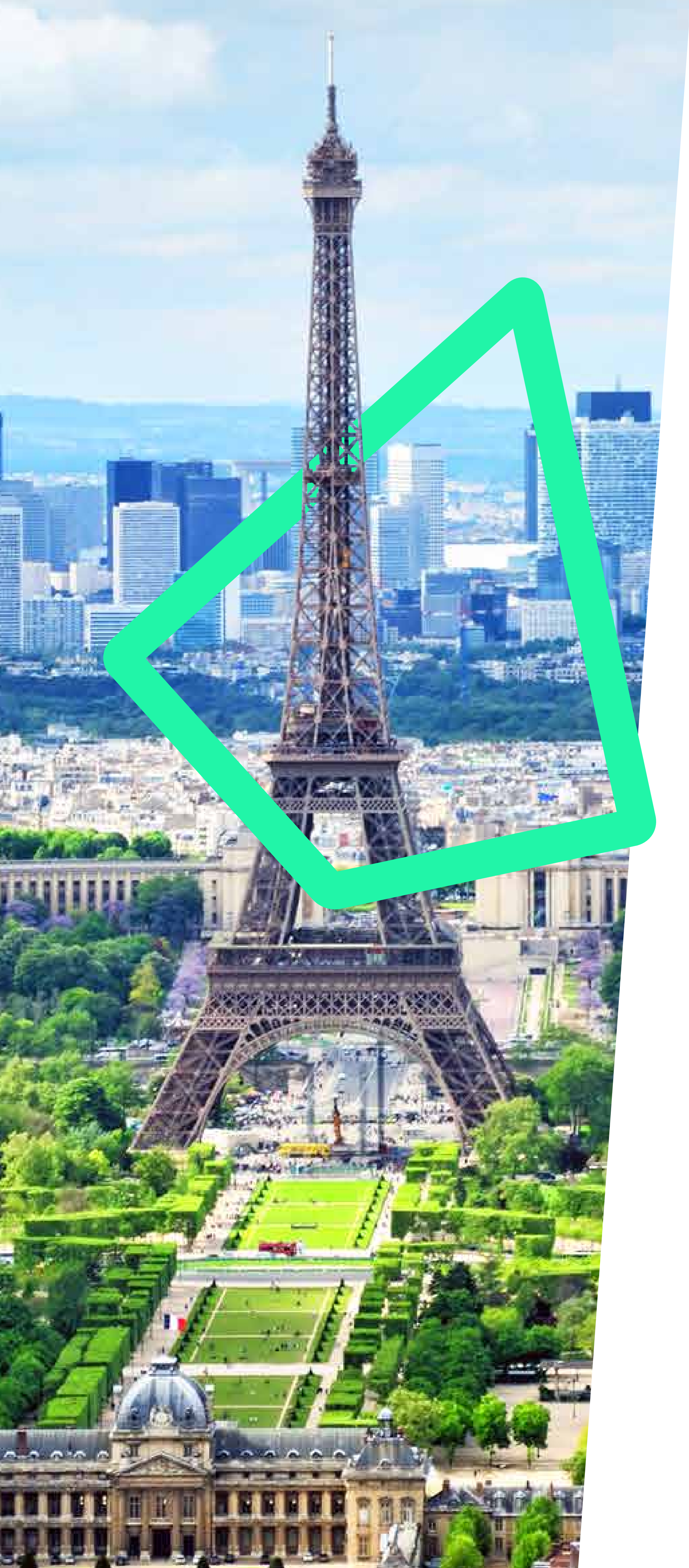
Impact 3
Increased cost of trading.

Impact 4
Increase in number of IPOs in the UK.

Impact 5
Ongoing uncertainty.

Key Europe-based agency broker UK-based agency broker

Source: GreySpark analysis



A physical presence in Europe

Since Brexit, UK firms can no longer 'passport' their services into the EU without additional regulatory clearances. Most national European regulators require that, to conduct business in Europe, a firm must have staff in a European branch or affiliated entity.

While a few European jurisdictions have made temporary allowances for UK firms to continue to undertake specific activities – for example Cyprus, Sweden and Liechtenstein – the large majority of nation state regulators require staff and businesses to have a physical presence in Europe in order to work with clients in that state and in other European states via passporting. It is no longer possible to operate remotely across the EU from the UK.

The stay-at-home restrictions put in place across the world to combat the Covid-19 pandemic have led to the widespread acknowledgement that it is perfectly possible to conduct a great deal of business remotely or at a distance. However, there is an overwhelming sense that client relationships and corporate access still require a degree of face-to-face contact that may necessitate the relocation of even more salespeople and other staff than is required by the regulators.

For logistical reasons, many firms do not yet have people in the right roles located in the correct geographies to be effective and efficient in those locations. This is leading to some interesting workarounds to ensure that business gets done without breaking any rules.

For instance, a Fixed Income trader based in the UK can no longer assist a European client wanting to trade a Fixed Income product. Instead, the client may need to speak with an Equity Derivatives specialist based in Europe, who in turn consults with the UK-based Fixed Income trader to ensure the business is concluded. As well as the inconvenience, this kind of scenario is clearly not good for client relationships. Anecdotal evidence shows that some smaller firms are simply no longer able to conduct business with end clients on the other side of the English Channel as a result.

Differences in the regulatory stance

The FCA is taking a more sympathetic approach to European firms doing business with UK clients than most EU regulators took in regard to UK firms doing business with European clients. From January 2021 until December 2023, the UK regulator is allowing a temporary passporting of EU firms to enable them to do business in the UK while they seek UK authorisation.

However, there is no reciprocal EU-wide scheme for UK firms. In addition to the immediate and asymmetric pain felt by those UK entities conducting business with the EU, it is unclear what the situation will look like ultimately, and this uncertainty is hurting European clients and UK agency brokers, as it hampers their ability to make long-term strategic plans.

The cost of trading

The cost of trading is expected to increase for agency brokers that have clients both in the EU and UK regardless of the agency broker's geographical location, due to the increase in complexity of doing business in the post-Brexit environment. For instance, if firms are now required to trade across multiple exchanges or clearing houses, or to interpret and comply with multiple sets of differing regulations, costs are likely to increase correspondingly.

Currently, this remains minor in most cases, but agency trading works with tight and decreasing margins, so even this small increase is potentially problematic and if it gets larger in future, it could become a more significant threat.

The increase in UK Initial Public Offerings

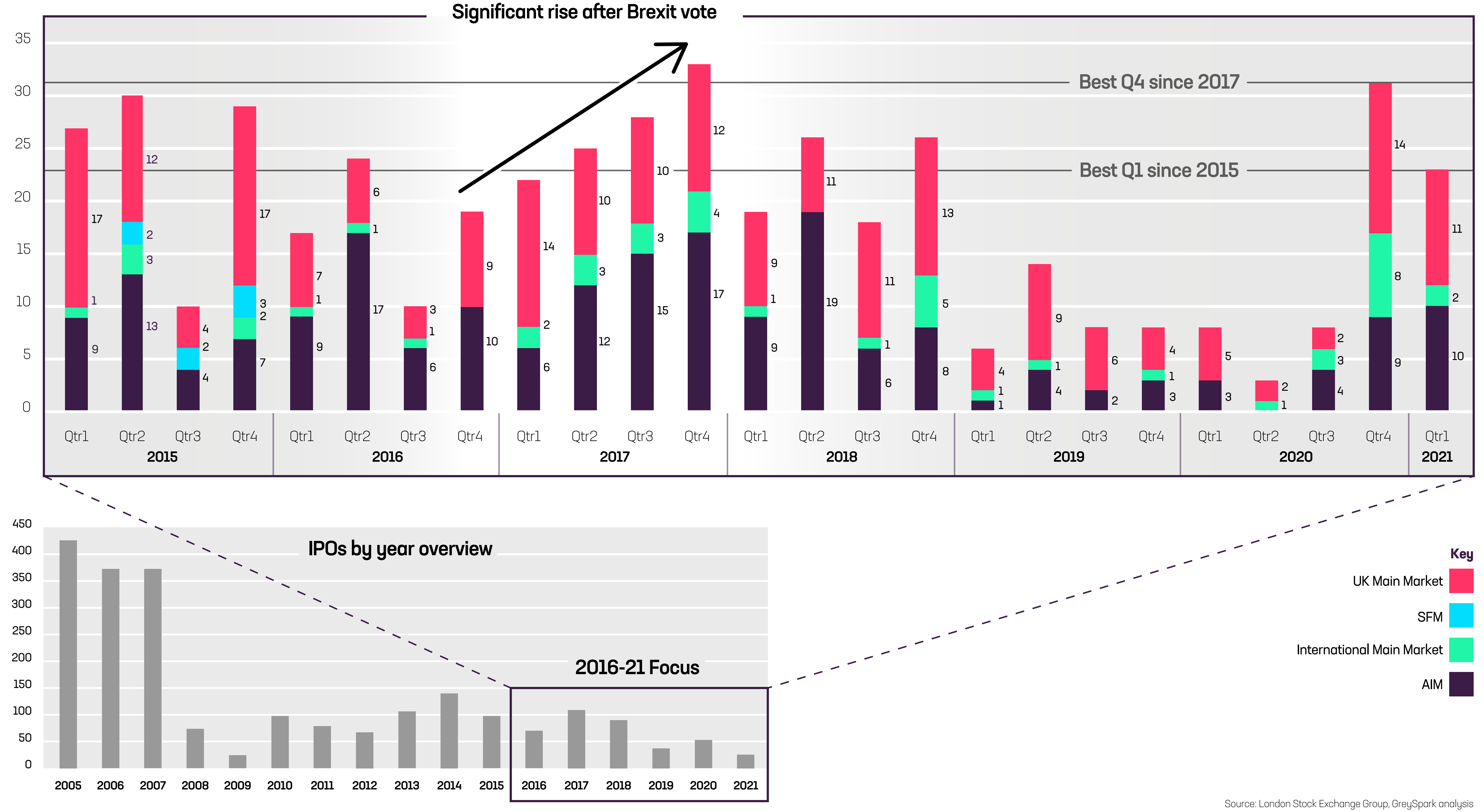
There has been an immediate small but noticeable upswing in IPOs in the UK in the aftermath of Brexit as companies across a variety of industries seek to raise capital in the UK. It is too early to say whether this is a blip in the long-term downward trend experienced over the last decade or is the beginning of a real change in direction.

Although there is a general downward trend in the number of UK IPOs since 2005, there was a noticeable increase in the five quarters following the Brexit vote in 2016. Furthermore, during and after Brexit, at the end of 2020 and beginning of 2021, the rise in the number of IPO's is significant - indeed, the London Stock Exchange reported the best first quarter since 2007[1].

While movements in the number of IPOs have little direct effect on agency brokerage businesses, there is certainly a correlation with the health of the secondary equities market generally – higher prices and a greater willingness to invest mean more IPOs – which in turn is positive for brokers.

[1] Brignall, 2021, London Stock Exchange has best first quarter for IPOs since 2007. [online] The Guardian. Available at: https://www.theguardian.com/business/2021/apr/12/london-stock-exchange-has-best-first-quarter-for-ipos-since-2007

Observing Brexit related UK upturns in a general downward trend of IPOs



Source: London Stock Exchange Group, GreySpark analysis

Managing ongoing uncertainty

The ultimate impact of Brexit on financial services remains uncertain – arguably more so than other areas of the economy. This is summed up in one wry comment from an investment banker who noted that while the word 'fish' appears sixteen times in the UK-EU Trade and Cooperation Agreement (TCA), the term 'financial services' was mentioned a mere six, despite the respective relative importance of those industries to the UK economy.

As the details critical to financial services in Europe and in the UK continue to be hammered out, the UK has instituted temporary equivalence on some limited aspects – one on central securities depositories and another on central counterparty clearing houses, but there are a further 37 decision points on equivalence still outstanding. (For context, Australia and Canada have 19 and 20 equivalence agreements in place respectively and the US has 23).

In March 2021, the EU and UK agreed a Memorandum of Understanding in which the Joint EU-UK Financial Regulatory Forum was established to facilitate discussion and agreement on cross-border issues including those of equivalence. While this is a positive development, it only creates the framework for discussion over the coming months and years rather than making any determinations on equivalence, and so uncertainty will prevail for potentially years to come.

The longevity of uncertainty was unexpected by financial services, even in the latter months of 2020. It is still hindering both long- and short-term planning for agency brokers and has a knock-on effect on technological innovation and development.

Contingency plans

In general, Brexit preparation undertaken by agency brokers appears to be largely satisfactory, despite the lack of clarity around eventual Brexit 'T&Cs'. The many delays to the various stages in the Brexit process proved to be both a blessing and curse. On the one hand, there was ample time for financial sector firms to prepare for the – mostly uncertain – outcome, but on the other, the drawn-out nature of the process led many to develop a level of complacency and, in some cases, a progressive lack of focus over time. Furthermore, the metaphorical fog around the agreement between the EU and UK from 2016 to 2020 led to a 'doomsday' feel as banks struggled to prepare for the impact of Brexit on agency trading that could have fallen anywhere between inconsequential and calamitous.

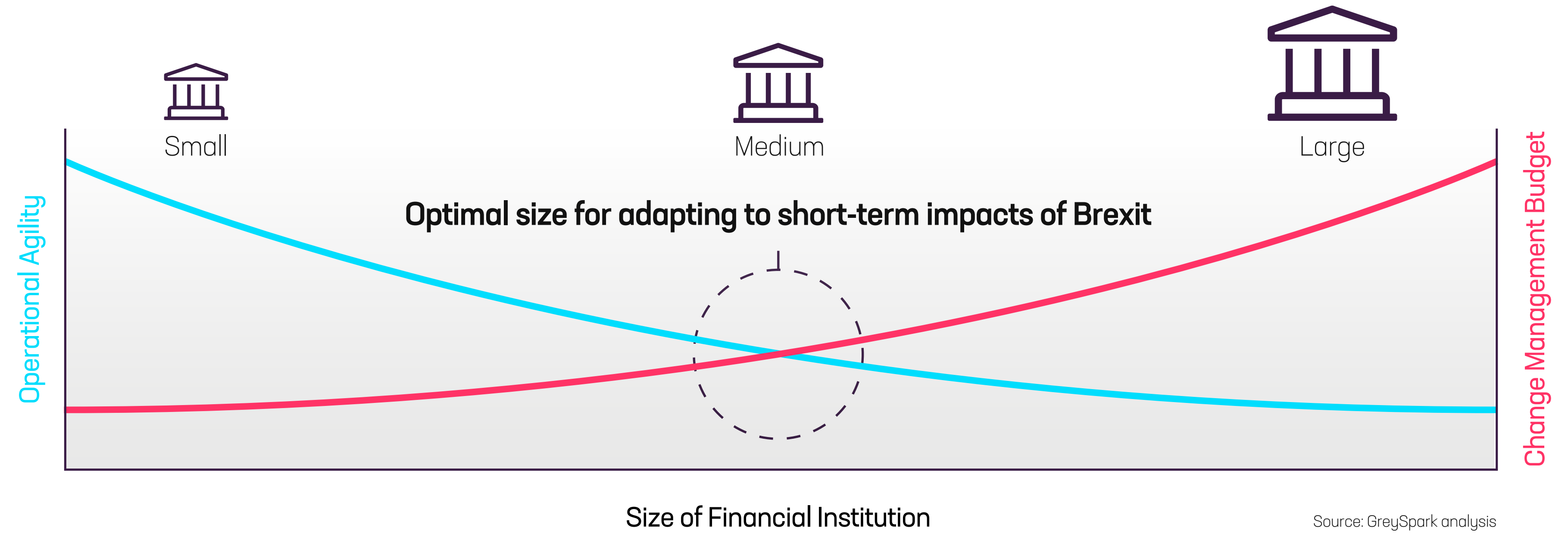
Many brokers took the opportunity to firm up their European or UK presence: creating new entities and branches; enhancing the capabilities and staffing levels in existing branches and entities; entering into partnerships and joint ventures to facilitate trading on the opposite side of the English Channel. However, this was easier to achieve for some than others.

Organisational size had a bearing on the ease with which the agency brokers were able to prepare.

- **Large institutions** found preparation challenging because their size meant that tasks such as setting up new entities involved both internal and external 'red tape' that could be cumbersome;
- **Medium-sized banks and brokers** were arguably in the best position as they were able to be relatively nimble, yet had enough of a financial cushion to absorb the additional expense of Brexit preparations;
- **Small brokers** found preparation challenging because of the expense it entailed.

Despite their best efforts, many agency brokers find that they have continuing remediation work, which they anticipate will be ongoing through 2021 and beyond.

Ability to prepare contingency plans for Brexit in advance of the end of the transition period



> "While the word 'fish' appears sixteen times in the UK-EU Trade and Cooperation Agreement, the term 'financial services' was mentioned a mere six."

Preparing for what happens next

Hopes for a reduction in the uncertainty faced by agency brokers and the wider financial services industry are tempered by the concern that decisions may come suddenly and without adequate warning to allow mitigating plans to be carried out. In addition, the changes to existing systems and processes are unlikely to be trivial, as they will be driven by external and internal forces.

Diverging regulation

How Brexit will impact the financial services industry in the medium to long term is heavily dependent on the direction that regulators both in the EU and the UK choose to take. There will almost certainly be some divergence between EU and UK rules. The green shoots of this are evident in, for example, the tail end of SFTR and how it treats non-financial counterparties, as well as in the differences in passporting processes.

However, much of the existing EU financial law was significantly shaped by the Financial Conduct Authority (FCA). Given the major role that the UK regulator played, and the view held by many that London is a 'safe environment' in which to do business, the FCA would be unlikely to threaten that position or to deviate too far from regulations which it was instrumental in formulating.

The 'Singapore-on-Thames' idea has been touted in the global press, but the industry view is that it is unlikely to transpire in the immediate future, if at all. Although some commentators talk up deregulation of the financial services sector in the UK, the industry remains sceptical that this will happen. In the UK particularly, reputation is an important consideration. Since 2007, the public perception of the financial services industry has been somewhat negative, and any deregulation could jeopardise that already fragile relationship.

The way that future regulation is implemented in law, however, is likely to diverge. While EU law tends to be highly prescriptive in nature – setting out provisions for all conceivable scenarios, the UK historically relies more on the judicial system. Indeed, UK law places a higher emphasis on the intention and substance of the law than on specific provisions, and this is a highly respected and often-replicated model across the world. It is arguably more robust, as it allows for less exploitation of unspecified loopholes.

Perhaps most significantly, to trade with the EU, it is clear that UK businesses will have to comply and be seen to comply with EU regulation. Although non-EU economies are significant markets, there is broad agreement that UK financial institutions will be reluctant to turn their back on the EU market, as it is one of their closest trading partners in recent years. However, global UK-based brokers may have a different view, and those that do only a small amount of business with the EU may simply choose to withdraw that business entirely.

[2] Vincent, M., 2020, Top City bosses reject post-Brexit 'Singapore on Thames'. [online] The Guardian. Available at: https://www.ft.com/content/03c1e302-58a2-11ea-a528-dd0f971febbc

Evolution of business strategies

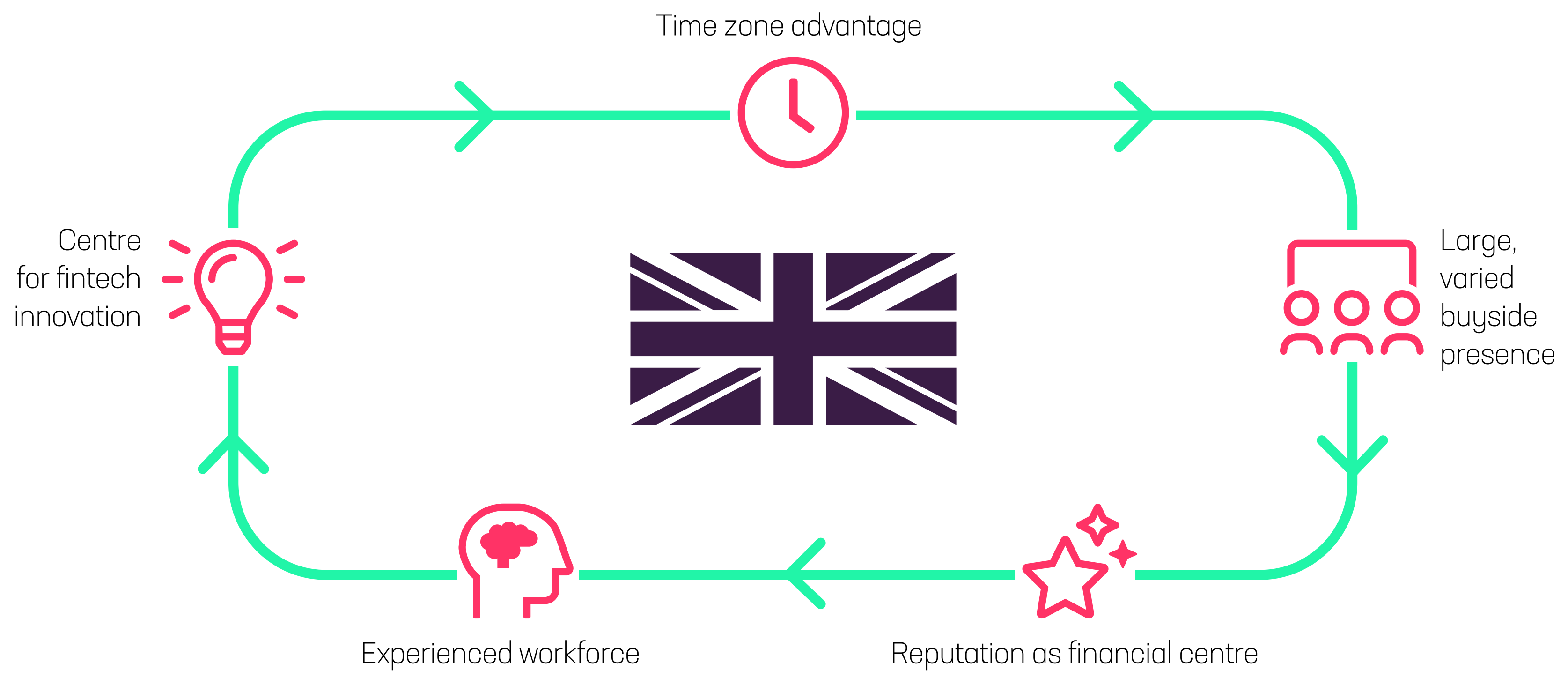
There is a general expectation that the cost of trading will continue to increase as operational complexity rises; an inevitable consequence of the divergence of regulations and conventions. For an industry that already works with tight margins, this could be challenging and may result in some business strategies becoming untenable in the long term.

Over the past few months, there has been a clear shift of some lines of business to the EU from the UK. UK firms have observed a flight of equity liquidity to Amsterdam, which arose because of the lack of agreement on equivalence for stock exchanges. Many agency brokers expect a reduction in liquidity in UK stock exchanges to continue in the short to medium term.

Even if some markets and activities shift away, however, London and the UK remain important for many reasons; financial technology, buy side presence, the time zone, reputation, workforce experience and others. So, it is likely that this effect will tail off in the long-term as uncertainty decreases, and businesses in the UK and EU will refocus their strategies and adapt to regulatory change.

Although agency brokers expect to continue to see a 'Brexit effect' on their businesses, most consider that it is unlikely to have an impact on their long-term strategies and, indeed, there are reasons to be cheerful on both sides of the English Channel.

UK virtuous circle: reasons that London will remain a global financial centre



Source: GreySpark analysis

> “There are reasons to be cheerful on both sides of the English Channel.”

Seizing the opportunity

As well as creating bumps in the road, Brexit provides opportunities for firms operating in Europe, in the UK and worldwide as well as some collective opportunities. In the UK and Europe, especially amongst the smaller and more niche brokers, it is likely that strategic partnerships, mergers and joint ventures will arise, in order to maintain access to all desired markets.

The European advantage

Many brokers agree that most immediate post-Brexit opportunities are there to grasp by either European businesses or those with a solid European presence. The demise of passporting for UK businesses operating in the EU, as well as the current dearth of equivalence agreements creates opportunities for EU players to step up and has potential financial and reputational benefits for Europe.

This has already been illustrated by the recent share-trading volume shift from the UK to Amsterdam due to the loss of equivalence for exchanges, which, though not in itself enormously impactful on the market as a whole, has allowed European exchanges to exploit the changes.

Additionally, there have been a significant number of new branches and entities of UK headquartered firms opening up in the EU. Research by the New Financial think tank suggests that more than 400 UK financial services firms have moved at least some operations to Europe as a response to Brexit and the EY Financial Services Brexit Tracker estimates that there have been as many as 7,600 Brexit-related job moves to date created by these new European hubs among the 222 firms monitored in the tracker.[3,4]

[3] Wright, W., 2021, Brexit & the City: Some Initial Reflections [online] New Financial. Available at: https://newfinancial.org/brexit-the-city-some-initial-reflections-january-2021

[4] EY, 2020, EY Financial Services Brexit Tracker: Financial Services Firms continue moving staff ahead of Brexit deadline, with total jobs relocating from London to Europe now over 7,500. [Press release] 1 October 2020. Available at: https://www.ey.com/en_uk/news/2020/09/ey-financial-services-brexit-tracker-fs-firms-continue-moving-staff-ahead-of-brexit-deadline

The global advantage

Outside the EU and the UK, the impacts of Brexit are small so far, as expected, but there may still be opportunities for other global markets and participants to 'take up the slack' in the instance that UK brokers choose to move business away from Europe. As observed earlier in this article, there are a number of other third countries with more favourable EU equivalence agreements than the UK currently has. This may give globally domiciled firms the opportunity to move into Europe where UK businesses have opted to pull out, as well as potentially being in a position to do business with any UK brokers looking to increase their reach outside Europe as part of their post-Brexit strategy.

The UK advantage

There are certainly potential opportunities for the FCA and the UK government to make the UK attractive to business – through regulation, subsidies, rewards, fiscal policy and other methods – although there is uncertainty in the industry about exactly what will transpire and when.

There remain opportunities for the City of London to maintain and build on its position as an important global financial centre. The talent, infrastructure and reputation of The City are extremely strong, as is the global perception of the UK as an emergent epicentre of 'green' finance.

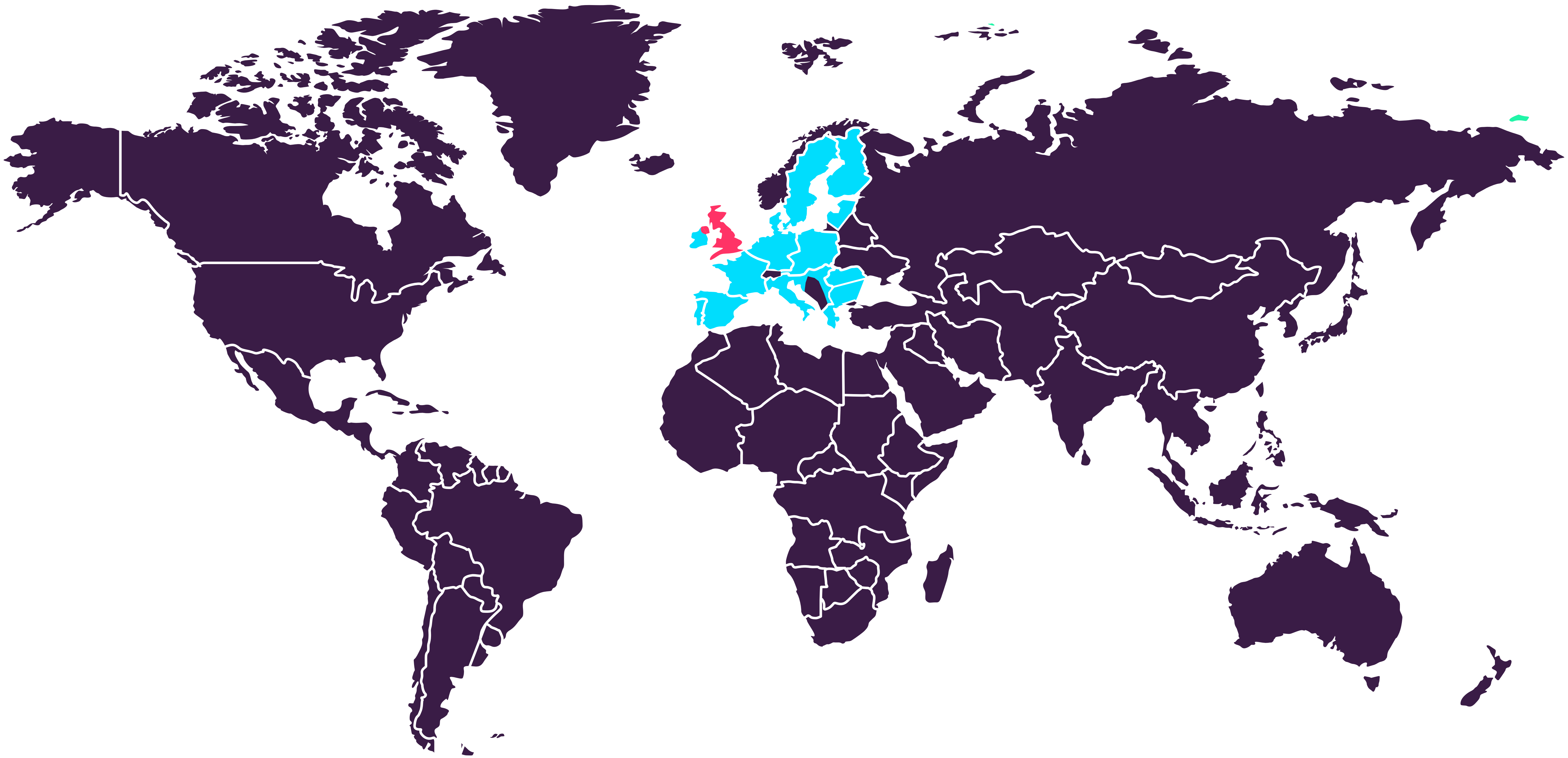
Many European firms plan to start or continue to operate in the UK post Brexit, which suggests that European financial services firms still consider London to have importance. Indeed, a Freedom of Information request made by financial regulatory consultancy, revealed that circa 1,500 EU-based firms have applied for permission to operate in the UK, and over 1,000 of these are opening their first UK office[5].

Post Brexit, London remains a fiercely innovative fintech hub, despite efforts to create rival hubs in Europe. The skills base and highly developed infrastructure cannot be replicated quickly or easily, and London has a head start. It is clear that technology, and specifically fintech, is an area of huge potential and ongoing growth in the UK. In banks with UK branches or entities, there are many exciting technologies being implemented and a great deal of platform automation taking place across the financial services industry.

[5] Bovill, 2021, London to remain financial services centre of Europe. [press release] 22 February 2021. Available at: https://www.bovill.com/london-remains-financial-service-centre-of-europe-final-numbers-show

> “Post Brexit, London remains a fiercely innovative fintech hub with a skills base and infrastructure that cannot be replicated quickly or easily.”

Regional advantages post-Brexit



The demise of passporting for UK businesses operating in the EU, as well as the current lack of equivalence agreements, creates opportunities for EU players to capture business lost by UK-based players.

The FCA and the UK government may make the UK attractive to business through regulation, subsidies, rewards, fiscal policy and other methods. London also benefits from being a dominant fintech hub, despite efforts to replicate its success in hubs elsewhere in Europe.

Other global markets are in a position to 'take up the slack' where UK brokers choose to move their business away from Europe, and where EU brokers choose to move their business away from the UK.

Source: GreySpark analysis

What the future holds

Challenges lie ahead, but the dominance of the City of London will endure.

For agency brokers, while noticeable changes have occurred, the impacts have been inconvenient rather than game changing and the preparations agency brokers put in place appear to have achieved what they set out to do, despite the lack of solid advance information on the final withdrawal agreement.

There remains a great deal of speculation about how the situation will play out in the future for financial services firms. The prevailing view is that, while agency brokers do anticipate some divergence in regulatory approach in the medium term, it will not necessarily manifest in the UK as a significant relaxation of the rules. The FCA was instrumental in the formation of many of the big EU financial services regulations, and the underlying strategic goals and intentions behind the implementation of those regulations have not changed.

There is little doubt that London and the UK will continue to face some challenges as a result of Brexit, particularly until the finer details of the agreements between the EU and the UK are ultimately finalised, but it will remain an important player in the financial services industry and, while the focus of the various business units within financial firms may require adjustment over time, the dominance of the City of London will endure in the long term, with the burgeoning fintech and green finance industries serving only to further boost that global influence.

Are you ready for the future?

If your trading system is holding you back from the future you want, it might be time to think about switching to something better suited to the way you want to work.

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