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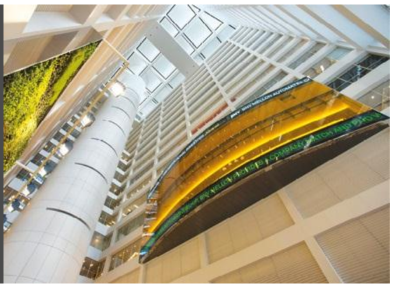

# HOW THE UK'S VOTE TO LEAVE THE EU COULD HIT THE BANKS

*Newton's Charles French says the only thing the banks can be certain of is uncertainty as the UK and EU negotiate the split.*

An extended period of uncertainty, low visibility and one that will be characterised by shifting responses in fiscal and monetary policy is the expected fallout from the UK's EU decision, says Charles French, head of investment at Newton Investment Management, a BNY Mellon company. Once the UK formalises the decision to leave the EU by triggering article 50 of the Lisbon Treaty, the future shape of UK banks and the regulatory framework in which they operate within the EU will depend on the outcome of lengthy negotiations.

The backdrop has for some while been uncertain and difficult for the banks, with the 'Leave' decision by the UK only creating more uncertainty and further eroding confidence, says French. Uncertainty is never helpful for a financial system, which is, by its very nature, highly levered, he adds.

The share prices of financials typically react unfavourably to deteriorating economic news or extreme political environments, comments French. In the immediate aftermath of the UK vote to come out of the EU, UK bank share prices performed poorly as did European ones, particularly in some of the peripheral European economies. According to French, this reflects an environment that is stretched and challenging for European banks as well. Banks are facing a very low interest-rate environment and this is putting significant pressure on the revenue streams of the banking sector and further eroding profitability, notes French. Banks typically have large and complex businesses and their business models appear less able to meet the challenges of operating in the environment that emerged since the financial crisis of 2008.

Some banks have made progress, particularly UK ones, and are in a better financial shape than they were six or seven years ago. Balance sheets are far stronger in term of capital and funding structures are greatly improved, says French.

However, the UK can expect a period of slower economic growth, while this political change is absorbed, with corporates and consumers becoming increasingly cautious, comments French. The operating environment is likely to remain tough for the banking sector.

The concentration and polarisation towards London as the dominant financial centre within Europe has built up over many, many years, notes French, adding, for instance, most investment banks have the majority of their European staff based in London. French would expect business to drift away from London as a result of policy intervention, to France and Germany keen to develop their own financial centres.

Eurozone members have largely tolerated the conduct of euro-related business in London, while the UK has been part of the EU, says French. In the event of a formal exit from the EU, that pressure for a migration to, say, Frankfurt or Paris can be expected to grow. Equally, banks may make their own judgement that, with the UK no longer part of the EU, it is necessary to have more operations and resources within EU countries.

For other segments of financial services, it will depend on the outcome of negotiations between the UK and EU and the extent of 'passporting' that allows continued access to the European market.

Besides the UK's pending exit from the EU, investors need to be assessing other challenges from a global point of view, such as the slowdown in China or Japan's attempt to shake off the shackles of deflation, says French. Asset markets have been supported by aggressive monetary policy by the authorities and this has not proved to be sustainably effective, leaving some parts vulnerable. This reinforces the need to be selective when investing and being rigorous in terms of analysis to identify companies that can thrive in a wide range of potential outcomes.

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