SPECTRUM
Asset Management

Brexit Risk Manageable for UK Banks

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Polarized Politics

Conservative Prime Minister Boris Johnson's "no deal" plan to leave the EU by October 31 has been blocked by opposition-led legislation to make way for a 3-month extension, which needs full EU approval. Mr. Johnson now leads a minority government given party defections and dismissals. What likely lies ahead are fresh elections for a new government to execute a new Brexit solution. Polls are favoring the Conservative party to lead the process.

What does Brexit mean for UK banks?

In the 2018 UK bank stress test, the BOE stated that "the UK banking system is resilient to deep simultaneous recessions in the UK and global economies that are more severe overall than the global financial crisis", and further that banks "started the test with an aggregate common equity tier 1 (CET1) nearly three and a half times higher than before the global financial crisis…the major UK banks' aggregate CET1 capital ratio after the stress would still be twice its level before the crisis."

> ***Spectrum believes that while a no deal Brexit could significantly impact the UK economy given more difficult trade arrangements with Europe, it should not be a crisis-like event.*** *In a worst-case scenario, the UK banks will likely lose a portion of their earnings in the coming quarters — though remain profitable. We do not expect a material impact on the industry's sound asset quality and liquidity, and little to no erosion in its solid capital position. We believe that EU banks will experience indirect, though manageable, Brexit effects. In general, bank balance sheets should remain resilient.* ***Importantly, the recent stress test illustrates the strong credit profile of UK banks.***

What's Next?

A transition period to January 31, 2020 gives the UK economy more time to prepare for Brexit, again. With a new Conservative government, Brexiteers could propose another no deal which could include softer variations of a border, at best, between EU-member Republic of Ireland and Northern Ireland of the UK. But during the three-year period of Brexit negotiations, the EU has yet to relent on its insistence of a "backstop" agreement to ensure no cross-border interruption in Irish commerce. A Labor-led government could offer some version of an EU compromise without upsetting intra-Irish relations, and Scotland (which attempted to become an independent sovereign in 2014), or even push for a second referendum giving voters the opportunity to remain in the EU. The stalemate continues.

Based on resilient underlying fundamentals, our UK and European bank contingent capital (CoCo) holdings should be well-positioned for continued Brexit uncertainty.

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