

## **Brexit Should Be Manageable for Financials**

June 24, 2016

In a close vote, the UK electorate decided yesterday to *Leave* the EU under a long-awaited referendum. As expected, David Cameron resigned as Prime Minister due to his failed attempt to convince constituents to remain in the EU bloc. Mr. Cameron will be staying on for several months until a new PM is in place. Notably, Conservative Boris Johnson is the odds-on favorite. This historic Brexit decision will be accompanied by a period of adjustment as the UK considers its direction. This could entail a second referendum providing a more conclusive margin of victory to *Leave* or *Remain*, or an immediate start to EU exit negotiations which would be completed in two years after the UK invokes Article 50 of the EU Lisbon Treaty. Since neither the UK nor Brussels benefits by undermining talks, Spectrum expects an orderly unwinding of the treaty.

As we opined in an earlier release, Brexit risks outweigh the benefit of UK sovereignty. Among other challenges, the UK now faces the end of cross-border (passport) trade with the EU, potential negative effects on its economy, and a change of leadership. The future appeal of London as the world's most important financial center is in peril through the loss of passport rights. There are a number of capital market oriented banks such as Barclays, JPM, Deutsche Bank and BNP, to name a few, that will have to reconsider locating to other EU centers such as Dublin or Paris to avoid cross-border issues. Other hurdles remain. European countries who export to the UK may encounter more trading difficulty. Brexit could heighten Eurosceptic populism, present in Euro sovereigns such as the Netherlands and Italy. And, Nicola Sturgeon, head of the Scottish National Party, said that a second independence referendum is "highly likely" to protect the country from leaving the EU.

Post-Financial Crisis, the British banks have improved significantly in terms of capital, leverage and profitability. In his response to the Brexit outcome, Bank of England (BOE) governor, Mark Carney, stated "the capital requirements of our largest banks are now ten times higher than before the crisis." The banks are successfully addressing lingering global issues. Asset quality is good. And while UK bank earnings may decline in the interim — perhaps from lower loan demand and transaction volume as customers wait on the sidelines — *we do not believe Brexit negatives will materially stress bank credit profiles.*

Despite risk-on and risk-off trades in the near term, market volatility should not be particularly meaningful to the fundamentals of financials, including bank and insurance companies. The BOE and ECB are poised to provide the necessary market liquidity to the UK and Europe, respectively. **A post-Brexit environment does not change our sound fundamental credit opinion of the UK and continental European banks and insurers in which we invest.** *Spectrum views a Brexit-induced sell-off of preferred securities as an attractive opportunity to buy.*

Joe Urciuoli  
Managing Director

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