COMMERCIAL BANKING

# The EU Referendum:
## The future of the UK and Europe

Fourth edition – September 2016

The views expressed in this document are not representations by or on behalf of Lloyds Banking Group plc, or any of its related companies

LLOYDS BANK

**Following the EU Referendum, Lloyds Banking Group plc (the Group) notes the outcome that the UK electorate has voted in favour of the UK leaving the European Union (EU).**

We remain committed to our purpose of helping Britain prosper through our focus on UK retail and commercial banking, funding business investment, and serving the financial needs of our customers to support them throughout this period and beyond.

There are no changes in the products or services offered to customers, either in the UK or overseas. Customers can continue to use our banking and insurance services as they did before.

Customer deposits in the UK continue to be protected by the Financial Services Compensation Scheme; and the Prudential Regulation Authority and Financial Conduct Authority remain our primary regulators.

With the expected timescales for the negotiations, the Group will have time to consider any future changes that may be required in the new environment.

**GROUP STATEMENT ON THE EU REFERENDUM, LLOYDS BANKING GROUP, 24 JUNE 2016**

# Introduction

ED THURMAN

Managing Director
Head of Financial Institutions

GROUP AMBASSADOR FOR LONDON

We remain committed to our purpose of Helping Britain Prosper.

**Welcome to our fourth client update on the future of the UK and Europe. Following the break-neck pace of June and July, August gave us Parliament's annual recess and some room to pause for thought. Clarity is gradually emerging regarding the roles and responsibilities of the key actors in Government for leading on negotiations. We offer a little colour on the UK end, and a brief summary of the key individuals and institutions within the European Union who will negotiate the terms of the UK's exit from the EU with their British counterparts.**

Adam Chester, our Head of Economics in Commercial Banking, provides a summary of the key developments in financial markets. The Bank of England's base rate cut and the first economic data released since the EU Referendum provided much for our clients to think about over August. Our Bond Syndicate desk provides a view of activity in the debt capital markets since the Referendum. We saw transaction activity in July and August increase substantially, following a very slow first half of the year, reflecting pent-up demand and attractive market conditions reinforced by the rate cut and the Bank of England's intention to purchase bonds in the secondary market.

Three months on from the Referendum, it is clear that clients have started to adjust to the 'new normal'. Based on almost forty interviews across our team, we share a view of the short-term implications which you have discussed with us, and a summary of the opportunities and challenges raised. Many of you have asked for analysis of what the Referendum result means per sector in the short-term, and our Group, Government and Regulatory Solutions team has consolidated a view.

Finally, Adrian Walker, Managing Director of Global Transaction Banking, offers a perspective on the short-term implications for Trade Finance, and the opportunities presented by the current macro environment. As ever, in uncertain times, we remain committed to supporting clients and Helping Britain Prosper. We will continue to focus our attention on the mechanical and technical aspects of negotiating the UK's exit from the EU to aid business planning. If you have any comments or questions, please contact your Relationship Manager, who will be delighted to introduce you to our team of experts on the topics covered in this issue.

### KEY MARKET MOVEMENTS

| Indices | As at 15/9 | Δ since 23/6 |
|---|---|---|
| **£/$** | 1.3216 | -10.76% |
| **£/€** | 1.1756 | -9.88% |
| **FTSE 100** | 6,719.53 | 6.02% |
| **FTSE 250** | 17,804.73 | 2.72% |
| **DAX** | 10,431.20 | 1.70% |
| **CAC40** | 4,373.22 | -2.08% |
| **UK 5YR Gilt Yield** | 0.3060 | -58 bps |

### AT A GLANCE

- UK August manufacturing & services PMIs rebounded to pre-referendum levels
- UK consumer confidence recovers from -12 to -7 in August – back above its long-term average
- Surge in UK money supply growth may be a statistical quirk – but maybe not
- European Central Bank leaves rates on hold, but hints at further measures to come
- EU leaders (excluding the UK) met on Friday 16 September to discuss the response to the Referendum result
- Soft data but hawkish Fed comments leaves the US market guessing on prospect of September tightening.

# Political landscape: What happens next?

BEN BROGAN

Director,
Group Public Affairs

**The return of Parliament from the summer recess has brought only a little clarity on the UK's exit from the EU.**

**In response to repeated questions in the House of Commons, the Prime Minister has confirmed her intention that "the new relationship will include control of the movement of people from the EU into the UK, and it will include the right deal for the trade in goods and services." Mrs May has also been clear that future negotiations with the EU will focus on "developing our own British model." This statement confirms that there is little possibility for UK businesses to access the EU Single Market via existing structures, like the European Economic Area (EEA – e.g. Norway) or an à la carte model (e.g. Switzerland).**

The Prime Minister also confirmed that MPs will not be given a vote before the Government triggers Article 50 of the Lisbon Treaty (the legal mechanism for giving notice to leave the EU) and that Parliament "will not be provided with a running commentary," therefore ensuring that government planning, and the negotiations themselves, will largely be conducted behind closed doors. There has been no further clarity on the timing of when the Government will invoke Article 50, with Mrs May previously stating she did not envisage giving formal notice in 2016.

During David Davis' first statement to the House of Commons as Secretary of State for Exiting the EU, he remarked that it would be "highly improbable" for the UK to remain a member of the European Single Market if the country were to regain control over immigration from the EU. While an accurate statement, as freedom of movement of people is held as an immutable condition of Single Market access by Brussels, the statement drew a rebuke from the Prime Minister that it was not right to "put all your cards on the table" and that Mr Davis was setting out "his opinion" and not Government policy.

The Cabinet, when gathering at Chequers in August, emphasised its commitment to the devolved nations of the UK to ensure that "Brexit works for all." However, Downing Street was quick to emphasise that the UK Government will be taking the ultimate decision as to when the UK leaves the EU and ruled out the prospect of a Scottish veto.

At the G20 summit in China, we learned that several major non-EU countries with significant investments in the UK are deeply concerned about the consequences of the UK's exit from the EU. President Obama said that the UK wouldn't be a priority for a US trade deal because Washington wanted to focus on trade negotiations with the EU and the Pacific nations first. Similarly, Japan issued a fifteen page warning, outlining the possibility of a series of corporate departures from the UK should Single Market access not be maintained.

In Brussels, Michel Barnier has been appointed by Commission President Jean-Claude Juncker as the Chief Negotiator for the Commission on the UK exit. Mr Barnier is the former French EU Commissioner responsible for financial services between 2009 and 2014, who oversaw the introduction of unprecedented levels of EU financial regulation following the global financial crisis.

The potential start of UK negotiations over EU exit is set to be overshadowed on the continent by forthcoming political milestones in several of the larger member states. Italian Prime Minister Matteo Renzi's political future is hanging on the result of a referendum on constitutional reforms already passed by the Italian Parliament. Should the Italian public strike the reforms down in a vote later this year, Mr Renzi could resign and throw open the possibility of further gains by the populist Five Star movement in an early general election. Five Star have promised a referendum on membership of the euro should they form a government.

The French presidential elections in Spring 2017, and general elections in the Netherlands and Germany later in the year, each offers the opportunity of electoral gains for populist, nationalist parties in favour of referenda on EU membership. But perhaps more concerning is the prospect of the National Front in France, the Party for Freedom in the Netherlands and the Alternative for Germany parties, influencing the policies of established parties on Europe, and on UK exit, just as the government begins the two year, formal negotiation process.

Mrs May will meet all of her fellow EU leaders at the European Council summit scheduled for 20-21 October and the final 2016 summit of 15-16 December, where informal discussions on the terms of EU exit are set to take place.

Future negotiations with the EU will focus on developing our own British model

### SHORT-TERM

**SEPTEMBER 2016:**

Theresa May and her Cabinet prepare their strategy in advance of triggering Article 50.

### NEGOTIATED WITHDRAWAL FROM EU UNDER ARTICLE 50 OF THE LISBON TREATY

**2017 – 2018:**

UK Government negotiates with the EU-27. The Treaty defines the period for this to be two years, but could be extended with the unanimous agreement of EU members. It remains uncertain when Article 50 will be triggered, though the Prime Minister has made clear that she does not envisage triggering Article 50 this year.

### STEADY STATE

**2018 EARLIEST; POSSIBLY CONSIDERABLY LATER:**

Steady state, post-enactment of the UK's exit: the 'new environment' after leaving the EU.

2016 2017 2018

## Timeline post-referendum, prior to enactment of Article 50

Theresa May has committed to uphold the Referendum result although she has also been clear that Article 50 should not be triggered in 2016. It is worth bearing in mind that the Referendum is not legally binding; Parliament remains sovereign and the Referendum, in principle at least, is advisory only. Following the appointment of Boris Johnson as Foreign Secretary, May appointed David Davis as Secretary of State for Exiting the EU. In the third key appointment regarding an EU exit, she appointed Liam Fox as Secretary of State for International Trade. Fox will be responsible for the negotiation of trade agreements with non-EU states (with some of which the UK currently trades under umbrella EU-level agreements). Davis took over the team formerly reporting into Oliver Letwin in the Cabinet Office, drawing on civil servants from across the Cabinet Office, HM Treasury and Foreign Office. For Liam Fox, a key challenge will be the mass recruitment of trade negotiators required to build the new trade agreements required with non-EU countries. Letwin warned on 15 July that Britain has no trade negotiators of its own to lead on negotiations – the UK's negotiators are currently employed by the EU.

## The process for leaving the EU

Any member state can decide to leave the EU. The terms of withdrawing from the EU are set out in Article 50 of the Lisbon Treaty. This is the only method of achieving lawful withdrawal from the EU under the treaty, although in extremis, the UK Parliament could conceivably repeal the European Communities Act of 1972. To leave the EU, the member state concerned must notify the European Council of its intention. Once notice of withdrawal has been received, negotiations can formally commence on the terms of exit from the EU.

The prescribed initial period for negotiation is two years from notice being given, although this may be extended with the unanimous agreement of the European Council and the withdrawing member state.

If there is no agreement to extend the two year period, and after two years an agreement has not been finalised, the UK will cease to be a member with no finalised terms of withdrawal.

A withdrawal agreement could include interim rules to apply to existing situations, while new rules are negotiated and implemented. However, ongoing EU decision- and policy-making would continue to apply while the UK negotiated its terms of exit and the UK would have to adhere to EU legislation until the day it exits. However, legislative bodies in the UK may have to decide case by case how the exit negotiations impact UK law[1]. Once Article 50 is triggered, the terms of the UK's departure would be negotiated with the EU institutions. Donald Tusk, President of the European Council, has appointed Didier Seeuws, a Belgian civil servant and diplomat to lead a task force of EU negotiators for the exit of the UK from the EU. Michel Barnier, a former French EU Commissioner has been appointed to represent the European Commission whilst Guy Verhofstadt MEP, leader of the ALDE group in the European Parliament and former Prime Minister of Belgium, will be the Parliament's lead negotiator.

**Source:** 1 HM Government, The process for withdrawing from the European Union

# Negotiating the UK's exit from the EU

**Article 50 of the Lisbon Treaty, also known as the Treaty for the Functioning of the European Union, provides for the legal mechanism for an EU member state to withdraw from the EU. However, following the Referendum outcome we remain in a holding pattern, as Theresa May has said that she will not trigger the mechanism "until 2017" at the earliest; and Jean-Claude Juncker and Donald Tusk have both said that any negotiations cannot begin until the UK formally begins the Article 50 process.**

However, assuming that the upcoming legal challenge in the High Court in October, on the constitutional authority of the Prime Minister to initiate the process without the explicit consent of Parliament, is unsuccessful, it is expected that the process will gain momentum and that the pace of progress will accelerate in the New Year. The European Commission, following a mandate received from the European leaders will begin negotiations on how, and through which transitional arrangements, the UK will extricate itself from the numerous EU structures– e.g. the Common Fisheries Policy, Justice and Home Affairs cooperation, joint universities and science funding, the European Investment Bank etc – see more detail below. For the EU, that process will be led by Michel Barnier, the former Commissioner and Foreign Minister and Didier Seeuws, the veteran Belgian diplomat. It is not yet clear who will lead the UK team – but the UK's Permanent Representative to the EU, Sir Ivan Rogers (who previously worked for both Citigroup and Barclays Capital) will be a pivotal figure.

All of this said, with an upcoming busy year of elections – first the Netherlands, France and then Germany – it is possible that the most challenging negotiations, on fundamental questions like Single Market access and the free movement of labour, will be held back until there is a new German Government in October/ November 2017. It is anticipated that there will then be a push in 2018 to ensure that negotiations are concluded before the European Parliamentary elections in May 2019. There are however, widespread doubts that this timetable will be achieved and many think that the European Council will have to extend the two year window that Article 50 provides for. Of course, this is all subject to when the UK Government triggers Article 50.

Main Decision Makers

Ministers and Commission Officials

Department for Exiting the EU oversee:

| UK | Key areas of negotiation | EU |
|---|---|---|
| **Cabinet Office/ No.10** | | |
| **Department for Exiting the EU** | EU Institutional Questions | European Council |
| Foreign and Commonwealth Office | Common Security and Defense Policy | European Council |
| Department for International Trade | Trade/ Competition/ Single Market | Relevant Directorate General from the European Commission with European Parliamentary Representation |
| Her Majesty's Treasury | Financial Services/ Capital Markets Union/ EU Development Funds/ EIB | |
| Department for Business, Energy and Industrial Strategy | Energy Union/ Climate Change | |
| Department for Environment & Rural Affairs | Common Agricultural Policy<br>Common Fisheries Policy | |
| Home Office | Free Movement/ Migration<br>Justice and Home Affairs | |
| Department for Education | Universities/ Science/ Research | |
| Other Government Departments | + Transport, Culture, Innovation, Youth, Sport, Digital, Regional Policy, European Medicine Authority, International Development, Telecommunications etc | |

## 1. THE HEADS OF STATE

### THERESA MAY
**Prime Minister, United Kingdom**

The Prime Minister has said that 'Brexit means Brexit'. The Prime Minister has talked about her desire to achieve a 3rd Party Status with the EU that is distinct from all of the existing models – i.e. Norway, Switzerland, Turkey etc. She has shown her willingness to do some of the heavy lifting – and has already personally visited Berlin, Paris, Bratislava, Dublin and Rome.

### ANGELA MERKEL
**Chancellor, Germany**

May's chances of securing a bespoke agreement will in large part be determined by whether Angela Merkel will agree to any special dispensation from existing rules for the UK. However, Merkel's ability to carry her European partners has been significantly curtailed by both her loss of standing following her response to the refugee crisis and the election of nationalist / populist leaders in Poland and the Czech Republic, who have proven less willing to follow Franco-German leadership.

### FRANCOIS HOLLANDE
**President of France**

Hollande has wavered a little – between an initial angry response to the Referendum vote to a more measured tone on the Prime Minister's desire to trigger Article 50 in 2017. France's presidential elections in May 2017 will materially influence his approach to negotiations – his approval ratings are currently extremely low.

## 2. THE UK MINISTERS

### BORIS JOHNSON
**Secretary of State for Foreign & Commonwealth Affairs**

Johnson is formally listed as the 4th most senior member of the Cabinet (after the PM, Chancellor and Home Secretary) and should have a role to play in the EU exit negotiations.

However, with Machinery of Government (MOG) changes such as the transfer of the Foreign and Commonwealth Office's (FCO) EU-institutional teams to the Department for Exiting the EU (DExEU) it is unlikely that he himself will play a major role in the negotiations.

Instead the Foreign Office is likely to focus on:
1) the soft power campaign #GlobalBritain;
2) preparing the ground in the 27 EU capitals for the negotiations;
3) preparing the ground internationally for trade agreements with non-EU states following the UK's EU exit.

### DAVID DAVIS
**Secretary of State for Exiting the European Union**

Davis is listed as the 8th most senior member of the Cabinet. DExEU is charged with both "supporting" the negotiations to leave and to establishing the future relationship between the EU and the UK.

DExEU & the UK's Permanent Representation to the EU will be in charge of the day-to-day, dossier-by-dossier operational-level negotiations. The department is currently housed within the Cabinet Office – and includes 50 staff on loan from the Foreign and Commonwealth Office. It is expected to grow to around 400 by the end of the year and get its own building in Whitehall.

This displacement, plus the PM's desire not to invoke Article 50 until "early 2017", could mean little is done over the remainder of 2016.

### LIAM FOX
**Secretary of State for International Trade**

Fox is listed as the 9th most senior member of the Cabinet. His department has two functions:
1) "developing and negotiating free trade agreements with non-EU countries"; and
2) providing support for UK exports and facilitating inward investment. However, given that EU treaties explicitly prohibit EU member states from negotiating trade arrangements with third countries, and the fact that some partner countries are already negotiating deals with the EU (e.g. the US with the Transatlantic Trade and Investment Partnership (TTIP)) it is unclear to what extent third states would be willing to engage in meaningful negotiations with the UK at this stage. The Department for International Trade (DfIT) is likely, when fully staffed, to constitute approximately 50 trade officials (in the FCO's building in Whitehall) and 2,330 export and investment officials in 140 countries.

## 3. THE EU OFFICIALS

### MICHEL BARNIER
**European Commission**

Barnier has been appointed as the Chief Negotiator for the European Commission by Commission President, Jean-Claude Juncker. This means that he will be in charge of the European preparations and the eventual negotiation process once Article 50 is invoked.

The negotiations will range from the UK's withdrawal from existing policies such as the Common Agricultural Policy and the Common Fisheries Policy to the engagement of British troops in Bosnia. The area that has received most media coverage has been the UK's future trade relationship with the EU. It remains to be seen whether the UK replaces EU membership with alternative membership such as the Customs Union/ the European Economic Area/ the European Free Trade Area.

### DONALD TUSK
**President of the European Council**

Donald Tusk, as the President of the European Council (the body that brings together the 28 Heads of State and Government), will be a key figure in the EU exit negotiations – as indeed he was for David Cameron's pre-Referendum negotiations.

Article 50 of the Lisbon Treaty currently says that it will be the European Council that will 'conclude' the agreement that sees the UK leave the EU. Hence Tusk is likely to be central in marshalling the different views of the 27 Heads of State and Government.

### MARTIN SCHULZ
**President of the European Parliament**

The Lisbon Treaty stipulates that the Council will conclude the exit agreement only with the 'consent of the European Parliament'. As such, Martin Schulz, the German Social Democrat and President of the European Parliament, will be a prominent figure, albeit one not involved in the daily negotiations.

Guy Verhofstadt will be more involved on a day-to-day basis. There is a hope in Brussels that full UK withdrawal from the EU can be achieved before European Parliamentary elections in May 2019. This would ensure that there would be no elections for the 73 UK Members of the European Parliament; and clarity on how many MEPs will constitute a majority for the full term of the next European Parliament (2019-2024).

# Macro-economic and market update

**Even during the supposed summer lull, there was no shortage of activity. The decision of the Bank of England to cut interest rates, alongside other easing measures, raised the question of whether the UK Base Rate could soon move negative and whether the effectiveness of monetary easing is close to its limit. Away from the UK, a big fiscal announcement in Japan and a surprisingly strong US employment report also helped shape market sentiment.**

ADAM CHESTER

Head of Economics,
Commercial Banking

The first post-Referendum 'official' data releases were published in mid-August. At first glance, they suggested that the UK economy was continuing to tick along nicely. For sure, the surge in retail sales and fall in claimant count unemployment in July were reassuring. But it was still early days and monthly data can be volatile. Moreover, there was little concrete information on how business investment or external trade were faring, and the pound's decline would still take months to fully feed through to inflation and real income.

Global financial market sentiment has taken a turn for the worse, following the European Central Bank's decision to keep rates on hold (8 September) and some hawkish comments from US rate-setters ahead of the key Fed meeting. It seems markets are getting nervous about just how much longer the world's central banks will keep the punchbowl out. Adding to the general sense of policy unease was the decision of the European Central Bank to keep policy on hold. Despite revising down both its GDP growth and inflation forecasts, the ECB felt no further policy stimulus was needed – at least for now.

## Hot Topic: Interest Rates – How much more can the Bank of England do?

The early August stimulus package from the Bank of England was widely covered, but to recap: Base Rate was cut for the first time in seven years to a new low of 0.25%; the Bank also cranked up its printing press, creating £170bn of new central bank money. This will be used to purchase an additional £60bn of government stock and £10bn of corporate bonds, while around £100bn was earmarked to provide cheaper funding for banks and strengthen the pass-through of the rate cut.

Advocates of monetary policy easing greeted the Bank's latest stimulus announcement as a welcome shot in the arm at a time of significant economic uncertainty. But the growing army of detractors argued that it was at best symbolic and, at worst, fuelling asset bubbles.

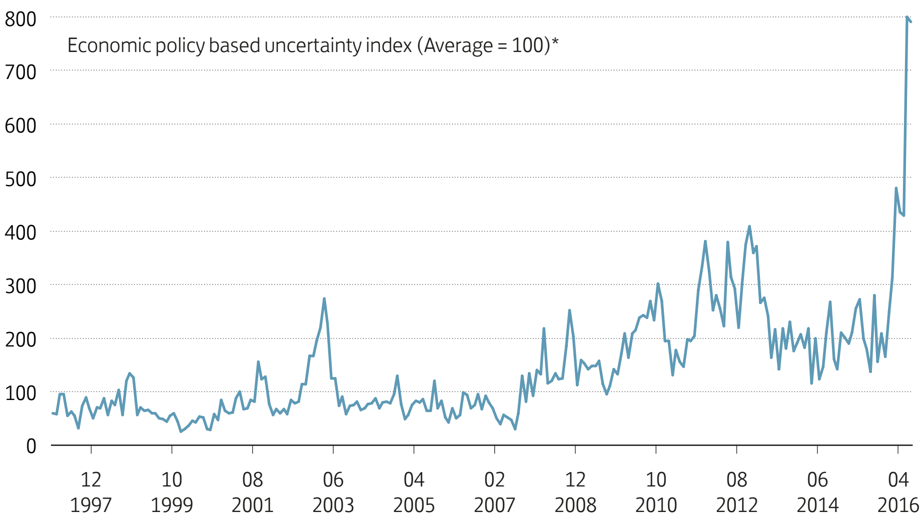
Even members of the Bank's own monetary policy committee seemed split on this issue. While there was unanimous support for the rate cut, three of the nine-member panel voted against the additional government bond purchases. Still, the Committee has hinted strongly that it intends to cut interest rates again over the coming months to just above zero percent. Inevitably, such a move would fuel speculation that Base Rate may move negative. We, and more importantly the Bank of England, see this as highly unlikely.

Mark Carney stressed that a rate just above zero is now considered to be the effective

## AT A GLANCE

- UK retail sales are up over July and August, while claimant count unemployment was broadly flat over the two months
- UK inflation also edged higher, supported by food and fuel costs
- UK August manufacturing & services PMIs rebounded to pre-referendum levels. Strong UK data led to a rally in the pound
- Mixed signals from US rate-setters suggest no consensus for a September hike
- Soft data but hawkish Fed comments left US markets guessing on prospect of September tightening
- UK industrial production rises by 0.1% in July, but manufacturing output contracts by 0.8%.

**SHARP RISES IN UNCERTAINTY TEND TO PRECEDE ECONOMIC DOWNTURNS**




*The number of news articles containing the terms uncertain or uncertainty, economic or economy, and one or more policy-relevant terms, such as policy, tax spending, regulation, central bank, budget or deficit.

Source: Haver Analytics LBCB Data Analytics (08/08/16) floor. There are good reasons why rates are likely to remain above zero. Not least, managing the smooth function of the financial system becomes more difficult in a negative rate environment, as depositors always have the option of holding their money as cash. In theory, this poses a lower bound on how low rates can go.

The Bank of England has repeatedly acknowledged that monetary policy has its limits. It's a policy geared towards stimulating demand. It can do very little to induce the supply-side changes required to boost productivity and drive sustainable improvements in output. This is the job of government and fiscal policy. Still, the Bank of England has not ruled out further action. As the Governor noted, it has a suite of policy instruments it could still extend if economic conditions deteriorate, although cutting interest rates into negative territory is unlikely to be one of them.

That said, going forward the onus for stimulus is likely to shift increasingly to fiscal policy. The new Chancellor has already said that he is ready to 'reset' the government's economic policy and that he will take "whatever measures" are needed to shore up the UK economy. The focus now shifts to the Autumn Statement on 23 November to see just how much 'heavy lifting' the Chancellor is prepared to do.

## Hot Topic: Will inflation prevent further rate cut?

The impact of sterling's over 10 per cent fall since the Referendum result has yet to be felt fully in consumer prices. Annual CPI inflation edged up to 0.6% in August from 0.5% in June, supported by higher food and fuel costs which are expected to feel the brunt of the weaker pound first. However, 'core' inflation, which excludes food and energy, actually slipped back to 1.3% from 1.4%.

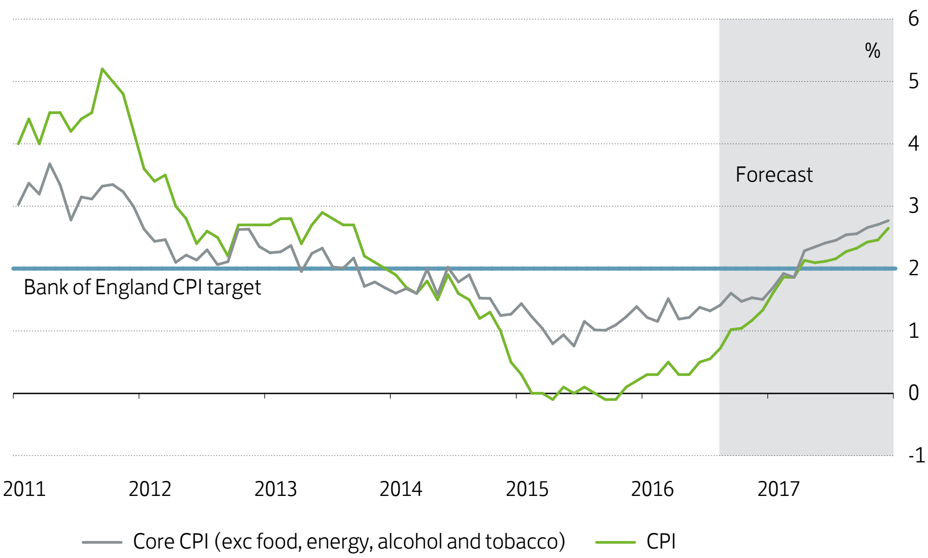
The important point, though, is that the effect of the weaker pound will continue to feed through to higher import prices and broader consumer prices in the coming months. Indeed, the recent recovery of oil prices combined with mounting downward pressure on sterling means the pickup in UK inflation is going to be sharper than in our previous forecasts. We envisage an overshoot of the 2% target for CPI by the spring of next year – see chart.

The important question is how policymakers will react to this expected overshoot. Will the Bank of England raise interest rates to counter higher inflation or cut interest rates further to offset weaker economic growth? Well, we know the Bank of England has already cut its policy rate to a new record low of 0.25% on 4 August. It also restarted asset purchases to drive longer-term interest rates lower (including corporate bond yields) and introduced a new Term Funding Scheme to encourage banks to pass on the policy rate cut.

Higher inflation in the coming quarters will weigh on household real income. The potential for higher unemployment as the economy slows would not help but, even in its absence, real consumer spending will still suffer. While the 2% inflation overshoot may persist for some time, it won't be permanent, as decelerating growth pushes inflation back down.

The upshot is that the Bank of England will probably not respond to what is expected to be a temporary inflation overshoot by raising interest rates. Quite the reverse, we think they could cut interest rates again this year on signs that the sterling-induced rise in headline inflation will drag consumer spending and therefore overall economic growth lower.

**UK INFLATION FORECAST TO OVERSOOT THE 2% TARGET IN SPRING 2017**




Source: Lloyds Bank Data Analytics (22/08/16)

Judging by the latest bounce in business confidence, the UK economy is holding up remarkably well

## Hot Topic: Money growth surges

**Amid all the excitement about the rebound in some of the business surveys in August, another development which may help inform the post-Referendum debate has gone largely unnoticed. That is the Bank of England's latest money supply figures for July. According to their latest statistics, its preferred measure of the money supply (M4 excluding 'intermediate other financial companies') surged by a three-month annualised rate of 14.7% in July. This was the largest rise on record (see chart).**

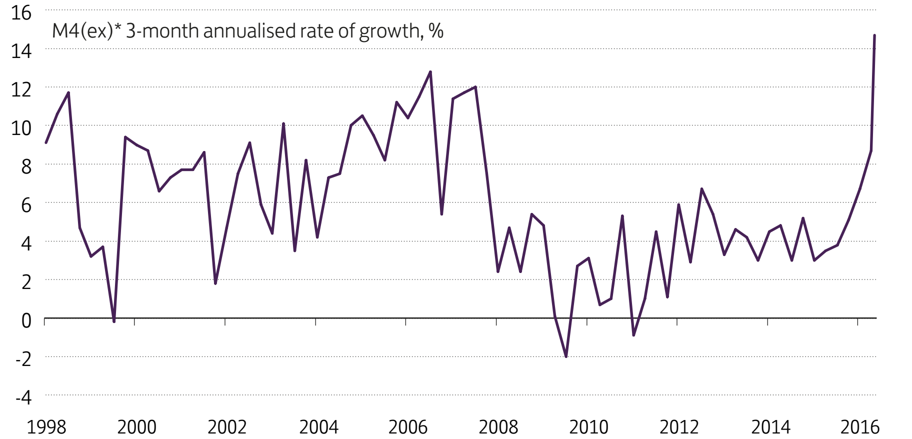
It may be that the latest data is a quirk due to shifts in financial transfer payments around the Referendum. In the past, intergroup transfers between banks and non-deposit taking entities have caused big shifts in the money numbers - albeit not on this scale. However, as the chart shows, money growth has been heading north for some time. The improved health of the banking sector, the unprecedented reduction in UK interest rates and the BoE's money printing have all contributed.

So what are the potential ramifications of this? It will depend on how quickly households or businesses spend the money. Over the past twenty years structural changes in the banking system have led to a marked fall in the velocity of money. This drop appears to have continued after the 2008/09 financial crisis as households and businesses have sought to build up their savings.

Given the uncertainty over the economic outlook, there are good reasons why the speed limit for money may remain low. Nonetheless, the recent surge raises the question of whether or not the Bank of England may be overcooking the stimulus. Not only is it contributing to a potentially unsustainable rise in financial asset prices, but it also runs the risk of stoking inflation if, or when, the uncertainty recedes.

The Bank of England's preferred measure of money supply growth has surged in recent months, raising doubts about whether further stimulus is needed

**MONEY SUPPLY POSTS BIGGEST RISE ON RECORD**




*M4 (ex) is the main measure of the UK money supply, comprising cash in circulation and private sector bank accounts, excluding those of intermediate 'other financial companies'

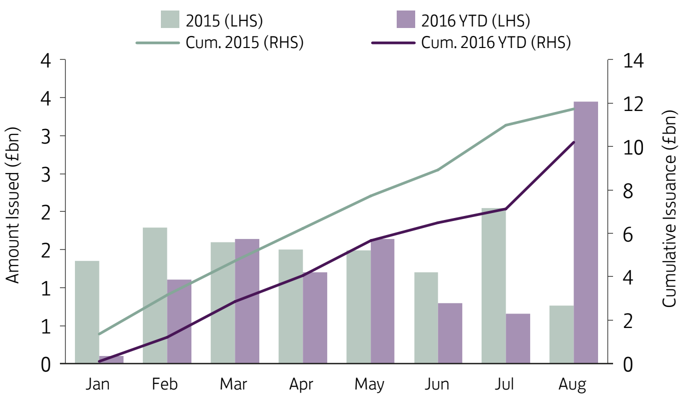
Source: Bank of England; LBCB Data Analytics (09/09/16)

# Update on sterling debt issuance

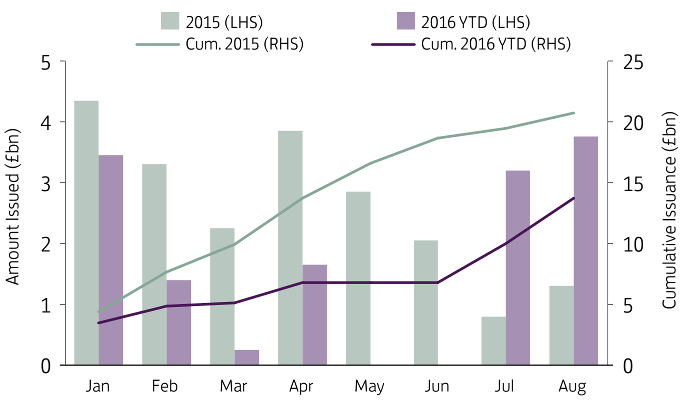
**August is traditionally a very quiet period in the European bond markets, trumped only by the Christmas week. This year however is entirely different, particularly in sterling, where issuance levels have already surpassed the highest seen in any month this year. The vote to exit the EU set in train a series of events – reduced business confidence, market volatility and political uncertainty – which led to the Bank of England putting in place a number of measures to support the market.**

Both the timing and the magnitude of the actions taken by the Bank of England resulted in a significant shift in market sentiment. Yields fell further, and are now trading at historic lows. At the same time, credit spreads moved sharply tighter with virtually all borrowers now enjoying a lower implied credit risk than they had before the Referendum. This has resulted in many issuers accelerating their borrowing plans to lock in at the current low rates.

### CORPORATE GBP ISSUANCE




### FIG GBP ISSUANCE

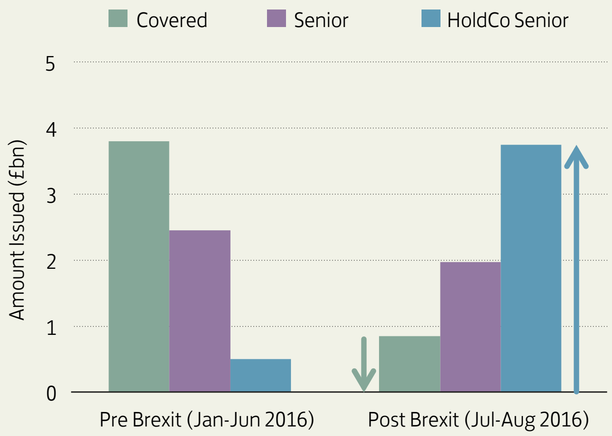



The sterling market, when compared to those for euro or US dollars, is not seen as being deep in terms of liquidity. The Bank of England's intention to purchase bonds in the secondary market has injected the market with liquidity as investors seek to recycle their capital from older bonds into more recent transactions. Previous limitations of funding in sterling are yet to emerge with transaction sizes as large as £1 billion and still no sign of investor appetite dissipating.

## Record Breaking Coupons

Immediately post the Referendum, client engagement was very high which allowed some immediate opportunistic funding. As detailed below, the first mover was BAT which priced a £500m 5-year bond with a coupon of 1.75%, their lowest sterling coupon by some margin. Shortly thereafter, Swan Housing was at the other end of the spectrum in terms of duration, pricing a 32-year transaction at a yield of 3.33%.

Subsequently, supply has been very strong as issuers with ability to raise funding across the global markets selecting sterling as their currency of choice. Lloyds Bank worked with both Heathrow (£400m 33-year at 2.75%) and BP (£650m 7-year at 1.177%) to execute their first funding exercises post the Referendum. Other issuers include BMW (£600m 6-year at 0.875%) and Vodafone (£800m 33-year and £1 billion 40-year at 3.375% and 3.000% respectively).




- £ issuance during Jul-Aug is almost equal to Jan-Jun issuance
- Strong performance of £ has led to uplift in holdco £ senior issuance.

# Client reactions to the vote

## Post Referendum Reactions

**To many people the result of the EU Referendum in June came as a surprise. The initial reaction was most clearly manifested in the volatility caused in the financial markets, especially in those for foreign exchange. The impacts are explored in other sections of this document.**

Since the initial market activity, attention has expanded to a broader set of reactions, from the business community and from consumers, and the way they are picked up through a range of economic and confidence indicators. Furthermore, as a bank at the heart of the UK's business sector, we are in the fortunate position of hearing direct feedback from an extremely wide range of clients.

### SURVEY DATA

Recent survey data are mixed. In the immediate aftermath of the Referendum, the UK Purchasing Managers' Indices, the GfK Consumer Confidence survey and the Lloyds Bank Business Barometer all showed steep declines which rebounded with varying degrees of rigour.

The PMI figures were particularly encouraging as the Servicing and Manufacturing Indices returned to pre-referendum levels. However, despite a healthy bounce in both the business and consumer confidence indices, there is still evidence of a downward trend. This is particularly clear in the Lloyds Bank Business Barometer, which fell back again slightly at the end of August.

### CLIENT FEEDBACK

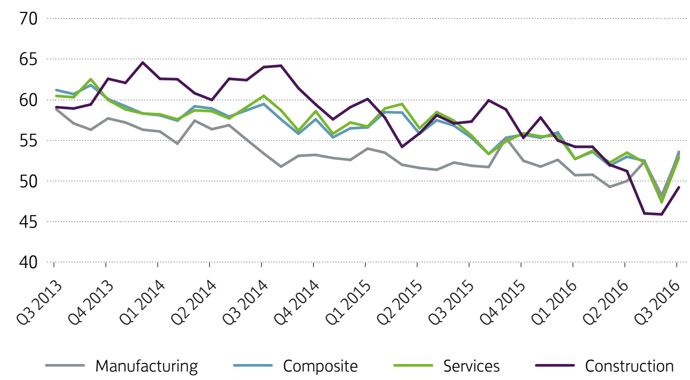
Based on the feedback we have received, many firms feel they are experiencing the impact of post-referendum market movements or monetary policy reactions rather than the prospect of the EU exit itself – second or even third order effects. There is wide acknowledgement that this phase may last for a couple of years or more until the ultimate design of the UK's future relationship with Europe and the rest of the world becomes clear. Many businesses report a slow-down but this is not necessarily ascribed to a post-referendum malaise.

> "We're unsure whether the downturn is sector-related, Brexit-related or just a summer lull – we expect things to be clearer as we move into the 4th quarter"

**Client Feedback**

### SENTIMENT ACROSS ALL SECTORS BOUNCED STRONGLY FOLLOWING A POST-REFERENDUM DIP

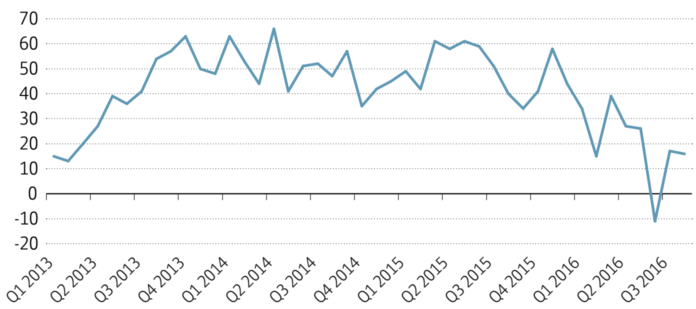
UK Purchasing Managers Index




Source: Markit/CIPS data as at 31/08/16

### AFTER A STRONG POST-REFERENDUM BOUNCE, BUSINESS CONFIDENCE HAS SLIPPED BACK

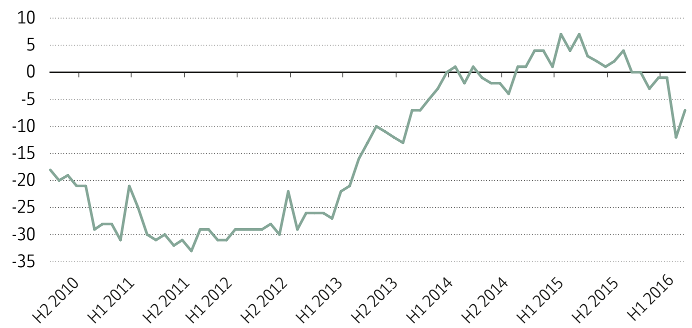
Lloyds Bank Business Barometer




Source: Lloyds Bank Commercial Banking analytics as at 31/08/16

### CONSUMER CONFIDENCE REBOUNDED BUT IS STILL IN A DOWNWARD TREND

GfK Consumer Confidence Index




Source: GfK Consumer Confidence Index as at 31/08/16

## Common Themes

### Foreign Exchange Rates

The fall in the value of sterling, most notably versus the euro or US dollar had a fairly obvious impact – making imports more expensive and exports apparently cheaper.

An interesting difference between sectors is the degree to which FX exposures are hedged – and if they are hedged, for how long? The timescale over which businesses had innoculated themselves against currency variations varies significantly by sector, sometimes due to the term of outstanding contracts, or perhaps limited by the potential variation of volumes. Consequently the longer term impact of the currency variation will emerge at different stages in different business areas as the hedging put in place unwinds. We highlight some of these sectoral differences over the page.

### (Much) Lower for (Much) Longer

The actions of the Bank of England on 4 August have made it clear that sterling interest rates will be 'lower for longer'. This is a repeated theme in discussions with clients, but again different sectors are affected in differing ways. The availability of cheap funding is encouraging businesses to bring forward their funding plans and facilitating acquisitions. But the ultra-low interest rate environment is challenging for investors in their various guises.

### Availability of Labour

Although in theory the true impact of any changes will only become clear once negotiations over the UK's future relationship with the EU are under way, several clients are already reporting changing sentiment on this front. Whether the concern is availability or cost of labour in the future or the treatment of EU nationals who are already working in the UK, this is a leading source of concern.

### Passporting and Regulation

Again this is a theme mentioned by all sectors, but with differing implications and assumptions. Everyone is concerned about the future market for their products or services. Some sectors assume that regulation will be maintained at a similar or even higher level to that in Europe, as a means of demonstrating equivalence. Other sectors are more confident that withdrawal from Europe will permit greater regulatory latitude.

Businesses are at varying stages of contemplating what such changes to access might mean for the location of their offices; some are already discussing contingency plans to relocate substantial parts of their business should they no longer have the access they need to European clients.

### Uncertainty

Most sectors report that even if their clients were surprised by the outcome of the Referendum they were relatively well positioned for the volatility which followed. The greatest challenge faced now is the degree of uncertainty regarding the ultimate outcome of the UK's negotiations. Most firms acknowledge that they will have to operate in an uncertain environment for several years. In the meantime, many are focussed on keeping their businesses lean, focussing on discretionary costs and efficiency, and leaving any longer term strategic decisions until there is greater clarity.

## SME, Mid-Markets and Corporates

**Credit debt spreads tightened significantly following the Bank of England action, reducing rates and announcing a corporate debt buying programme. Corporates have taken advantage of benign conditions, accelerating funding plans. BP issued sterling denominated bonds for the first time in 5 years.**

Initial business sentiment is mixed. The FX moves have had the most immediate impact, penalising importers and benefitting exporters, but some of these impacts are obscured by hedging. Many are concerned about market access going forward but appreciate that there is not a great deal which can be done now.

2H16 corporate reporting might begin to demonstrate the real short term impact more clearly. There is concern that existing pension scheme deficits may be exacerbated.

### MANUFACTURING

- More interest in exporting to Eurozone markets short and medium term
- Possibility of less onerous UK regulation going forward
- FX impact on imported materials costs
- Concern regarding the attractiveness of the UK as a destination for EU labour
- Some see EU exit as an opportunity to seek new external markets
- Evidence of capex decisions being delayed

**Main Concern: Access to markets and availability of labour**

### AGRICULTURE

- EU subsidies a major concern – currently ~34% of total UK farm income
- UK Government will maintain subsidies until 2020
- EU subsidies are paid in euro – have appreciated since the vote
- Without subsidies, some smaller family businesses are not viable
- What happens to food regulation post EU? What can be sold domestically and internationally?
- Dependent on seasonal EU labour

**Main Concern: Subsidies and availability of seasonal labour**

### PROFESSIONAL SERVICES

- Accounting / advisory firms already seeing business uptick
- Not much increase yet for law firms but more work expected to follow – including immigration law
- Ability to serve EU clients from the UK
- Mobility of existing staff – both in UK and Europe
- Data sharing across the EU is a significant issue
- Will English law still be the jurisdiction of choice for business transactions?

**Main Concern: Ability to serve EU clients and impact on existing EU staff**

### RETAIL, TRAVEL AND LEISURE

- Many Asian imports denominated in USD – some retailers hedged out to ~6 months but usually no further
- Grocers tend to hedge further out, 12-18 months, FX impact takes longer to emerge
- General merchandise operators most concerned about a consumer-led recession
- Travel firms exposed to USD fuel costs and USD/EUR accommodation commitments but some firms may benefit from increase in domestic tourism

**Main Concern: Impact on margins and potential consumer-led recession**

### ENERGY, UTILITIES & INFRASTRUCTURE

- Several major UK infrastructure projects have been delayed (Hinkley Point, HS2, new London runway)
- European banks requiring higher returns from UK I&E deals going forward
- Implications for EIB funding of infrastructure projects?
- Availability of labour for future large scale projects
- Investment decisions not being reversed, but new ones not being made

**Main Concern: Delayed spending commitment and availability of labour**

### CONSTRUCTION

- Highly dependent on infrastructure spending – possibly more clarity post Chancellor's Autumn Statement on 23 November
- Any restriction on foreign labour would be operationally challenging
- Concern that foreign workers may choose to leave UK if the economy stagnates or if sentiment towards them hardens

**Main Concern: Availability of labour and attraction of UK as a place to work**

## Financial Institutions

**Most large firms were extremely well prepared for the market volatility which accompanied the run-up to the Referendum and its aftermath. Flows in some businesses such as FX and equity trading have been extremely strong, with as much as 5x or even 7x the normal volume of trade being executed.**

However, there are challenges ahead. The primary concern is passporting – to what extent will businesses be able to execute across the boundaries of Europe in the post EU exit environment?

What changes will businesses need to make? The second immediate concern is the low interest rate environment. Whilst this is providing a good supply of funding and sterling weakness is facilitating M&A activity, the prospect of operating in a very low interest rate environment for a considerable period of time is challenging to many types of financial institution – to banks, insurance companies, pension firms and other institutional investors. The private equity funds appear alone in embracing the volatility.

### GLOBAL BANKS

- Clients were surprised and disappointed, but certainly ready
- Passporting and access key – US Banks if necessary will set up in Europe for some activities in order to retain access
- Several leading banks are rumoured already to have plans in place to relocate significant proportions of their UK-based operations to mainland Europe
- Frankfurt and Madrid named as potential destinations so far in addition to Dublin

**Main Concern: Passporting, market access and treatment of EU staff**

### UK-FOCUSSED BANKS

- Passporting is the overwhelming theme
- "Lower for longer" makes the business environment tougher
- Banks will likely remain under serious cost-cutting pressure
- No expectation of an easing of regulation when the UK leaves the EU
- "Step-change in morale for our EU colleagues"

**Main Concern: Passporting, market access and low interest rate environment**

### INSURERS

- Passporting an issue – e.g. US firms accessing Europe from the UK
- Insurers need to increase leverage – impact on solvency ratios
- Still able to access funding
- Dublin a possible contingency location for firms with displaced activities

**Main Concern: Passporting and interest rate environment**

### PENSION FUNDS

- Global investment yields depressed
- Issues compounded by BoE action – particularly acute in Gilts
- Access to repo continues to be difficult
- Existing fund deficits exacerbated

**Main Concern: Interest rate environment and market liquidity**

### PRIVATE EQUITY / FINANCIAL SPONSORS

- EU exit dislocations provide opportunities – sector is buoyant
- Able to react speedily – fleet footed and have capital committed
- The best funds are still able to raise money
- PE funds one of few remaining sources of yield
- Approximately 25% of UK PE employees are EU nationals – future treatment of these staff very important
- Will relocate if it makes economic sense

**Main Concern: Market access**

### ASSET MANAGERS / INSTITUTIONAL INVESTORS

- Passporting matters – where will they be able to market their funds?
- Many suggesting they will relocate at least part of businesses to Europe
- "Dublin looks like a good option – low tax, English speaking, rebounded well from credit crunch, good work force"
- Planning difficult due to uncertainty
- Medium term concerns are the future of UK regulation and the UK economy

**Main Concern: Passporting and dealing with uncertainty**

£

# Opportunities to support trade development

**Since June, the outcome of the EU Referendum has dominated the headlines – and the thoughts of financial services professionals worldwide. Although the historic vote to leave the EU may have presented some organisations with challenges, Adrian Walker, Managing Director of Global Transaction Banking at Lloyds Bank, believes there are opportunities for financial institutions to work in partnership to support the future of British trade across the globe.**

Collaboration will need to function across a number of areas: service excellence, credit appetite, documentation negotiation, funding support, and FX.

**In the wake of the EU Referendum result, one thing has remained a constant for the British economy: uncertainty. At a time when economic recovery was starting to show promise, Britain voted to leave the European Union, its largest trading partner, and now faces negotiating a withdrawal.**

Aside from the initial impacts on exchange rates, stock markets, and interest rates, one of the most significant challenges facing both financial institutions and their corporate clients is that the view of the future remains opaque. It is still unclear for instance, when Article 50 will be invoked and what the UK's exit strategy will look like. Only as negotiations start to unfold will this picture become clear.

## ADDITIONAL CHALLENGES

Compounding the uncertainty, some, including the Financial Policy Committee, see the present high level of the UK's current account deficit as a potential source of risk (Figure 1). Perhaps reflecting this and the level of uncertainty, the Pound is at a 30-year low against the US dollar. To help mitigate some of the risks in the economic outlook the Monetary Policy Committee has reduced interest rates to an all-time low of 0.25%.

Although the picture might appear somewhat challenging, there is often opportunity to be found. As has been widely discussed in the press, with a fall in the Pound, British goods and services are becoming less expensive – and therefore more attractive – to companies and consumers around the world.

This is an excellent opportunity for UK businesses to export – either for the first time, or expand into new markets as part of an existing overseas strategy. At Lloyds Bank, our vision is to 'Help Britain Prosper, Globally'. As a major UK financial institution, we are committed to facilitating British trade both now and in the future.

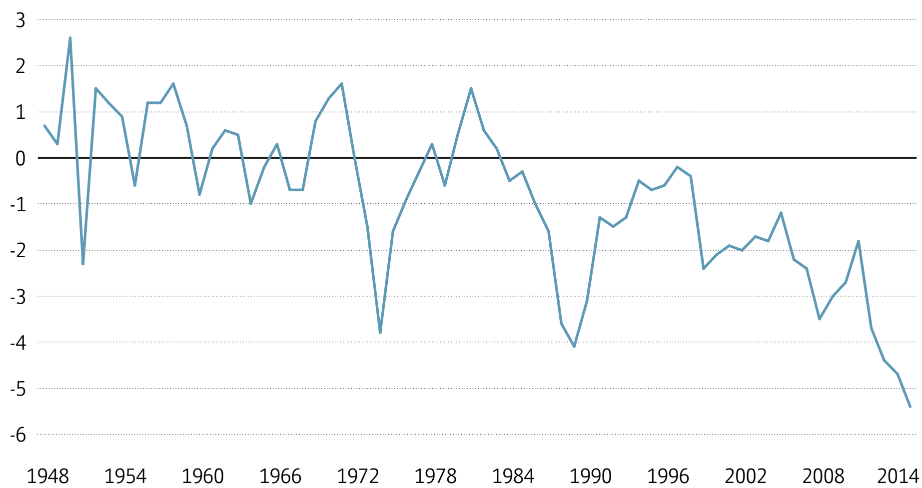
## WORKING TOGETHER

One of the key ways that UK banks, including Lloyds Bank, are looking to accomplish this is through strategic partnerships. Not only with bodies such as Britain's new Department for International Trade, but also through a network of trusted partner banks across the globe.

As such, British financial institutions may increasingly look to establish new partnerships and reinforce existing working arrangements with banks worldwide in order to support their corporate clients as they export into new territories. Such collaboration will need to function across a number of areas including service excellence, credit appetite, documentation negotiation, funding support, and foreign exchange (FX). Inevitably, companies looking to expand their export base may come up against challenges at each step of the value chain, and will require support to overcome them.

This could give rise to numerous partnership opportunities for UK and overseas financial institutions.

**Figure 1 BALANCE OF PAYMENTS CURRENT ACCOUNT BALANCE AS PER CENT OF GDP**




Source: Office for national statistics 'BOP: Current Account Balance as per cent of GDP – July 2016'

**Take a typical manufacturing value chain (Figure 2), for instance. At each of the five steps, UK banks and overseas partner banks will be able to work together to help British exporters settle payments, take advantage of currency movements, reduce risk, and maximise working capital in a post-Referendum world, while maximising business opportunities. Let's take a closer look at each of those five steps.**

Figure 2 **MANUFACTURING VALUE CHAIN**


### 1. TENDERING/NEGOTIATING CONTRACTS

With the euro having strengthened against the Pound and the Dollar, European buyers and those further afield are likely to be hungry for high-quality British exports.

This is where financial institution partnerships that cover a range of different geographies will become even more important for the future of British exports. For example, while traditional trade instruments, such as tender guarantees and performance guarantees could help corporates boost their attractiveness to existing and prospective overseas buyers (and are therefore likely to be in growing demand), UK banks will require the support of local partner banks to issue these guarantees in-country.

Additionally, supporting the beneficiary's needs across the globe will necessitate the expertise and coverage of a network of partner banks. This creates a win-win situation for partner banks as working with UK financial institutions and their clients will lead to new business opportunities.

### 2. SOURCING OF INPUTS

Due to their often globalised supply chains, British companies ramping up their export activities are likely to see an increased requirement to bring goods and inputs of production into the UK. To manage supplier performance risk, especially as these companies look further afield for new inputs, they are likely to use products such as Import Letters of Credit (LCs), Guarantees and Standby LCs. In order to be delivered globally, such instruments require strong collaboration between partner banks. Financial institutions also play a key role in jointly ensuring that working capital is optimised for both buyer and seller.

Clients may also increasingly look to use solutions such as Supplier Finance or Bills of Exchange to help bolster suppliers' working capital and underpin sourcing. This will drive a growing requirement for UK banks to on-board suppliers globally, as well as making payments into new geographies, and mitigating risk – all of which will require the assistance of a worldwide ecosystem of local partner banks.

### 3. MANUFACTURING

Productivity is a crucial consideration for British companies looking to remain competitive in the wake of the EU Referendum. As new technologies such as 3D printing and additive manufacturing become more accessible, there will be a number of companies considering reshoring their manufacturing activities, especially as the cost of off-shoring goes up. Implementing a reshoring strategy will of course require significant capital expenditure, which may also include importing equipment from overseas. However, with interest rates at an all-time low, it's a great time for British companies to be investing.

As well as driving a flow of Import LCs out of the UK, this increased capital expenditure will bolster the requirement for overseas suppliers to access working capital by discounting receivables and bills of exchange from UK corporate buyers, via their own local banks. Consequently, UK banks, such as Lloyds Bank, have the necessary appetite to support these local banks, either by participating in the UK corporate buyer's risk or providing Bill Avalisations. Additionally, for companies looking to manage their working capital when making significant equipment and machinery purchases, there may be a need for bank syndicates to form in order to support asset-backed lending.

### 4. SHIPMENT/SALES

Understandably, clients considering opportunities with new buyers or in new markets will be looking for support to assess and mitigate risks. As a result, we will likely see more Import LCs being requested by UK exporters to manage buyers and/or sovereign risk. This will not only drive UK LC flow, but also increase traditional trade business for overseas banks, in particular those in close partnership arrangements with UK financial institutions.

### 5. SERVICING/AFTER-SALES

This final part of the value chain can be an important differentiator for overseas companies looking for new UK suppliers. By facilitating the delivery of excellent after sales support, through the provision of a warranty guarantee issued by a local partner bank, for instance, financial institutions can work together to help give British exporters a competitive edge in overseas negotiations.

At Lloyds Bank we are committed to facilitating British trade, both now and in future

## A BRIGHT FUTURE

In summary, by working in partnership to facilitate safe and efficient international trade, financial institutions are in a position to Help Britain Prosper, Globally, and to generate new business opportunities both at home and overseas across traditional trade, open account and FX. We at Lloyds Bank are looking forward to playing our part in helping our clients grow and prosper in this new paradigm.

# Alternatives models of relationship with the EU

**No member state has ever left the EU. For this reason 'Brexit' is an unknown, the nature of which cannot be predicted accurately. Law firms, economists and political commentators commonly refer to a framework, similar to that we have reproduced on the next page, which looks at possible scenarios. Trade agreements are the key driver, which in turn define the degree of harmonisation, or separation, between a non-EU member state, and the EU. Predictably, there is much debate about which outcome is most likely. Several of these scenarios align well to the aims of the 'Leave' campaigns, but each involves trade-offs. Fundamentally, any negotiation involves two parties, and it is unclear what terms the EU would accept, given the UK's decision to leave.**

## Existing alternative arrangements in Europe

### 1. FULL MEMBERSHIP OF THE EU

The European Union currently comprises the 28 member states who all commit to the terms of the various European Treaties. However, there are other groupings within Europe who may share similar principles, but slightly differing rules.

### 2. EFTA AND THE EEA

EFTA is the European Free Trade Association. The members of EFTA are Liechtenstein, Iceland, Switzerland, and Norway. EEA is the European Economic Area. The EEA comprises the 28 member states of the EU and 3 of the members of EFTA. Switzerland is not a member of the EEA. The EEA was formed by the Agreement of the European Economic Area (EEA Agreement) which came into force on 1 January 1994.

The EEA Agreement is concerned principally with the four fundamental pillars of the Single Market, known as "the four freedoms" – movement of:

- goods
- persons
- services
- capital

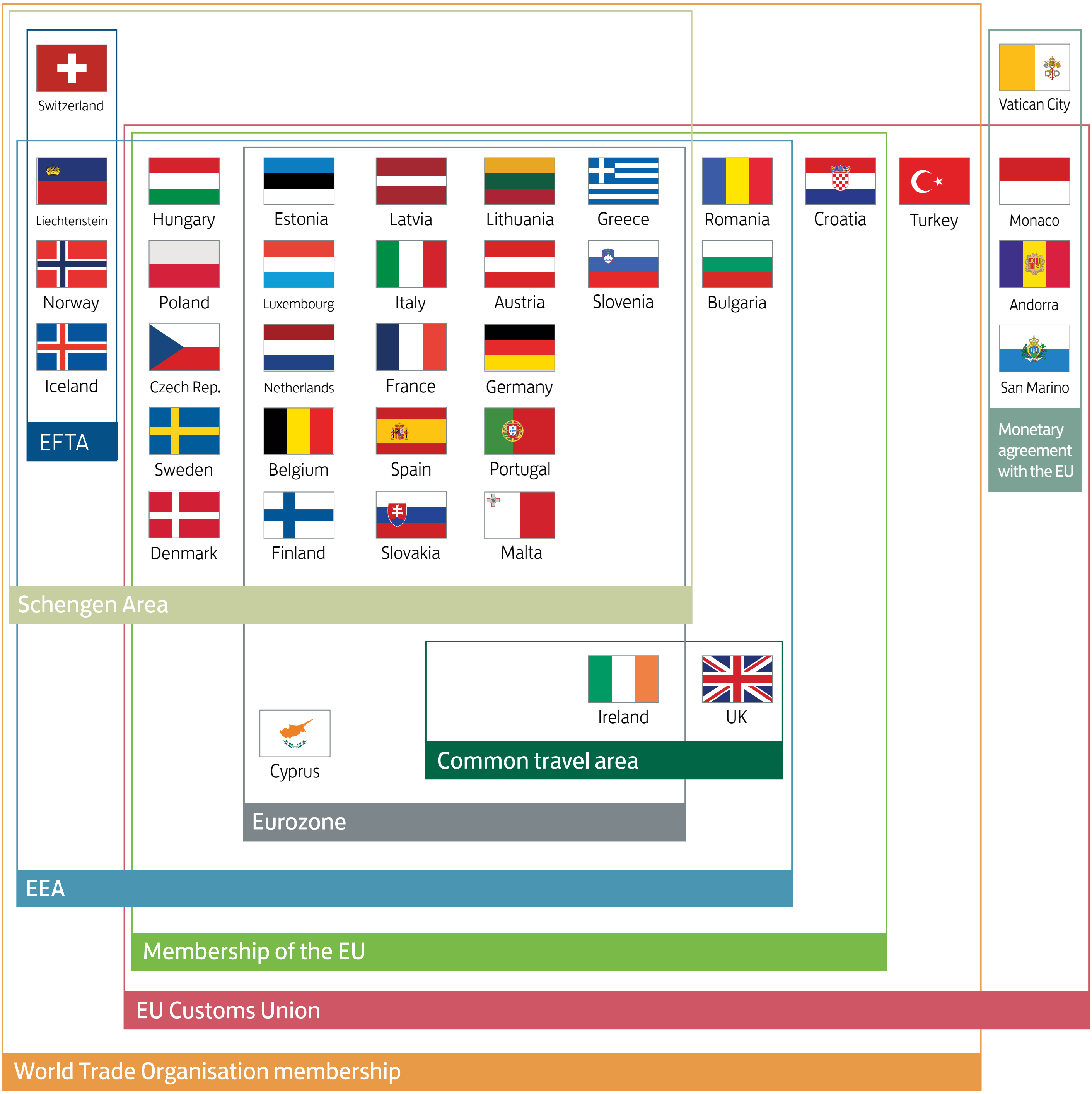
Predictably, there is much debate about which outcome is most likely. Several of these scenarios align well to the aims of the 'Leave' campaigns, but each involves trade-offs.

All members have free access to the Single Market. However, the EFTA-EEA members (Liechtenstein, Iceland and Norway) have no right to vote on EU matters.[2]

The EEA Agreement does not cover Common Agriculture and Fisheries policies, Monetary Union, or a Customs Union[3] and EEA-EFTA members also make financial contributions (reduced in comparison to full members).

Source: 2 Europa, EU Relations with European Economic Area (EEA)
3 EFTA, EEA Agreement

## Selected European organisations and treaties



> Migration and border controls were arguably the most contentious issue of the 'Vote Leave' campaign.

## Migration and safeguard measures

**Migration and border controls were arguably the most contentious issue of the 'Vote Leave' campaign. Although there is limited value in speculating on the future model of the UK's relationship with the EU, many assume that the UK could only subscribe to a future model which provided sovereignty over border controls. This is assumed, therefore, to exclude membership of EEA-EFTA, given the importance of "the four freedoms".**

However, the issue is more complex. Under Article 112 of the EEA Agreement [4] all signatories to the agreement (EU member states plus Liechtenstein, Norway and Iceland) are allowed to implement "safeguard measures".

So far, safeguard measures have been invoked twice:

### LIECHTENSTEIN

- is a member of EFTA
- is not a member state of the EU
- is a member of the Schengen Area and the EEA
- has a monetary and customs union with Switzerland

Liechtenstein has access to the Single Market. However it also has a quota on migration of workers from EEA countries. Liechtenstein has implemented a migration quota which has been in place since 1995.[5]

### ICELAND

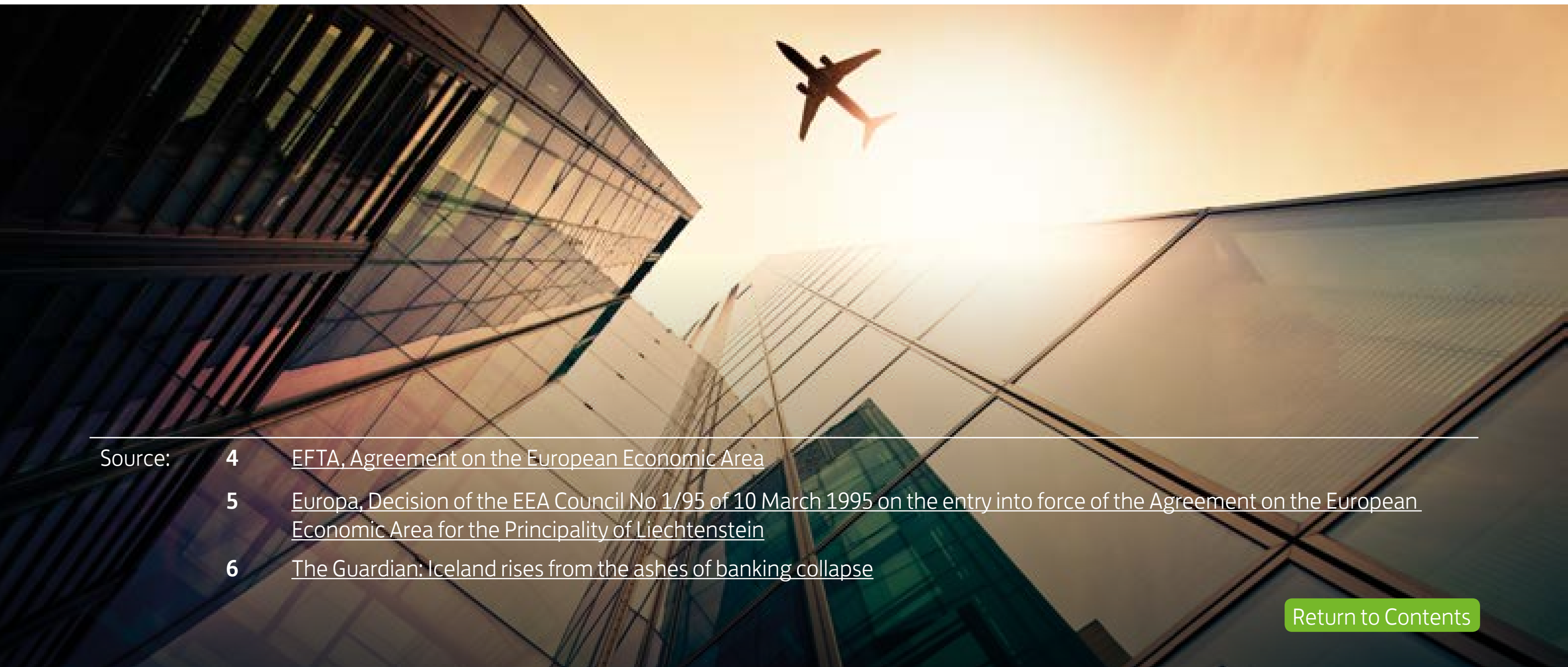
The other incident of safeguarding measures was when Iceland unilaterally implemented a freeze on the free movement of capital in the wake of the 2008 financial crisis.[6]

### JUDGEMENT OF EEA COUNCIL ON LIECHTENSTEIN[5]

The EEA Council agreed the quota on the following grounds:

The EEA Council recognises that Liechtenstein has a very small inhabitable area of rural character with an unusually high percentage of non-national residents and employees. Moreover, it acknowledges the vital interest of Liechtenstein to maintain its own national identity.

The EEA Council agrees that in the context of the review of the transitional measures provided for in the EEA Agreement, account should be taken of the elements which, according to the Declaration by the Government of Liechtenstein on the specific situation of the country, might justify the taking of safeguard measures by Liechtenstein as provided for in Article 112 of the EEA Agreement, i.e. an extraordinary increase in the number of nationals from the EC member states or the other EFTA States, or in the total number of jobs in the economy, both in comparison with the number of the resident population.



Source:

4 EFTA, Agreement on the European Economic Area

5 Europa, Decision of the EEA Council No 1/95 of 10 March 1995 on the entry into force of the Agreement on the European Economic Area for the Principality of Liechtenstein

6 The Guardian: Iceland rises from the ashes of banking collapse

Return to Contents

## Possible Alternative Models: increasing degrees of separation from the status quo

| | | 1.Membership of the EU | 2. EEA (e.g. Norway) | 3. Bilateral agreements with Non-EEA nations (e.g. Switzerland) | 4. Free Trade Agreement (e.g. South Africa) | 5. Customs union (e.g. Turkey) | 6. World Trade Organisation: Most Favoured Nation status (e.g. Australia) |
|---|---|---|---|---|---|---|---|
| **Trade with EU** | Freedom from external tariffs? | Yes | Yes | Dependent on nature of the agreement (but central premise is no tariffs) | Partial | No | EU's Common External Tariff and substantial non-tariff barriers |
| | Full access to the Single Market | Yes | Yes | No guarantee of full access. Swiss precedent is free trade on goods but restrictions on exports of services | No – FTA on goods but not services | No full access, but can still trade | No full access, but can still trade |
| **Trade with Non-EU states & trade blocs** | Ability to negotiate trade with other non-EU nations | No | No | Yes | Yes | No | Yes |
| **EU legislative and regulatory compliance** | | Full compliance required, but ability to vote on legislation | Full compliance required, but reduced ability to influence development of legislation | Uncertain, but regulatory 'level playing field' likely to be required in order to access to the free market | Yes, theoretically, but regulations must be consistent with EU to access Single Market | No, regulations must be consistent with EU norms or membership suspended | No – full independence |
| **Autonomy over border controls** | | Free right of passage for citizens within Schengen area | Free right of passage for citizens within Schengen area | Uncertain | Yes | Yes | Yes |
| **Receipt of Common Agricultural Policy subsidies** | | Yes | No | No | No | No | No |
| **Contribution to EU fiscal budget** | | Yes – full | Reduced contribution (83% of the full rate) | Reduced contribution (e.g. Switzerland is 52% contribution of the full rate) | No | No | No |

**Source:** Lloyds Banking Group analysis.
**Note:** in Scenarios 5 and 6, although nations in these scenarios do not have full market access, they are not prohibited from trading with EU nations.

# Possible implications for EU legal and regulatory regime

**Law firms have been sharing impact analysis, thought leadership and contingency planning material on the Referendum. Links are provided to some of this analysis at the back of this document. We have provided a brief summary of some of the key findings from the legal material which may prove useful (though does not constitute, and is no substitute for, formal advice from qualified legal advisors).**

## Legislation

Three main types of legislation operate in the EU: Treaties, Regulations, and Directives.

**EU Treaties** are binding agreements between EU member states. These would no longer apply if the UK was no longer a member.

**Regulations** are binding legal instruments which are applied directly across all EU member states. Existing Regulations may no longer apply in the UK unless specific legislation is adopted in the UK to maintain them.

**Directives** do not automatically pass into UK legislation, they need to be transcribed into national law by the respective parliament. In the event that the UK leaves the EU, the domestic legislation passed as a result of Directives would continue to apply.

**Case Law:** In the event of an exit from the EU, the UK may no longer be under obligation to apply EU jurisprudence. Even if the UK retained some EU legislation following exit negotiations, there is a possibility that the UK may not be bound by the EU Courts of Justice. However, the UK Parliament has an option to pass legislation that ensures all existing EU legislation is in effect until each piece of legislation is amended or repealed for the UK.

| Status Quo | EEA | FTA |
|---|---|---|
| **Treaties (both EU treaties and where the EU is a signatory, e.g. trade agreements)** | ▪ Only EFTA free trade agreements apply<br>▪ Other Treaties cease to apply | ▪ Treaties cease to apply |
| **EU Regulations** | ▪ Regulations under the EEA Agreement still apply<br>▪ Regulations not under the EEA Agreement cease to apply | ▪ Regulations cease to be part of UK law, unless specifically transposed and any associated guidance ceases to apply |
| **EU Directives transposed into UK law** | ▪ Required to retain Directives that apply under EEA Agreement | ▪ Directives continue to apply unless repealed but associated guidance ceases to apply |
| **Case law of the Court of Justice of the EU (CJEU)** | ▪ Case law of EFTA Court replaces that of CJEU, but it is largely aligned. CJEU case law applies so far as it has been implemented by the UK courts (but can now be overridden by UK courts and parliament) | ▪ Assumption that CJEU case law applies so far as it has been implemented by UK courts (but can now be overridden by UK courts and parliament) |

## Possible implications for areas of UK law

**Capital Markets:** If the UK leaves EEA, the potential loss of 'passporting' would impact firms marketing to investors across EEA. The UK would need to secure some form of functioning of the capital market cross border.

**Data Protection:** Given limited push-back to date, it seems reasonable to expect the UK to continue to align to EU data protection regulations after an EU exit. Establishing equivalence in data protection regulations will be important to enable UK and EU firms to manage their data across borders effectively.

**Employment law:** UK employment regulation is determined partly by UK regulations, and through alignment with the EU's broader regime. The National Minimum Wage and rules regarding unfair dismissal were implemented locally. Most pension law, originally derived from the EU, has been enacted into UK law and would continue to apply.

**Health and Safety:** UK's Health and Safety at Work Act of 1974 and a range of EU directives determine the key obligations between employers and employees. Material deviations from EU standards are unlikely.

**Intellectual Property (IP):** If the UK leaves the EU, it would also no longer be a part of the future Unified Patent Court (UPC) system and Unitary Patent, which, from 2017, will manage the granting and enforcement of patents across the participating EU states. Existing European patents will not be impacted.

**Mergers and Acquisitions:** After an exit from the EU, transactions may require approval by both the European Commission and the UK's Competition and Markets Authority. Oversight by multiple regulators may introduce additional complexity and extend timescales for approval.

**Real Estate:** UK common law, which underpins real estate regulation in the UK, is determined domestically, so limited impact is anticipated.

**Tax:** VAT could be independently determined by the UK government after an EU exit. However, change in the short-term is unlikely. It is possible that an 'import' VAT levy may be imposed by the EU on UK imports, and vice versa. UK firms would no longer be covered by the EU Parent-Subsidiary Directive, with implications for the levying of withholding tax. The applicability of EU law and regulation after the UK's departure from the EU would be dependent on whether it derives from Treaties, Regulations, Case Law or Directives.

During the transition period once Article 50 has been triggered the UK remains part of the EU, and the current regulatory and legislative regime applies.

Under the EEA there is no expected material change in both financial and non-financial regulation, given the need for the UK to adhere to Single Market rules under an EEA agreement. The UK would have no direct influence over formulating /designing the rules going forward.[6] Under a Free Trade Agreement the regulatory void would need to be filled; although only limited regulatory changes would be expected given the UK's stance on financial regulation.

## Filling the void

Current EU Directives are already transposed into UK law, but EU Regulations and guidance (which today have direct effect) would need to be implemented into UK law in those cases where it is the intention of the UK Government that they should remain in place. There could be concern regarding the capacity of the UK authorities to address the void left by EU regulations swiftly given the scale of the challenge.

## UK approach to changes

The UK would enjoy a degree of flexibility that it does not currently have, but limited changes to the UK regulatory regime could be expected as part of this process because:

1. The UK is likely to continue to seek alignment to the Financial Stability Board (FSB) principles and guidance, with direction set by the G20 (UK is active in both forums).
2. Not unreasonable to expect continued preference of UK authorities for equivalence or super-equivalence (or 'gold-plating') of rules, based on past practice.
3. Access to the Single Market from a customer, payments/settlements and funding perspective is likely to hinge on a European Commission assessment of the UK regime's 'third country equivalence' to EU rules – so alignment to EU rules would be required in areas where this is considered advantageous, but there may be other areas where the UK chooses to adopt a different approach.

**Source:** The EEA Agreement sets out policy areas where EU legislation applies to EEA member states, notably all policy areas for the Single Market (including the "four freedoms", consumer protection and company law). Policy areas not covered include customs union, common trade policy, common foreign and security policy, direct and indirect taxation, economic and monetary union.

# Third country equivalence in financial services regulation

32

countries have had equivalence recognised in at least one area of regulation

90

difference equivalence decisions granted for Articles under the Capital Requirements Regulation (CRR)

173

different equivalence decisions have been taken by the European Commission so far (to 5th July 2016)

**A key focus for many firms in the financial services industry, and firms across the UK more broadly, is access to the European Single Market. We consider here the concept of third country equivalence, the demonstration of which is often key for entities based in nations which are not members of the EU or EEA seeking access to the Single Market.**

In certain cases, the EU may recognise that a foreign regulatory regime is equivalent to the corresponding EU framework though this isn't always straight forward or easy to achieve.

In a case where equivalence is successfully agreed, the EU will rely on an entity's compliance with the equivalent foreign framework rather than its own. This is an approach which the EU believes has benefits for both the EU and third country financial markets.

Third-country equivalence provisions have been included in some of the EU's more recent financial services acts. However, the provisions which determine whether another framework is equivalent are tailored to the needs of each specific act. Typically, equivalence provisions would include:

- having legally binding requirements
- having effective supervision by authorities
- achieving the same results as the corresponding EU provisions

## Who in the EU determines the equivalence of a third party nation?

An important aspect of the negotiations between trading partners is whether each one has suitably comprehensive rules in place such that one partner's rules or controls can be considered 'equivalent' to the other's and would they prove to be a suitable framework under which to conduct trade. Equivalence is considered the key prerequisite for access to the Single Market for goods and services

Technical assessments of equivalence are performed by European Commission services (DG FISMA), often incorporating the assistance of other European authorities such as the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) or European Insurance and Occupational Pensions Authority (EIOPA). Once a technical assessment is complete, the European Commission will make a formal decision on equivalence.

## Who has achieved equivalence?

The European Commission maintains a list of countries who have achieved equivalence status. It is determined on a case by case basis, and outlined relative to the EU Legislation to which it refers – with a total of 173 decisions to date. [7]

Source: **7** European Commission, Table of Decisions Taken on Equivalence

# Implications for financial services: EU Passporting

## What is passporting?

Passporting allows a UK-based firm or international firm with a subsidiary established in the UK to carry out permitted financial services activities in the EEA from the UK or via a branch in the EEA without the need of an additional subsidiary based in the EEA. If all host nation authorisations in the EEA state in question are met, an EEA passport allows the firm to set up:

- a branch in an EEA state via an 'establishment' or 'branch' passport; or
- provide cross border services or advice via a 'services' passport

The legal foundation for passporting originates in the Treaty for the Functioning of the EU (TFEU)(also known as the Lisbon Treaty) – this provides the legal framework. The Single Market Directives clarify the rights and freedoms within this framework.[8]

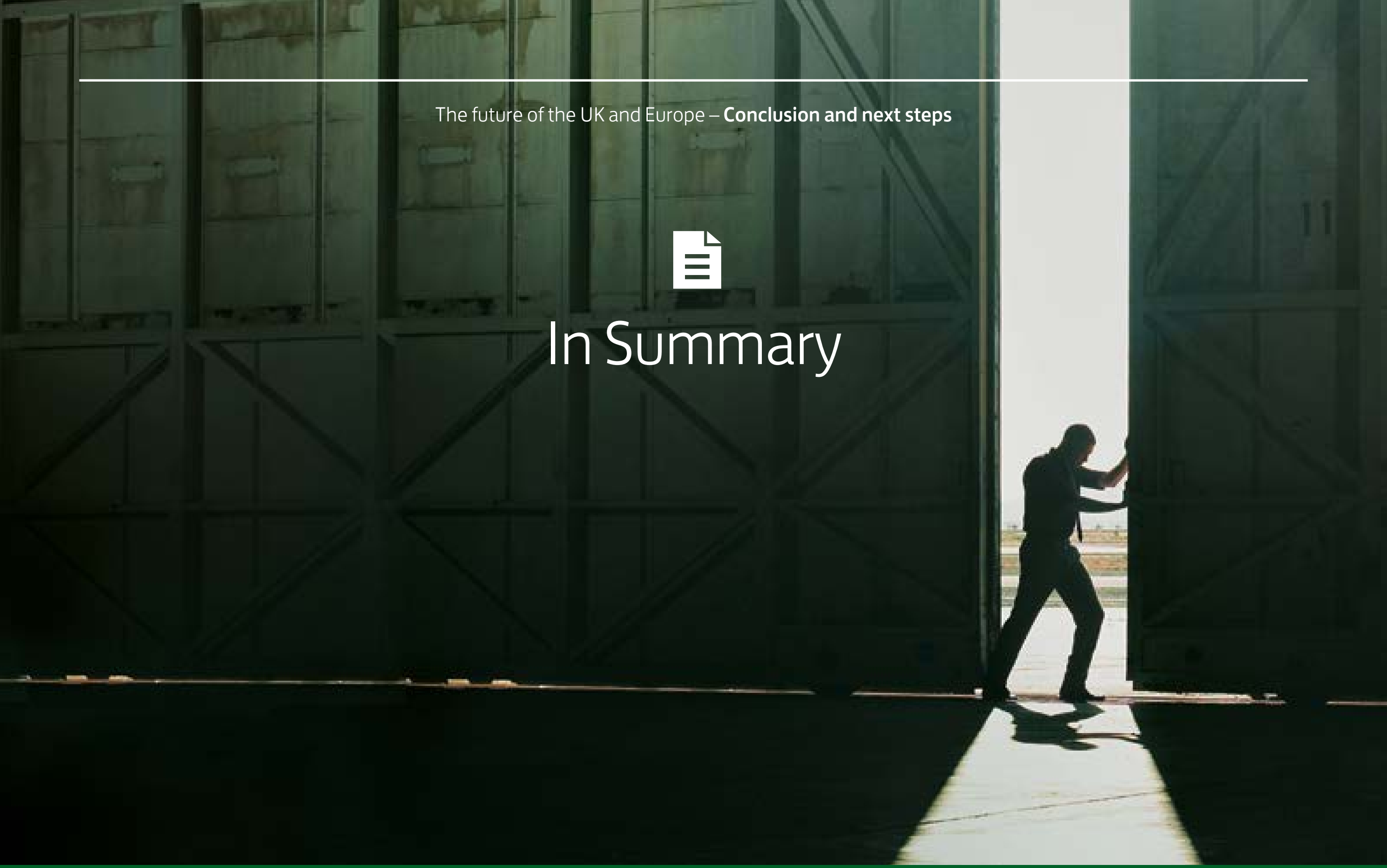
## Significance for UK as the financial services centre of Europe

Since the leave vote, many senior figures in the EU have expressed their views on the UK's future passporting rights in to the EEA. The Banque de France governor, François Villeroy de Galhau, said "they [the UK] won't be able to use what's called the banking passport system unless Britain signs up to all the rules of the Single Market". French president François Hollande insists that without passporting, clearing of euro-denominated securities should be repatriated to the Eurozone (this in spite of the existing provisions for third countries under EMIR).

Passporting is of significance to the UK; nearly 250 foreign banks operate in London with 70% incorporated outside of the EEA and accounting for 30% of banking assets in the UK. Non-UK EEA-owned banks make up 16%. The UK also hosts the third largest insurance sector and second largest fund management industry globally – London's access to the rest of the EU via passporting being amongst its key attractions.

| Sector | Implications | Significance |
|---|---|---|
| **Banks** | Passporting provided via CRDIV and MiFID (amongst other Directives) enables servicing of clients across Europe from a single entity – underpinning the UK's status as the largest global centre for cross-border banking | Cross border deposits placed in the UK banking sector at end-2015 totalled £3.1 trillion<br>UK banking sector cross-border lending to EU countries was £1.1 trillion at end-2015 |
| **Asset managers and funds** | Passporting enables marketing of investments, and management of funds cross-border<br>Passporting via UCITS (Undertakings for Collective Investment in Transferable Securities) Directive and AIFMD (Alternative Investment Fund Managers Directive) are amongst the rules which enable fund managers to market across Europe from a single operating company and permit management of funds cross-border | Approx. £6trn of assets are managed out of the UK or roughly 300% of GDP. Typically this would be 50 – 150% in other EU geographies[9]<br>Less than £1 trillion is domiciled in the UK, much of the AUM originating in Europe is domiciled in Dublin and Luxembourg |
| **Insurers** | General insurance, specialist insurance and re-insurance markets heavily dependent on passporting via Solvency II regime, IDD (Insurance Distribution Directive) and Third Life and Non-Life Insurance Directives | The UK is the EU's largest insurance market; 24% of total EU insurance premium income generated in UK |
| **Financial Markets Infrastructure** | UK central counterparties (CCPs) clear European trading flows, and are reliant on market access provisions provided by EMIR (European Markets Infrastructure Regulation) and authorised by ESMA | The volume of euro-denominated swaps cleared in London is 2.5x as large as the total volume cleared everywhere else. BIS stats for 2013 (latest available) showed that $927.8bn of euro-denominated derivatives clear in the UK daily |

Source: **8** FCA, Passporting
**9** EFAMA Asset Management in Europe report 2015, quoted in Oliver Wyman analysis



# In Summary

## Conclusion and Next Steps

Clearly a great deal remains unknown, but gradually we are all developing a clearer understanding of the structures and mechanisms by which the UK may leave the EU and develop alternative international relationships. The summer months have brought more clarity than some were expecting, with both a new Prime Minister and a leadership team for enacting Britain's exit from the European Union now in place. We will issue our next edition later in the Autumn with further insight on the latest developments, and hopefully some indication of the possible direction of the negotiations to come.

As ever, Lloyds Banking Group's primary objective is to provide clients with useful practical information. We aim to expand comprehension of this challenging environment in order to best position our clients and ourselves for the future.

As the situation develops, we encourage you to discuss any questions or observations you have with your Relationship Managers and look forward to receiving your feedback.

## The Editors

**ED THURMAN**

Managing Director,
Head of Financial
Institutions

**OLIVER KNIGHT**

Managing Director,
Group,
Government and
Regulatory Solutions

**SUSAN HINDLE BARONE**

Director,
Group,
Government and
Regulatory Solutions

**OLIVER JORDAN**

Director,
Group,
Government and
Regulatory Solutions

# Sources of further information

We have compiled this bibliography through a combination of desk research and engagement with some of the organisations below. Much of this material has been useful to Lloyds Banking Group, as we have explored the implications of the EU Referendum for our business, and we believe it may help you and your firm also. As far as possible, we have tried to present an objective balance representing the full spectrum of opinions, though the bibliography is brief on formally partisan materials for obvious reasons. The views expressed in the material below are those of the authors only – and are included here for ease of reference only, and the Group does not endorse the views of any third parties.

| Author entity | Author category | Title / Link | Date published |
|---|---|---|---|
| **The City UK** | Industry body | Brexit and the Industry | Sep-16 |
| **Hogan Lovells** | Law firm | Brexit: What will this mean for derivatives transactions | Sep-16 |
| **New Financial** | Think tank | What do EU Capital Markets look like post-Brexit? | Sept-16 |
| **Boston Consulting Group** | Consulting firm | What Brexit Means for Financial Insititutions | Aug-16 |
| **Eversheds** | Law firm | Navigating Your Way Through Brexit | Aug-16 |
| **Hogan Lovells** | Law firm | Brexit: Shaping your future | Aug-16 |
| **The City UK** | Industry body | The UK: Europe's Financial Centre | Aug-16 |
| **Clifford Chance** | Law firm | Brexit: What does it mean for multinationals? | Jul-16 |
| **Deloitte** | Accounting / consultancy | Deloitte CFO Survey Summer Results | Jul-16 |
| **Herbert Smith Freehills** | Law firm | Brexit: The UK Vote to Leave the EU | Jul-16 |
| **Hogan Lovells** | Law firm | Brexit: Impacts and actions for listed funds | Jul-16 |
| **LEK** | Consulting firm | Brexit: Building a strategic response | Jul-16 |
| **Clifford Chance** | Law firm | Brexit: What next for Environmental & Climate Change Law? | Jun-16 |

Please contact us if you would like this information in an alternative format such as Braille, large print or audio.

## IMPORTANT INFORMATION



**FOR MORE INFORMATION SPEAK TO YOUR RELATIONSHIP MANAGER**
lloydsbank.com/commercialbanking

LLOYDS BANK