COMMERCIAL BANKING

THE EU REFERENDUM: THE FUTURE OF THE UK AND EUROPE

THIRD EDITION - JULY 2016

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

EXECUTIVE SUMMARY

IN BRIEF

- Regions in England outside London, and Wales vote to leave; Scotland and Northern Ireland vote to remain. Prime Minister David Cameron resigns, but defers enacting the UK's exit from the EU, leaving this for his successor

- Following an accelerated leadership contest in the Conservative Party, Theresa May is appointed leader of the party and Prime Minister on Wednesday 13th July. The timescales for this appointment were significantly ahead of 9th September date originally set by the Conservative Party's 1922 committee

- It remains unclear what impact this will have on the timescales for the enactment of an EU exit – Theresa May stated in her speech announcing her candidacy that if elected, she did not envisage invoking the legal mechanism for leaving the EU this year (Article 50 of the Lisbon treaty)

- In a comprehensive shake-up of the Cabinet, Theresa May appoints David Davis as Secretary of State for Exiting the EU. Liam Fox is given a new role as Secretary of State for International Trade, and Boris Johnson becomes Foreign Secretary

We publish our third briefing for clients on the EU referendum, just over three weeks after the result was announced. Since then, the Conservative Party has completed the process to elect a new party leader and Prime Minister. The fates of Boris Johnson and Michael Gove, the figureheads of 'Vote Leave', have been widely reported – neither became the next Prime Minister. Having made the final two, Andrea Leadsom withdrew on 11th July, leaving Theresa May to replace Cameron on 13th July. Jeremy Corbyn, leader of the Labour Party, lost a vote of no confidence from party MPs but has remained in post thus far. Nigel Farage resigned as leader of UKIP on Monday 4th July. Mark Carney, Governor of the Bank of England, sought to reassure markets and indicated a likely further fall in interest rates over the summer.

In an extraordinary political environment, little clarity has emerged on the timing of the UK's exit from the EU, or the nature of its future relationship with Europe. This edition seeks to provide some objective insight on possible alternative models to EU membership, and sets out some case studies. We consider the implications of 'third country status', in which the UK would sit outside the Single Market and leave both the European Union and European Economic Area – a possible outcome given the importance of sovereignty in the 'Vote Leave' campaign manifesto. There is also a short briefing on the concept of EU passporting, of particular relevance to Financial Institutions, and of interest to those they serve. We also provide a market update and some commentary on the latest developments from the major credit ratings agencies.

The coming weeks will bring a great deal of questioning and debate, but there will be no change to Lloyds Banking Group's determination to put the needs of their clients first and help Britain prosper.

As more information becomes available and we develop a clearer picture of the UK's future relationship with Europe, we will endeavour to provide our clients with timely updates. We will continue to focus our attention on the mechanical and technical aspects of renegotiation, to aid business planning.

KEY MARKET MOVEMENTS

Indices	**As at 20/7**	**Δ since 23/6**
£/$	1.3208	-11.22%
£/€	1.1991	-8.27%
FTSE100	6,728.99	6.17%
FTSE 250	17,018.89	-1.82%
DAX	10,142.01	-1.12%
CAC40	4,379.76	-1.93%
UK 10 YR Gilt	110.235	4.58%

- Early indicators point to sharp fall in UK consumer and business confidence after the referendum

- Bank of England halts planned rise in banks' countercyclical capital buffers in an effort to stimulate credit growth...

- ...and is widely expected to cut interest rates by 25 basis points in August

- After a soft May, US jobs rebounded by 287,000 in June

- UK industrial production drops by 0.5% in May after previous month's 2.1% surge

- FTSE consolidates around recent highs, but pound and gilt yields continue to tumble

REACTION FROM FINANCIAL MARKETS

as at Monday 18th July

LOSING CONFIDENCE

The Bank of England's Monetary Policy committee met on 13th July, and held interest rates despite Mark Carney's guidance that a rate cut is likely over the summer. Amid the heightened uncertainty and the elevated risks to growth, the prospect of more monetary stimulus has pushed bond yields and the pound to fresh lows.

Early signs of the economic fallout of the referendum have started to emerge. It has been a mixed picture, although confidence has, not surprisingly, been hit hard. Until greater clarity emerges – on the economic and political front – the risk to interest rates, bond yields and the pound are likely to remain to the downside.

Early indicators paint a mixed picture of the UK's performance since the referendum, but confidence has clearly fallen.

SUMMARY

The UK currency fell to a fresh 31-year low of 1.2798 against the US dollar on 6th July, and a 2½-year low of 1.1592 against the Euro. The reaction of the markets to the referendum result and heightened expectations of more monetary stimulus have impacted sentiment.

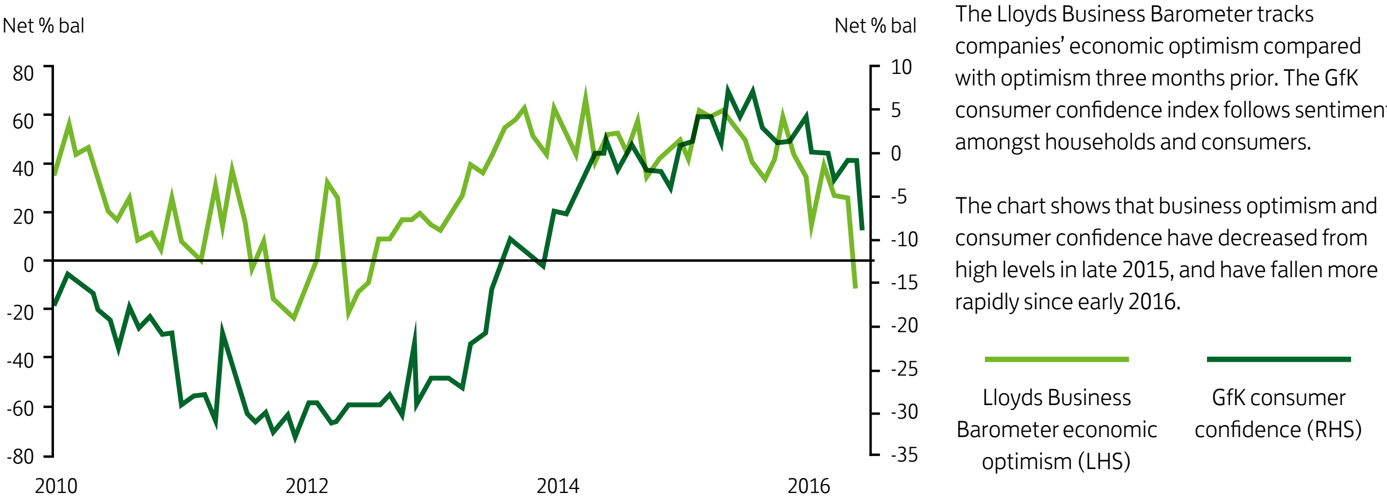
Even before the referendum result, the UK's need to attract substantial foreign capital inflows to finance a record current account deficit meant that the pound had to run to stand still. It is hardly surprising, therefore, that with the risks to UK growth and interest rates tilted to the downside, the UK currency has responded. Given the degree of uncertainty surrounding the outlook, it is impossible to confidently predict where it will settle.

Suffice to say that until some clarity emerges – on both the political and economic fronts – the risks remain tilted one way.

Similarly, bond yields rates have continued their inexorable decline. The yield on the UK 10-yr gilt bond dropped another 10bp to just below 0.8%. The fall brings the total decline in yield to 60bp since the referendum result. The sharp fall in government bond yields has occurred despite the recent downgrades to the UK's credit rating outlook. But any concerns stemming from this quarter have seemingly been overshadowed by the weight of global liquidity and the attraction of fixed rate instruments in a falling rate environment.

Figure 1.

UK CONFIDENCE DROPS SIGNIFICANTLY FOLLOWING THE REFERENDUM



The Lloyds Business Barometer tracks companies' economic optimism compared with optimism three months prior. The GfK consumer confidence index follows sentiment amongst households and consumers.

The chart shows that business optimism and consumer confidence have decreased from high levels in late 2015, and have fallen more rapidly since early 2016.

BANK OF ENGLAND POISED FOR FURTHER ACTION

The Bank of England met on 13th July with market and economists' expectations riding high that a cut in interest rates was due. The MPC held rates for July. According to market rates, a quarter-point drop was 70% discounted in the July meeting and almost fully discounted by the meeting in August. While the exact timing, magnitude and nature of further stimulus is unclear, Mark Carney has strongly hinted that further measures are on their way.

The Bank of England will give a detailed assessment of the economy and the full range of instruments at its disposal when it publishes its August Inflation Report.

It has already taken steps to try to stimulate credit growth, with its decision last week to halt the planned increase in banks' countercyclical capital buffers. Apart from cutting rates, it may decide this week to expand its £375bn Quantitative Easing (QE) programme. Under QE, the Bank of England buys assets (to date, mostly government bonds) in an effort to lower bond yields and pump more liquidity into the economy.

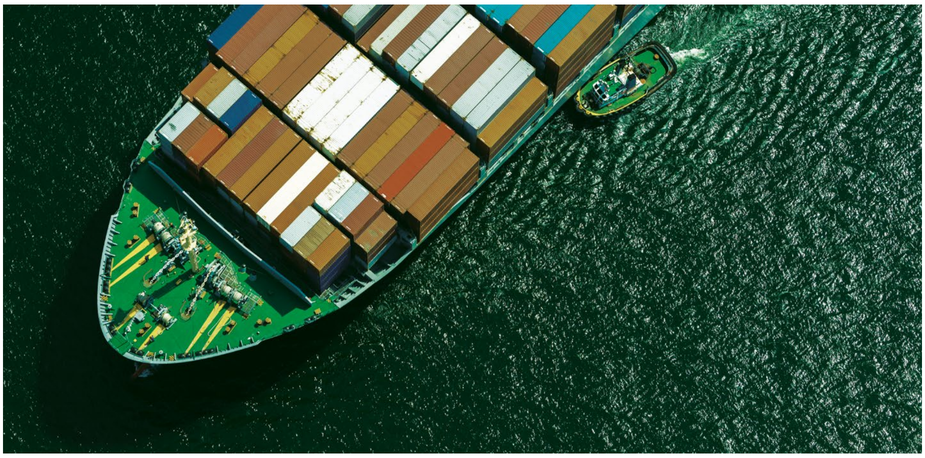
HOT TOPIC: POST-REFERENDUM ECONOMIC UPDATE

The UK economy appears to have taken a noticeable dip in the immediate wake of the referendum result, but early indications suggest the drop has not been as bad as might have been expected. The John Lewis Partnership reported that annual sales in the week after the referendum dropped 0.8% compared with the same period last year. Footfall also fell sharply in the first few days, but has since stabilised.

The impact on online recruitment seems to have varied. Some recruitment agencies have reported sharp falls in advertising, but Reed said that activity on its website was "unaffected' in the week after the referendum. Meanwhile, exporters have experienced a significant boost to their competitiveness. While domestic flight bookings are likely to have dropped, international bookings to the UK have reportedly surged, fuelled by the weaker pound.

Still, it is very early days. The biggest near-term risk is that the level of uncertainty itself leads to a marked weakening of economic growth. Surveys published over the past week show both consumer and business confidence have dropped back sharply. According to our own Business Barometer, the net percentage of companies that were optimistic about business and economic prospects dropped from 38% to 23% and from 26% to -11%, respectively, following the referendum. The latter was the steepest fall since fears of a double-dip emerged amid the euro area debt crisis in 2012. Meanwhile, a special post-referendum survey conducted by GfK reported that consumer confidence had fallen by the most since December 1994.

On one level, these multi-year comparisons appear alarming. But expressed another way, they seem less so. Neither December 1994 nor early 2012 turned out to be particularly distressing periods for the UK economy. Indeed, in retrospect it is difficult to single out what happened 22 years ago to justify such a sharp drop in confidence then. Still, there can little doubt that how confidence evolves will be key in determining the size and duration of any upcoming slowdown. President Franklin D. Roosevelt declared in his inaugural speech in 1933, 'the only thing we have to fear is fear itself'. While this may be stretching the point, there is a clear risk that until cooler heads prevail the drop in confidence and economic activity may start to feed off each other.



WHAT HAPPENS NEXT?

SHORT-TERM	NEGOTIATED WITHDRAWAL FROM EU UNDER ARTICLE 50 OF LISBON TREATY	STEADY-STATE
24th June - September 2016	**Late 2016 - 2018**	**2018 earliest; possibly considerably later**
David Cameron resigns; Theresa May is appointed his successor, the result confirmed much sooner than expected, on 13th July. May appoints David Davis as Secretary of State for Exiting the European Union.	Theresa May and her government re-negotiate with EU. It remains uncertain when Article 50 will be triggered, though May has made clear that she does not envisage this being before 2017.	Steady-state, post-enactment of the UK's exit: the 'new environment' after leaving the EU.

TIMELINE POST-REFERENDUM, PRIOR TO ENACTMENT OF ARTICLE 50

Theresa May has committed to uphold the referendum result although has also been clear that Article 50 should not be triggered in 2016. It is worth bearing in mind that referenda in the UK are not legally binding. Parliament remains sovereign and the referendum, at a technical level, 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 which the UK has previously traded under umbrella EU-level agreements).

Davis will take over the team formerly reporting into Oliver Letwin in the Cabinet Office. It is said that the 'brightest and best' are being drafted in 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 nations. Oliver Letwin warned on 15th July that Britain has no trade negotiators of its own to lead on negotations - the UK's negotiators are currently employed by the EU.

It remains to be seen whether Article 50 is triggered before alternative agreements are agreed (in principle, if not in writing) with key export markets including US, Canada and Australia.

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 simply repeal the treaty. To leave the EU, the Member State must notify the European Council. Once notice of withdrawal has been sent, negotiations can formally commence on the terms of the UK's exit from the EU. The initial period for negotiation is two years although this may be extended by the agreement of the European Council and the withdrawing Member State. A unanimous vote in the European Council would be required. 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. However, there is no time limit to the negotiation period providing an extension is agreed.

A withdrawal agreement could include interim rules to apply to existing situations, whilst new rules are negotiated and implemented. However, ongoing EU decision and policy-making would continue to apply whilst the UK negotiated its terms of exit and the UK will 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 European Council (comprising of the Heads of State / Governments of Members States). 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.

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

ALTERNATIVE MODELS TO MEMBERSHIP OF THE EU

No Member State has ever left the EU. For this reason an EU exit 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 shown on page 10, which looks at other possible scenarios, with trade agreement being the key driver which in turn defines 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. Membership of the EU

The European Union currently comprises the 28 Member States who 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 which came into force on 1st January 1994.

The Agreement of the European Economic Area is concerned principally with the four fundamental pillars of the Single Market, "the four freedoms" - movement of

- goods
- persons
- services and
- capital

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

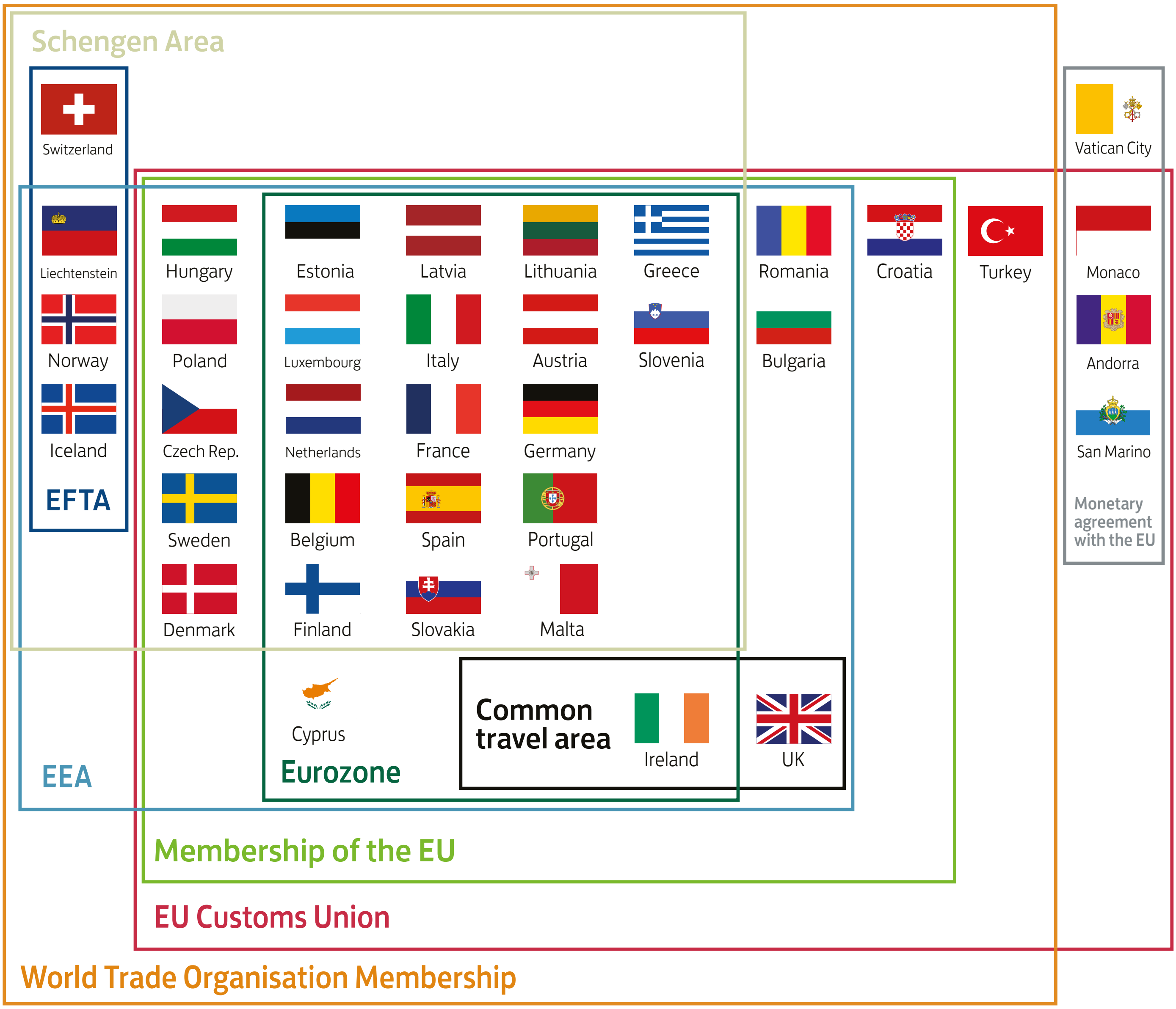
The EEA Agreement does not cover Common Agriculture and Fisheries policies, Monetary Union, or a Customs Union[3] and EEA-EFTA members also make financial contributions (reduced in comparison to full members).

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

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

Figure 2.

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 Agreement on the European Economic Area[4] (1994) 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.

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.

JUDGEMENT OF EEA COUNCIL ON LIECHTENSTEIN[5]

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

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

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 LEGISLATIVE AND REGULATORY REGIME

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.

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 ▪ Other Treaties cease to apply	▪ Treaties cease to apply
EU Regulations	▪ Regulations under the EEA Agreement still apply ▪ 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)

Law firms have been sharing impact analysis, thought leadership and contingency planning material on the Referendum. Links are provided to much 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. In addition, Case Law needs to be considered.

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. If 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.

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 within Article 50 provision (or alternate agreement), the UK remains part of the EU, and the current regulatory and legislative regime applies.

Under the EEA model, there is no expected material change in both financial and non-financial regulation expected, 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; beyond that only limited regulatory changes 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 following an EU exit. 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: 6 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 to enable access to the single market. 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 legislation around financial services. However, the provisions which determine whether another framework is equivalent are tailored to the needs of each specific piece of legislation. Typically, equivalence provisions would include:

1. having legally binding requirements
2. having effective supervision by authorities
3. 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.

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[8] 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) – this provides the legal framework. The Single Market Directives clarify the rights and freedoms within this framework.[9]

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 Francois 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% of firms incorporated outside of the EEA and accounting for 30% of banking assets in the UK. Non-UK EEA-owned banks makes up 16% of banking assets in the UK. 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	Materiality
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 UK banking sector cross-border lending to EU countries was £1.1 trillion at end-2015
Funds	Passporting enables marketing of investments, and management of funds cross-border. 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 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 FCA, Guidance on Passporting Issues

UPDATE ON CREDIT RATINGS

SUMMARY OF LATEST REACTION FOR UK SOVEREIGN RATINGS

All 3 leading credit rating agencies took rating actions on the UK Sovereign immediately post the UK referendum results to leave the EU.

1. Moody's shifted their outlook for the UK sovereign ratings (Aa1) from stable to negative.

2. Fitch downgraded the AA+ rating to AA and revised the outlook to negative.

3. Standard and Poor's (S&P) had a less moderate reaction with a two notch downgrade from AAA to AA and retained the negative outlook.

S&P's rating action reflects the change in UK's institutional assessment from strong to neutral. Additionally the downgrade encapsulates their view of the weakened economic prospects, fiscal and external performance and the role of sterling as a reserve currency. Risks to the constitutional and economic integrity of the UK if there is another referendum on Scottish independence have also been factored in. S&P also revised the UK's country risk assessment to '2' from '1' reflecting the downgrade and S&P believe that the referendum results will lead to a less predictable, stable, and effective policy framework in the UK.

Among the EU nations, S&P also cites that the UK has the most to lose in trade among EU 27 nations, having the highest share of exports to EU27 for both goods and services as a percentage of its GDP. (Figure 3). Fitch also cites that the main source of uncertainty relates to the future of the UK's trading relationship with the EU – its main trading partner and destination for 44% of UK exports. In addition to the export shock, Fitch highlights lower inward FDI (foreign direct investment) and reduced trade openness could impinge on UK productivity in the long term. Constraints on immigration would curtail labour supply growth.

Fitch believes the negatives are likely to outweigh any boost to GDP from an easing of the regulatory framework outside the EU or from lower EU transfers. Fitch's view on GDP growth is now expected to fall to 0.9% in 2017 and 2018, downward revisions of 1pp in both years compared to Fitch's forecast in the May 2016, just prior to the referendum.

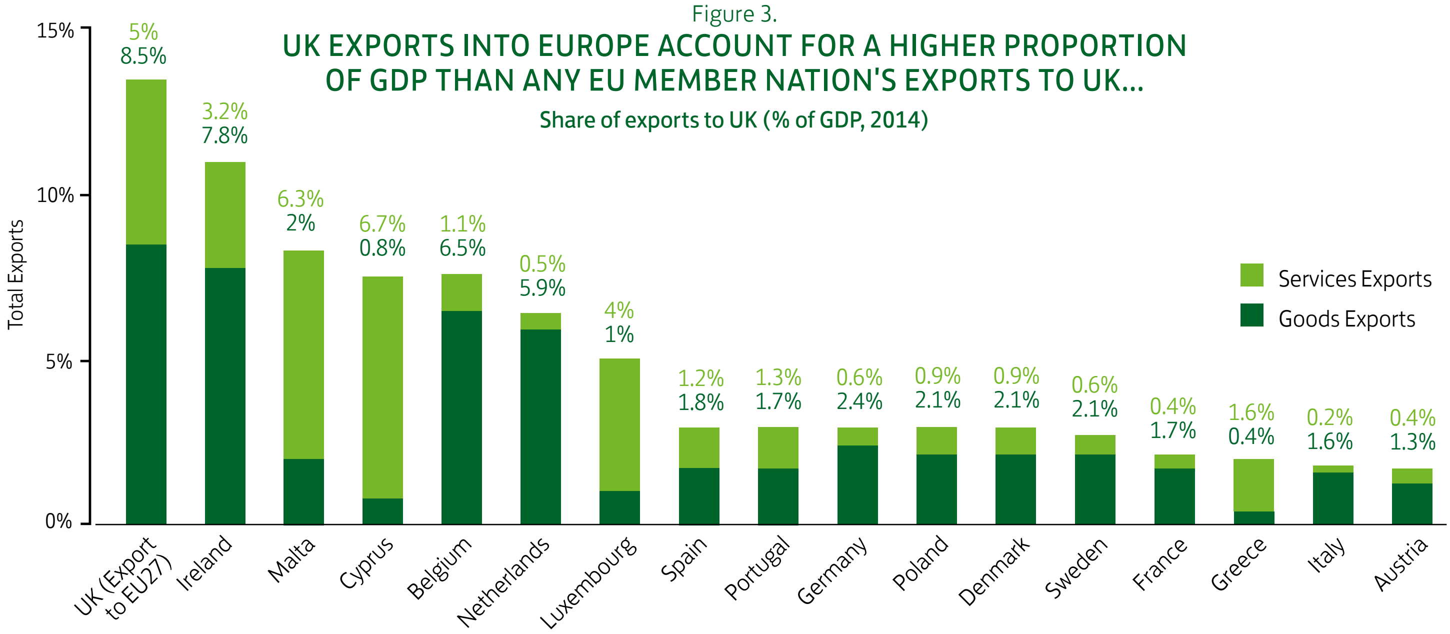
Medium-term growth will likely be weaker due to less favourable terms for exports to the EU, lower immigration and a reduction in foreign direct investment. Any sustained adjustment in the value of sterling and changes in the business environment could also affect growth, deter investment in the economy and decrease official demand for sterling reserves.

The agencies have commented that the outcome of the referendum has precipitated political upheaval. Furthermore, as a majority of voters in Scotland opted for 'Remain', a second referendum on Scottish independence is more probable in the short to medium term. The Scottish First Minister Nicola Sturgeon has indicated that a second referendum on Scottish independence is "highly likely". Agencies are united on the view that a vote for independence would be negative for the UK's rating. Scottish independence would lead to a rise in the ratio of government debt/GDP, increase the size of the UK's external balance sheet and potentially generate uncertainty in the banking system, notably in the event of uncertainty over Scotland's currency arrangement.

Figure 3.

UK EXPORTS INTO EUROPE ACCOUNT FOR A HIGHER PROPORTION OF GDP THAN ANY EU MEMBER NATION'S EXPORTS TO UK...

Share of exports to UK (% of GDP, 2014)



CONCLUSION AND NEXT STEPS

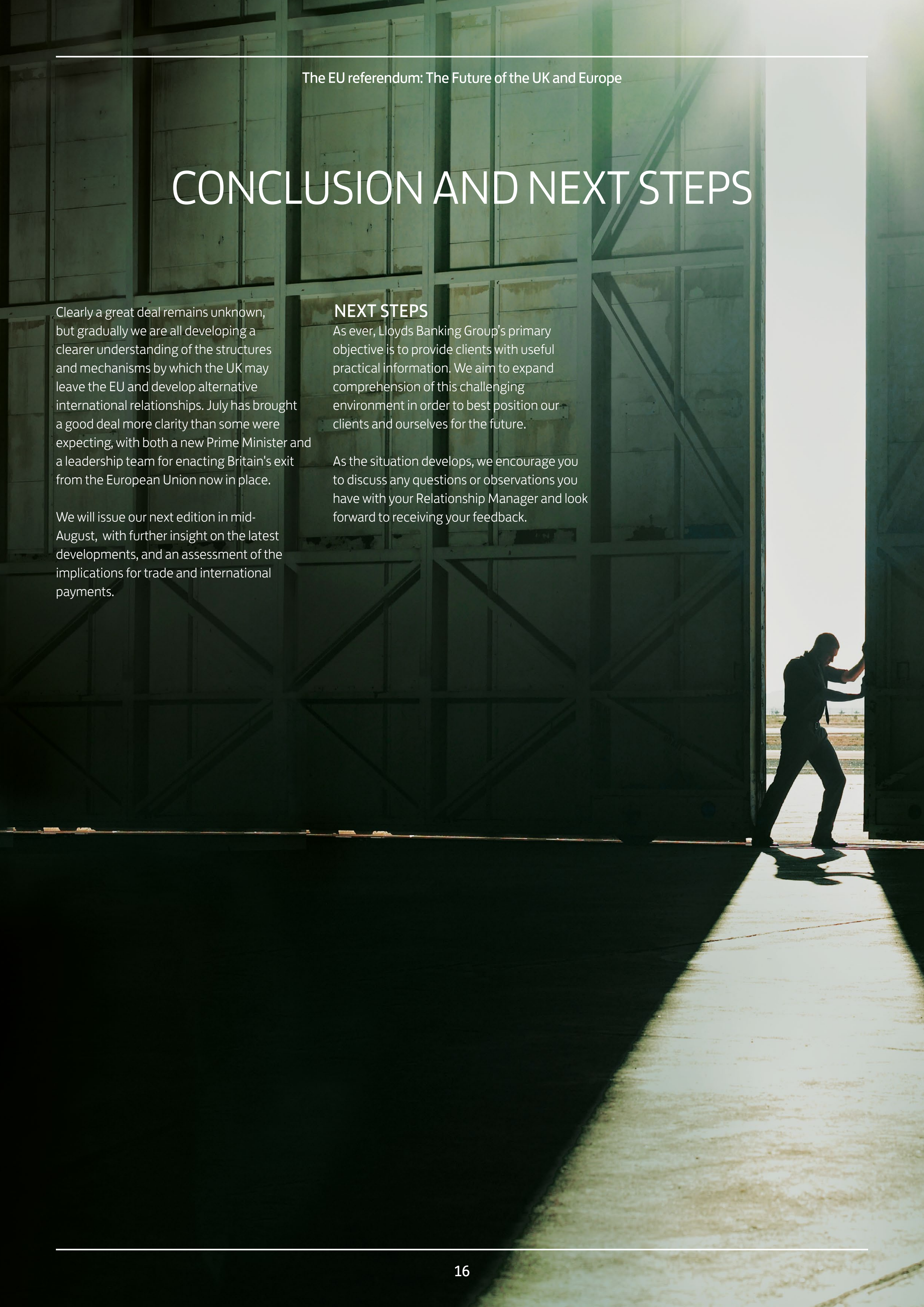
Clearly a great deal remains unknown, but gradually we are all developing a clearer understanding of the structures and mechanisms by which the UK may leave the EU and develop alternative international relationships. July has brought a good deal more clarity than some were expecting, with both a new Prime Minister and a leadership team for enacting Britain's exit from the European Union now in place.

We will issue our next edition in mid-August, with further insight on the latest developments, and an assessment of the implications for trade and international payments.

NEXT STEPS

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 Manager and look forward to receiving your feedback.



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

PUBLISHED POST-REFERENDUM

Author entity	Author category	Title / Link	Pages	Category	Date published
Allen and Overy	Law Firm	Brexit - legal consequences of commercial parties, Key immediate implications of the UK's vote to leave the EU	68	Impact Analysis	Jun – 16
Anderson Strathern	Law Firm	EU Referendum: The Result	40	Impact Analysis	Jun - 16
Baker & McKenzie	Law Firm	UK votes "leave" - Mechanics of leaving the EU	1	Impact Analysis	Jun – 16
		Brexit: issues to consider	7	Impact Analysis	Jun – 16
		Brexit - UK and third country firm strategies - briefing	1	Impact Analysis	Jun – 16
Bank of England	Central Bank	Governor Mark Carney's statement following EU referendum result	3	Impact Analysis	Jun – 16
		EU Referendum: your questions answered	4	Impact Analysis	Jun – 16
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		The pensions law implications of Brexit	2	Impact Analysis	Jun – 16
		Close-outs - a recap following the UK's Brexit vote	3	Thought Leadership	Jun – 16
		Brexit and data protection: keep calm and carry on?	3	Thought Leadership	Jun – 16
		Brexit: leaving the EU, Article 50 and UK constitutional questions	4	Thought Leadership	Jun – 16
		Brexit: what next for environmental and climate change law?	7	Thought Leadership	Jun – 16
		Brexit: what does it mean for multinationals?	12	Thought Leadership	Jul – 16
CMS	Law / Tax Advisory Firm	The future of the UK's relationship with the EU	1	Thought Leadership	Jun – 16

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FIA	Other	Brexit: what now for the cleared derivatives market?	14	Thought Leadership	Jun– 16
ICMA	Trade Body	Brexit: implications for capital market regulation	7	Impact Analysis	Jun– 16
Jersey Finance	Other	Brexit: the implications	7	Impact Analysis	Jun– 16
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Latham and Watkins	Law firm	The UK has voted to leave the EU - what now?	7	Impact Analysis	Jun– 16
MMS	Law firm	Brexit - what now?	1	Thought Leadership	Jun– 16
Norton Rose Fulbright	Law firm	Video: Brexit - what does the leave vote mean for financial services firms?	1	Impact Analysis	Jun– 16
Solicitors Regulation Authority	Other	News release: SRA and EU referendum result	1	Thought Leadership	Jun– 16
The Law Society	Trade Body	Brexit means 'unprecedented and complex' challenge for UK law	1	Thought Leadership	Jun– 16
Thomson Reuters Accelus	Risk Management Solutions	Brexit: continuity of current arrangements for banks and investment banks	3	Thought Leadership	Jun– 16

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Ashurst	Law Firm	Brexit: potential impact on the UK's banking industry	40	Impact Analysis	–
		Brexit	28	Impact Analysis	–
Bank of England	Bank	EU Membership and the Bank of England	100	Impact Analysis	Oct – 15
BBA	Trade Body	UK banking sector believes Brexit would have "negative impact" on their business	Web Page	Poll	Mar – 16
Bertelsmann Foundation	Consulting Firm	The Impact of Brexit	16	Impact Analysis	Jan – 16
		Brexit – potential economic consequences if the UK exits the EU	8	Impact Analysis	May – 15
Berwin Leighton Paisner	Law Firm	Brexit: A Practical Guide to the Potential Legal Implications	7	Impact Analysis	Feb – 16
Bloomberg	Other	Brexit Special	14	Impact Analysis	Feb – 16
British Chambers of Commerce (BCC)	Trade Body	BCC: Businesses want to be in the EU, but a reformed EU	1	Poll	Mar – 15
Brodies LLP	Law Firm	In or out - what will happen to employment law?	1	Impact Analysis	Jun– 16
		What does the renewables industry think about Brexit?	1	Thought Leadership	Jun– 16
		How might Brexit affect commercial contracts?	1	Impact Analysis	Jun– 16
		Banking & Finance: the consequences of Brexit	1	Impact Analysis	Feb– 16
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		What impact would Brexit have on the fishing industry?	1	Thought Leadership	Jun– 16
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		Choosing Our Future	17	Thought Leadership	2015
CBI (authored by PwC)	Trade Body	Leaving the EU: Implications for the UK Economy	79	Impact Analysis	Mar – 16
CCAB	Trade Body	Business in Europe: Researching Reforms for Sustainable Growth	47	Thought Leadership	Jan – 16
Centre for European Reform	Think Tank	If the UK votes to leave: The seven alternatives to EU membership	14	Contingency Planning	Jan – 16
CEP (LSE)	Academic Institution	The Consequences of Brexit for UK Trade and Living Standards	15	Impact Analysis	Mar – 16
		Should We Stay or Should We Go? The economic consequences of leaving the EU	10	Impact Analysis	Mar – 15
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CSFI	Trade Body	The City and Brexit	36	Poll	Apr – 15
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		Brexit: a financial services perspective on a post-Brexit relationship between the UK and the EU	8	Impact Analysis	Jun– 16
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Dentons	Law Firm	The great Brexit debate	30	Thought Leadership	Apr – 16
Deutsche Bank	Bank	The UK & EU: Exit Emergency	41	Impact Analysis	Feb – 16
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Author entity	Author category	Title / Link	Pages	Category	Date published
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Eversheds	Law Firm	Brexit and UK employment law: implications for the workplace	1	Impact Analysis	Jan – 16
		Seeing clearly: making sense of Brexit	24	Thought Leadership	Mar – 16
Freshfields Bruckhaus Deringer	Law Firm	Britain and the EU – legal implications for your business	6	Contingency Planning	–
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Global Counsel	Consulting Firm	BREXIT: the impact on the UK and the EU	43	Impact Analysis	Jun – 15
Grant Thornton	Consulting Firm	How would a Brexit impact UK business?	Web Page	Impact Analysis	Jul – 15
Haggie Partners	Consulting Firm	Lloyd's Market Future 2016	11	Impact Analysis	Mar – 16
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		Brexit: A possible UK exit from the EU	22	Impact Analysis	Feb – 16
HM Government	Other	Alternatives to membership: Possible models for the United Kingdom outside the European Union	54	Contingency planning	Mar – 16
		The best of both worlds: the United Kingdom's special status in a reformed European Union	45	Political / Lobbying	Feb – 16
House of Commons	Other	In brief: UK-EU economic relations	14	Other	Jan – 16
House of Lords EU Committee	Other	The Referendum on UK Membership of the EU: Assessing the Reform Process	31	Thought Leadership	Jul – 15
ICAS	Financial Services	The UK and the EU	10	Impact Analysis	Nov – 15
ICMA	Trade Body	The UK vote to leave the EU: implications for capital market regulation	6	Contingency Planning	Feb – 16

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		Better Off Out? The benefits or costs of EU membership	136	Impact Analysis	Jan – 01
		A Blueprint for Britain: Openness not Isolation	69	Thought Leadership	Apr – 14
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Invesco	Financial Services	Brexit – the pros and cons	6	Impact Analysis	Jul – 15
Ipsos Mori Captains of Industry survey	Trade Body	Key Influencer Tracking	6	Poll	–
IZA	Other	Economic Growth and Political Integration: Estimating the Benefits from Membership in the European Union	40	Impact Analysis	Apr – 14
Linklaters	Law Firm	In or out? Ready or not? The United Kingdom EU Referendum	4	Impact Analysis	Jun – 15
LSE	Academic Institution	Submission of evidence for inquiry in the costs and benefits of EU membership for the UK's role in the world, for the House of Commons Foreign Affairs Committee.	6	Impact Analysis	Oct – 15
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Oxford Economics	Academic Institution	Assessing the Implications of Brexit	5	Impact Analysis	Mar – 16
Practical Law Company	Other	The Future of Britain in Europe	6	Impact Analysis	Jun – 15
Rathbone Investment Management	Financial Services	If you leave me now: exploring the implications of Brexit for the UK economy and markets	32	Thought Leadership	Feb – 16
Rothschild	Financial Services	Market Perspective – Cyclical and secular risks – Brexit and UK Markets	12	Impact Analysis	Jan – 16

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YouGov for Easyjet	Other	Britain's small businesses unfazed by threat of Brexit	Web Page	Thought Leadership	Nov – 15

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