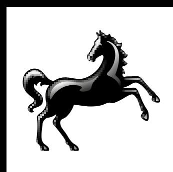
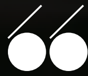
COMMERCIAL BANKING

The Future of the UK and Europe

Fifth edition – January 2017



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

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Introduction

EDWARD THURMAN

Managing Director
Head of Financial Institutions

GROUP AMBASSADOR FOR LONDON

Uncertainty will continue to be a theme for many of our clients. We remain committed to our purpose of Helping Britain Prosper

Welcome to this fifth client update looking at the future of the UK and Europe post the EU Referendum. We take the opportunity to reflect on developments in the political realm, both here in the UK and across Europe. We also look forward, particularly to the spate of General Elections scheduled for the coming months and the bearing these could have on the EU27's approach to the negotiation of the UK's departure.

Adam Chester, our Head of Economics in Commercial Banking also considers what 2017 may have in store. Global growth appears to be holding up well but a variety of factors, from the increase in US interest rates to the uncertainty surrounding the situation in Europe or even the prospect of a Trump presidency, may challenge this state of affairs. In the UK the anticipated increase in inflation may squeeze consumer spending; sterling remains susceptible to further large swings.

We continue to receive feedback from a wide range of Commercial Banking clients, telling us about the impact of the post-Referendum changes and how they plan to manage through the period of uncertainty. We look at the different ways Brexit may impact different types of banking entities in the UK and run through the considerations necessary for those contemplating the need to establish additional offices in order to continue to serve clients who want to do business in Europe, whatever the UK's eventual relationship with the EU bloc.

Adrian Walker, Managing Director of Global Transaction Banking presents an analysis of existing EU trade flows, identifying the main sources of imports to the UK and the main destinations for UK exports. It considers how the potential political and economic changes may impact the credit profile of various trading partners and what steps could be taken to circumvent any potential issues this might present.

We look at Free Trade Agreements – where do they exist and what do they entail? And how do trade tariffs actually work? We close with an overview of EU trade by sector and a word of encouragement for UK firms wishing to develop or expand their exporting capabilities.

If you have any comments or questions we encourage you to discuss them with your Relationship Manager, who will be happy to pass them on or introduce you to our team of experts on the topics covered in this issue.

KEY MARKET MOVEMENTS

Index	As at 30/12/16	Δ since 23/06/16
£/$	1.2340	-16.68%
£/€	1.1731	-10.07%
FTSE 100	7142.83	12.70%
FTSE 250	18,077.27	4.29%
DAX	11481.06	11.93%
CAC40	4,862.31	8.88%
UK 5YR Gilt Yield	0.488	-40 bps

AT A GLANCE

- Exchange rates remain headline sensitive
- The BoE and ECB currently have rates on hold but the US Fed is expected to raise again during 2017
- UK CPI inflation has started to increase, rising to 1.2%y/y in the latest figures released (in December, for end November)
- According to the Lloyds Business Barometer (23/12/16), business confidence ended 2016 at its highest level since March 2016. Sentiment improved in the industrial, consumer services and business services sectors
- December's manufacturing PMI rose to 56.1, well above the consensus expectation and providing reassurance that the depreciation in sterling is helping to boost manufacturing activity
- In the latest Business in Britain survey, although the confidence index rose relative to the level reported shortly after the EU Referendum outcome, it remained below the long-term average. Caution prevails with respect to hiring and capital spending prospects

Political update

BEN BROGAN

Director,
Group Public Affairs

2016 was a tumultuous year from a political perspective. We have been witness to two profound electoral events that will not only stick in our minds, but will have consequences for many years to come.

The UK electorate's surprise decision in June to leave the European Union (EU) and the improbable election in November of Donald Trump to the US Presidency have served as warnings to the 'establishment' parties in both countries that previously accepted assumptions of voter priorities are now out of date.

The result has quickly had an effect on the political landscape in the UK. David Cameron's resignation and the short Conservative Party leadership race that ensued has yielded a new Prime Minister; not to mention some high profile political friends striking one another from their Christmas card lists. Theresa May has promised a more responsible form of capitalism and efforts to ensure the benefits of global trade are more equally shared across the country. A comparatively protracted Labour Party leadership contest meanwhile saw the re-election of Jeremy Corbyn, despite the majority of opposition MPs favouring an alternative candidate. Two resignations by UKIP leaders resulted in Nigel Farage's temporary return to the helm of the party; though he appears to covet more the role of UK Ambassador to the United States.

In Whitehall two new Government departments have been formed to tackle the challenges posed by the prospect of negotiating the mechanics of Brexit and any future trade agreements with the EU and further afield. In the City, after extensive speculation the Bank of England Governor, Mark Carney, agreed to extend his stay at the 'Old Lady' of Threadneedle Street by an extra year, meaning that he will see the economy through to the expected date of the UK's withdrawal from the EU.

Mrs May's stated aim of triggering Article 50 of the Treaty on European Union – the formal mechanism for exiting the EU – by the end of March 2017, crucially without first seeking the UK Parliament's consent, has been challenged in court. In October the High Court judges ruled against the Government in the case of Santos & Miller vs. Secretary of State for Exiting the EU. The judgement, as it stands, requires the Government to secure an Act of Parliament, requiring votes in both the House of Commons and the House of Lords, before Mrs May can invoke Article 50.

The Government is appealing the decision in the Supreme Court, with the judgement expected early in the New Year. It tests, in addition to the validity of the initial judgement, whether an Act of Parliament is necessary by exploring the minimum level of parliamentary consent required to trigger Article 50. At the time of writing, it is expected that Mrs May will likely favour a non-amendable motion providing a two option choice, following a short debate in the House of Commons, as it would allow for the swiftest possible timeline for a vote to be held.

If the Government's appeal is denied, the judgement has far-reaching implications for domestic UK politics in 2017. Mrs May's timetable for triggering Article 50 would become more difficult to maintain. The Government would face challenging votes in both Houses of Parliament. Two thirds of

Members of the House of Commons supported the 'Remain' campaign and a sizable portion of those supporting 'Leave' now favour a 'softer' Brexit in which the UK remains inside the Single Market. Likewise there is substantial support in the House of Lords for the UK to remain inside the Single Market. Failure to pass the Bill in Parliament could well trigger a vote of no confidence in the Government and a general election could likely follow in 2017.

Scotland's First Minister, Nicola Sturgeon, has been following the developments in London with great interest. The 62% Scottish vote for 'Remain' at the EU Referendum has provided the impetus for the SNP's drive for another referendum on Scottish independence, on the grounds of independence being the only way to secure the will of the Scottish people to remain part of the EU. In October, the Scottish Government published a consultation on a Draft Referendum Bill, despite polls continuing to show that support for a 'Yes' vote for an independent Scotland remains steadfastly below 50%, apart from a short surge immediately after the EU Referendum in June.

The upshot is that Mrs May faces a colossal, but hopefully not titanic, task ahead. So the Prime Minister will seek to keep her cards as close as possible to her chest, keeping as many options open as possible until the final moment. The hope is that this negotiating strategy maximises the chances of the UK securing an agreement that provides a politically acceptable and economically viable outcome.

Political landscape – what happens next

Pollsters have been widely mocked for the inaccuracy of their electoral predictions. So it may be prudent to expect the unexpected when observing the upcoming general elections in the rest of Europe. It is difficult to judge whether a pattern of populist backlash is emerging, or if the UK and US results are isolated to the specific grievances of their respective electorates. Eight large EU member states have general elections looming over the next two years, each of which has the potential to play into the negotiations between the UK and the rest of the EU.

Italy had a referendum in December, on proposals to alter the Italian constitution. Voters determined that Prime Minister Matteo Renzi's reform agenda was not for them, so as he had previously undertaken, he stood down. Paolo Gentiloni has taken office as his successor but there are still potentially significant implications for the future direction of the euro-zone and EU as a whole.

In the Netherlands, the incumbent centre-right Prime Minister, Mark Rutte, is in the midst of a protracted and bruising campaign with the far-right figurehead Geert Wilders, prior to the general election in March. Dutch politicians hope that the use of proportional representation in the electoral system will act as a buffer to such disaffection with the more moderate political parties.

The first round of French Presidential elections take place in April, with the far-right candidate, Marine Le Pen of Front National, tipped to top the poll. How large a lead Ms Le Pen obtains over either of the mainstream Republican or Socialist candidates, is the question concerning EU leaders. The top two placed candidates then progress to the run off poll in May, which will likely be decided by the strength of feeling the eliminated third placed party's voters feel toward voting for a party they would otherwise oppose.

In Germany, Chancellor Angela Merkel has already committed to stand once more as the Christian Democrats' (CDU/CSU) candidate in the parliamentary elections next September. If successful, Ms Merkel could become the longest serving post-war leader in Germany, surpassing Konrad Adenauer and Helmut Kohl.

The potential for four, fresh, loud and differing voices representing some of the EU's most prominent members, could significantly alter the EU-27's priorities for its future relationship with the UK. Factor in the elections in the Czech Republic, Sweden and Hungary in late 2017 and into 2018, and the potential for populist movements to impact the exit negotiations is mind-boggling. Of course, any UK withdrawal agreement must have the unanimous support of all EU member states, not to mention the consent of the European Parliament. If nothing else, it promises to be a fascinating period in our political history.

2016

JUNE

UK **votes** to **leave** the EU with a 52% to 48% majority

NOVEMBER

High court rules Prime Minister **cannot invoke** Article 50 **without Parliament's support**

8th – Donald Trump wins the **US Election**

DECEMBER

4th – **Italian constitutional referendum** vote against changes to Senate and Renzi subsequently resigns

4th – Greens backed **Alexander Van der Bellen** wins **Austrian Election** ahead of far-right opponent

2017

JANUARY

20th – Inauguration of **President Trump**

Supreme Court rules definitively on the mater of **Gina Miller v Her Majesty's Government**

FEBRUARY

Article 127 test case to potentially be heard

MARCH

Article 50 expected to be triggered

It's been announced that the **Great Repeal Bill** will be brought in at new Parliamentary session

Dutch election – populist anti-EU polling strongly

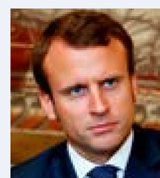
MAY – JUNE

European Council to hand the European Commission their negotiations mandate

7th – **French Presidential elections**

François Fillon – Self-confessed Thatcherite won race to become French right's candidate. The conservative Catholic has a Welsh wife and has called for a quick Brexit.

Marine Le Pen – Succeeded her father as leader of the National Front in 2011. Le Pen leads the polls however due to French electoral systems is unlikely to come to power – but after Brexit and Trump, who knows.



Emmanuel Macron – The former protégé of President Hollande is running as an independent candidate and has pledged to being "neither on the left nor on the right".

JULY

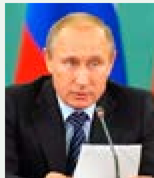
UK to relinquish EU presidency. To be taken over by Estonia

SEPTEMBER

Substantive talks between European Commission – UK, following outcome of the German elections

MARCH

Russian Presidential elections

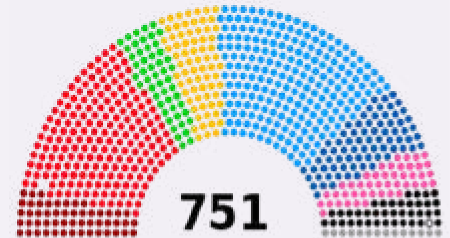


OCTOBER

Date indicated by Michel Barnier for Article 50 negotiations to be concluded

MAY

European Parliament Elections
Current makeup of the European Parliament:



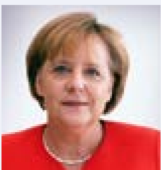
- 52 MEPs – European United Left–Nordic Green Left
- 189 MEPs – Progressive Alliance of Socialists and Democrats
- 50 MEPs – Greens; European Free Alliance
- 68 MEPs – Alliance of Liberals and Democrats for Europe Group
- 217 MEPs – European People's Party Group
- 74 MEPs – European Conservatives and Reformists
- 44 MEPs – Europe of Freedom and Direct Democracy
- 39 MEPs – Europe of Nations and Freedom
- 18 MEPs – Non-Inscrits

2018 | 2019

AUGUST – OCTOBER

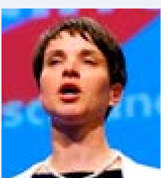
German elections

Merkel's CDU/CSU faction lead polling and Merkel likely to serve fourth term



CDU/CSU – Divided like never before – Merkel has said she will seek a fourth term but the Bavarian sister party, the CSU, has revolted against Merkel's refugee policy.

SPD – *A shrinking 'people's' party* – the party is polling at barely 20% and current chair and Vice Chancellor, Sigmar Gabriel, is polling at only 17% yet remains likely candidate.



AfD – The new conservative populist party has risen with the anti-refugee backlash. Set to be the third largest party in 2017 currently polling at 15%.

NOVEMBER

US Midterm elections

MARCH

Likely formal departure from EU – contingent on Article 50 being invoked Mar 17 and outcome of negotiations

Markets update – looking ahead to 2017

ADAM CHESTER

Head of Economics,
Commercial Banking

IN SUMMARY

- Global growth to hold up well, but decisive turn in US rate cycle poses key risk
- UK economy projected to slow as rising inflation squeezes consumer spending
- Huge uncertainties leave pound susceptible to further big swings

What will 2017 hold?

As we start the new year, what might there be in store? We have devoted this issue to this question. Inevitably, the perceived success or otherwise of 'Brexit' negotiations will dominate the domestic agenda. But 2017 is also likely to be a year of significant economic and geopolitical changes elsewhere. How these play out will also have a significant impact.

Despite significant "event risk", the global economy is expected to remain relatively resilient in 2017. The US is likely to top the 2017 G7 growth table – particularly if Donald Trump delivers on his fiscal promises. His victory has led to the biggest post-election rally in US equities since Ronald Reagan won the presidency in 1980. Market confidence is riding high on the expectation that he will reflate the US economy through a combination of substantial tax cuts, infrastructure spending and trade barriers aimed at protecting US business. In the euro area, growth is also likely to remain in reasonable shape, supported by a weak exchange rate and significant monetary stimulus.

Given China's inflated public and private sector balance sheets, a 'hard-landing' poses a danger. But China has so far managed an orderly slowdown and has room to ease policy further. Elsewhere in the developing world, India has surpassed China as the world's fastest-growing major economy. Brazil has emerged from recession, while the upturn in oil prices has improved the fortunes of oil producers.

A DECISIVE UPTURN IN BOND YIELDS

If President Trump enacts significant fiscal stimulus, 2017 will almost certainly mark a decisive turn in the US rate cycle. An improving economic outlook has already prompted the US central bank to resume raising interest rates. On December 14th, it increased its key policy rate by 25bp to 0.75%. It also signalled that it is likely to raise interest rates three more times over the coming year.

Against this backdrop, 2017 is likely to see global bond yields rise further. Cracks in the global bond market are already emerging, with the yield on US 10-year government bonds hitting a two-year high above 2.5%. Other international bond yields have also risen sharply. Inflation in many countries has crept up and market participants are questioning the case for further monetary stimulus. Increasingly the focus appears to be shifting towards tax cuts and government spending to support economic growth.

With global rate expectations likely to rise further, it could be a more challenging year for asset prices. Global equity, bond and housing markets have been underpinned by a flood of cheap central bank money. While hopes are running high that Donald Trump's policies will help to justify current valuations, much will depend on whether economic growth and corporate earnings can stay at least one step ahead of the US rate cycle.

RISING PROTECTIONISM POSES INFLATION RISK

Trump's presidency may also herald the onset of a more protectionist era. While barriers to free movement may favour domestic growth over the short term, they risk slowing growth and raising inflation further out. In Europe, opposition to open borders is also building. In the wake of the UK's EU Referendum, national elections in France, the Netherlands and Germany will give important insights into Europe's direction of travel. Following its rejection of constitutional reform, Italy may also hold an election this year.

The UK will have all this to contend with, as well as, of course, the 'Brexit' negotiations. Although the upcoming Supreme Court ruling and the possible challenge regarding Article 127 of the EEA Agreement could delay things, Article 50 looks set to be triggered by the end of March. The government has said it will provide more clarity in 2017, but the prospect of meaningful progress in the negotiations is likely to be hindered by the European political timetable. Those countries facing elections are unlikely to be in a mood to compromise.

BANK OF ENGLAND ON HOLD... FOR NOW

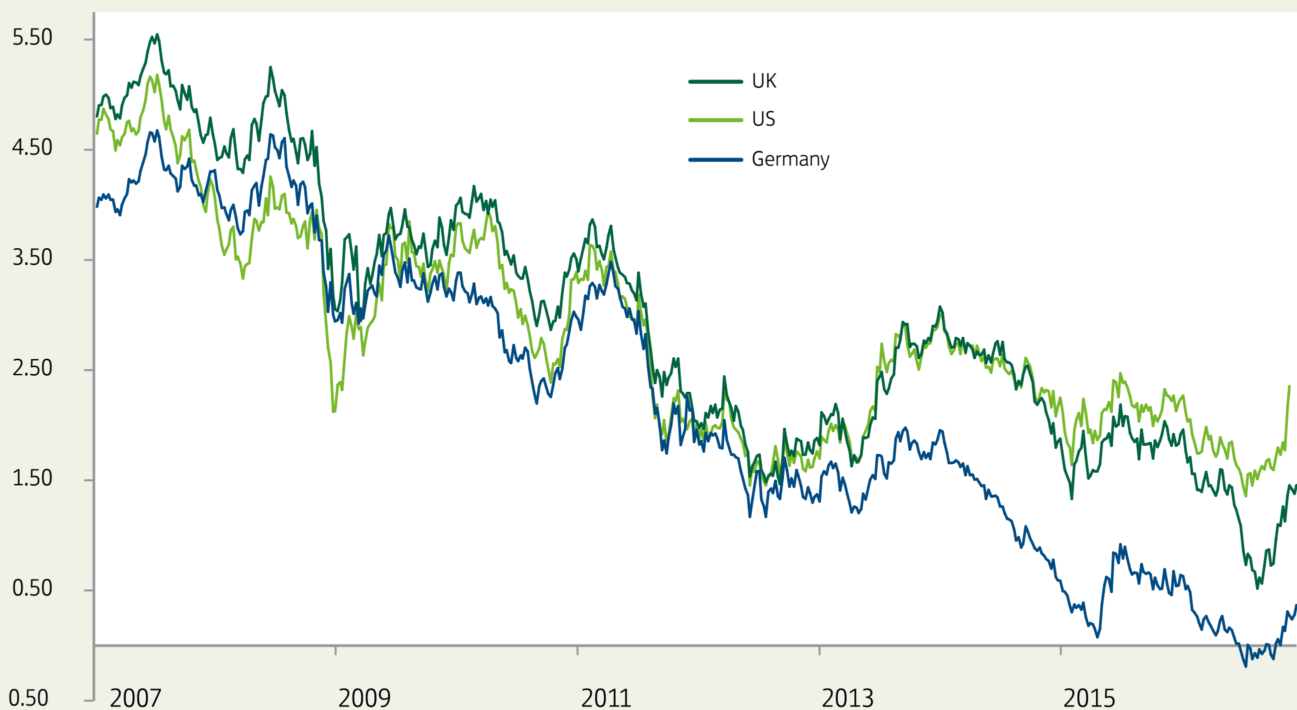
Until there is much greater clarity surrounding Brexit, forecasting the UK's medium-term outlook is largely conjecture. Still, we can be reasonably confident that a number of developments currently playing out will have a significant impact, not least a sharp rise in inflation.

Following the recent agreement among the major producers to cut output, oil prices are on the rise again. But the big impact on UK inflation will come from the drop in the pound. Although at one stage it had recovered some of its losses, the UK currency was 17% lower (versus the USD) by the end of 2016. So far, this has yet to significantly hit retail prices, but that will change as wholesale price rises feed through and currency hedges steadily expire. By early summer, consumer price inflation is likely to be back above 2% and headed towards 3% by the end of the year.

Typically, a rise in inflation of this size might be expected to prompt the Bank of England to raise interest rates. However it is only likely to do so if the rise in headline inflation starts to show up in a sustained rise in inflation expectations and wages. We doubt this will be the case this year, but it poses a clear risk further out. Through 2017 we expect Bank of England Base Rate to remain unchanged at 0.25%. The Bank will wait to see whether the risks to longer-term inflation and economic growth crystallise before deciding whether a shift in policy is justified.

> 2017 could see a decisive upturn in global interest rate expectations and bond yields

10 YEAR GOVERNMENT BOND YIELD



Source: Bloomberg; LBCB Data Analytic (16th December 2016)

A CONSUMER-LED SLOWDOWN

So what about the growth outlook? Given the EU Referendum result and the likely uncertainty generated by the protracted Brexit negotiations, it is tempting to dwell on the downside risks. But, as we've seen over the past six months, predictions of a sharp and immediate downturn following the vote to leave have proved wide of the mark. Despite the dire prognostications, consumer spending has been strong, business investment has so far held up and, after a wobble over the summer, business confidence has recovered.

Still, over the coming year there is a good chance the economy will soften. The rise in import prices and inflation looks set to squeeze household pay and corporate profits. There are also tentative signs that the labour market has turned. Although the unemployment rate remains at an eleven-year low, employment in the three months to October 2016 posted its first drop in over a year. Rising inflation and some easing in jobs growth could see household spending slow sharply. In addition, while the implications of Brexit for business investment are unclear, there is a risk that the related uncertainty starts to weigh more heavily on capital spending.

But there are also upside risks. Following the Chancellor's Autumn Statement, fiscal austerity is unlikely to bite quite so hard, with the emphasis now on infrastructure improvements. The coming year should see a pronounced re-balancing. Exporters and tourism-related sectors are likely to benefit from the competitive advantage resulting from the fall in pound, while price pressures may encourage importers to source from domestic suppliers. That, coupled with a sharp improvement in foreign currency earnings, should narrow the UK's balance of payments deficit.

ANOTHER VOLATILE YEAR FOR THE POUND

On balance, we think UK GDP growth will slow from around 2% in 2016 to 1.4% in 2017. While we expect the Bank of England to remain on hold, rising inflation and a potential reorientation away from monetary towards fiscal stimulus leave the medium-term risks to Bank Rate tilted to the upside. Towards the end of 2016, 10-year UK government bond yields rose to a seven-month high of 1.5% before dropping back slightly. The combination of rising domestic and international interest rate expectations is likely to see UK government bond yields and fixed term interest rates increasing further.

In the currency markets, we expect the pound to end 2017 slightly higher, at $1.30 and €1.21. We favour the pound because we believe the markets are already discounting a lot of bad news in the UK and a lot of good news in the US - with the euro area somewhere in between. Still, given the huge uncertainties, these point forecasts should be treated with caution. In particular, the Brexit negotiations, the implications of Donald Trump's presidency and the European elections leave plenty of scope for volatility.

Update on sterling debt issuance

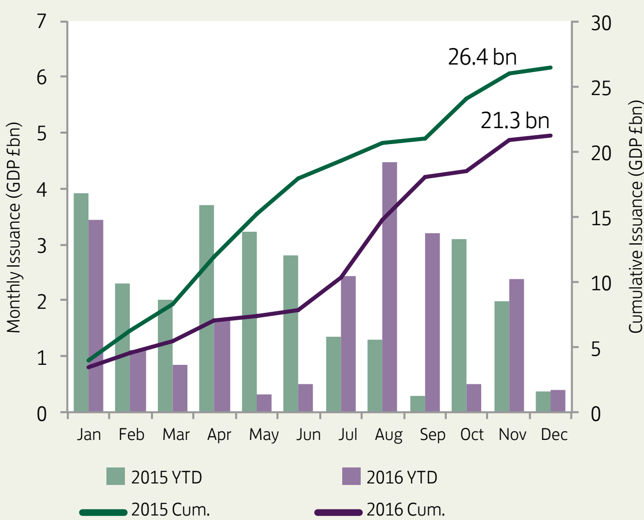
The vote to exit the EU set in train a series of events – reduced business confidence, market volatility and political uncertainty – which led to the Bank of England putting in place a number of measures to support the market.

Both the timing and the magnitude of the actions taken by the Bank of England resulted in a significant shift in market sentiment. The Corporate Bond Purchase Scheme, which formed part of the monetary stimulus, came into action at the end of September, is £10bn in size and has a proposed life of 18 months. Targeting corporate investment grade bonds in the secondary market, it purchased ~40% of its target size in the first nine weeks. As a result of its announcement, credit spreads significantly tightened with virtually all issuers enjoying a lower implied credit risk than they had before the EU Referendum. Yields fell further and reached historic lows. This resulted in many issuers accelerating their borrowing plans to lock in at the current low rates and take advantage of currency arbitrage opportunity.

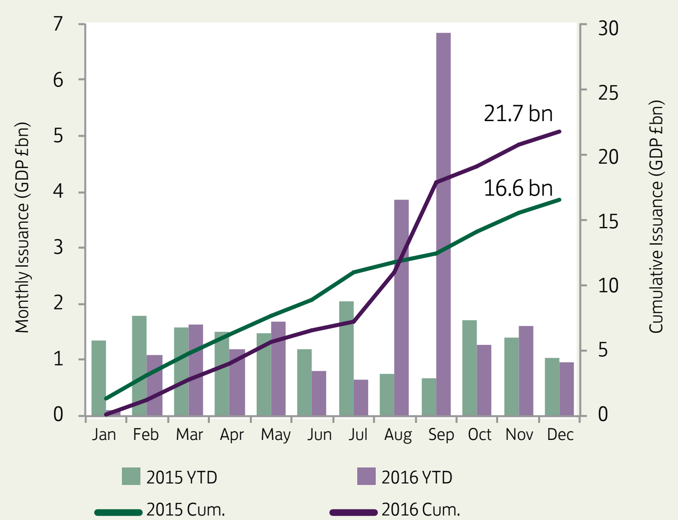
The sterling market, when compared to those for euro or US$, typically has lower liquidity. The Bank of England's intention to purchase bonds in the secondary market has injected the market with liquidity as investors seek to recycle their capital from older bonds into more recent transactions. Whilst the market depth naturally results in a cap on issuance size (in comparison to euro and US$), in September, National Grid Gas Finance plc did issue the largest non-financial sterling transaction to date achieving a total quantum of £3bn.

Of note there has been a pick-up in non-UK issuance following the EU Referendum (particularly in the banks space), with issuers taking advantage of the constructive sentiment.

FI STERLING ISSUANCE



CORPORATE STERLING ISSUANCE



Source: Dealogic, Markit, Lloyds Bank, as at 5th January 2017

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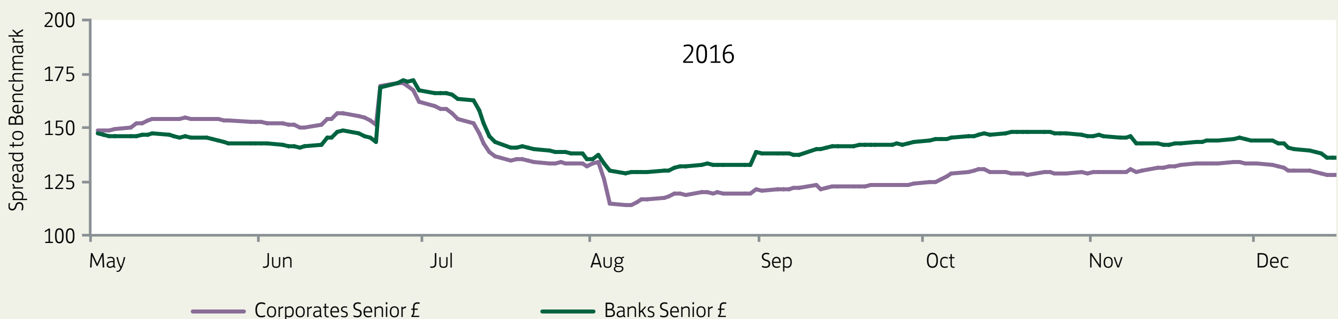

Source: Dealogic, Markit, Lloyds Bank, as at 5th January 2017

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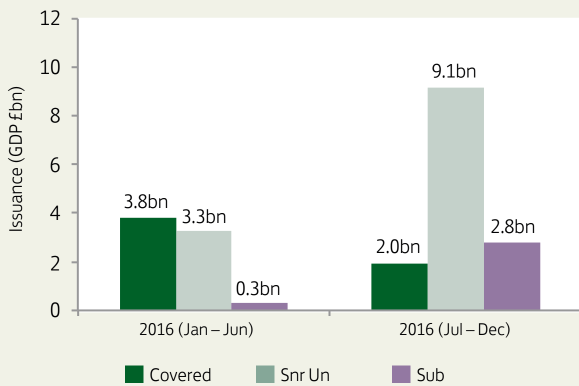
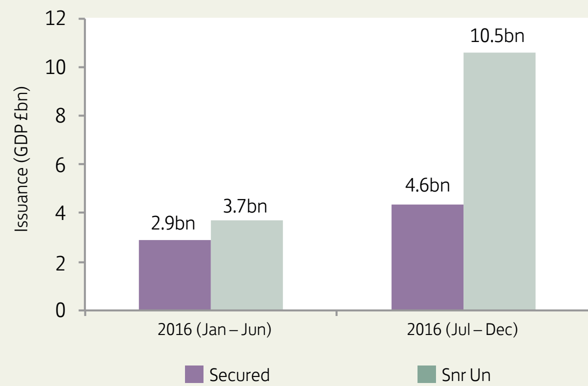


CORPORATE STERLING ISSUANCE



Source: Dealogic, Markit, Lloyds Bank, as at 5th January 2017

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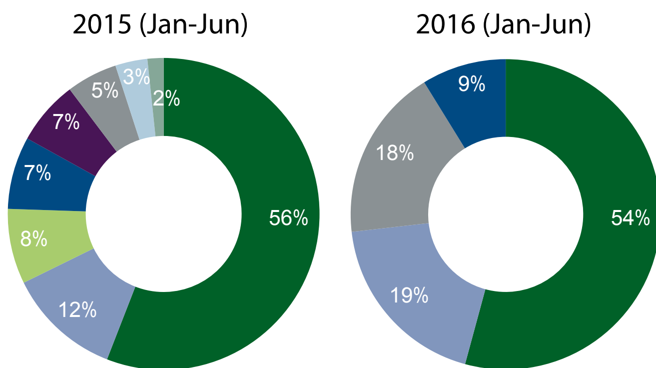

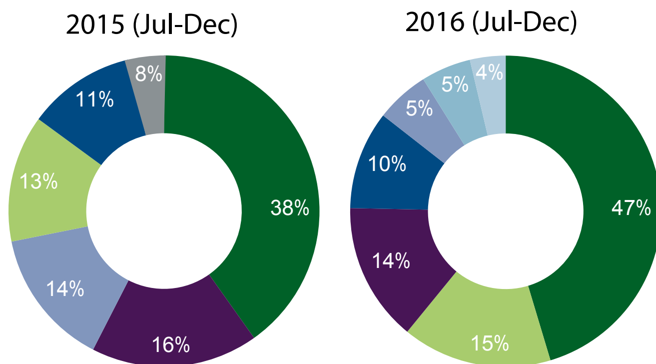

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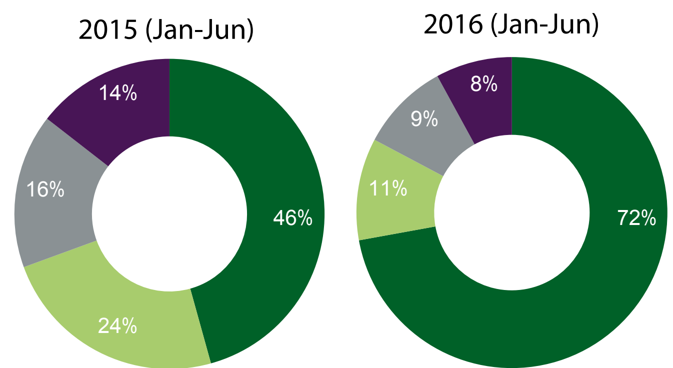
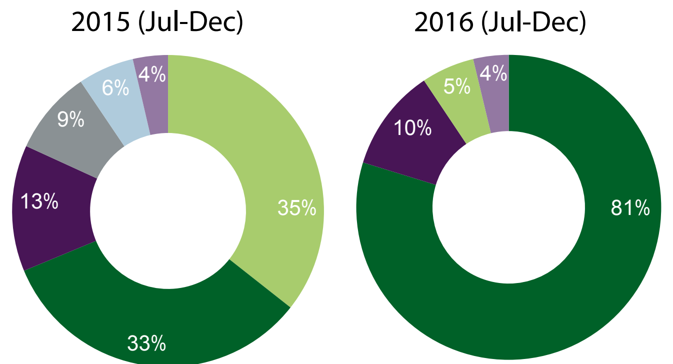




UK | US | Canada | Eurozone | Australia & New Zealand | Nordics | Switzerland | Middle East and Africa | Asia

Source: Dealogic, Markit, Lloyds Bank, as at 5th January 2017

Trade

Implications for trade post-EU Referendum

It has now been over six months since the EU Referendum, but the picture for companies looking to trade internationally is still unclear. Currency remains volatile, increased labour costs and skills shortages are an ongoing concern, and access to the EU Single Market is only a certainty for the next two years or so.

In spite of this, British exporters are surprisingly bullish, with 41% of companies surveyed by Lloyds Bank expecting exports to go up in the next 6 months, and 38% expecting exports to stay the same[1]. And they are bullish with good reason, as the current low levels of sterling versus other currencies continue to represent an unprecedented opportunity for competing on the world stage. For the British Government, the benefits of trade to the economy are clear, and they see this as a chance for the UK to command a much greater share of global trade flows. Through their new Department for International Trade (DIT) they are playing an active role in encouraging companies to take the plunge and begin exporting, with November of 2016 having seen them launch their new 'Exporting is GREAT' campaign, alongside a new portal containing a range of tools and insight. For Lloyds Bank, the importance of trade is also clear, and as part of our partnership with the DIT we helped over 6,000 new exporters in 2016, and have also recently launched our own International Trade Portal. But for those companies that are seizing the opportunities that are available, what are some of the implications of the EU Referendum?

THE CURRENT STATE OF PLAY

As a full member of the EU, the UK has the ability to trade without tariffs across all 27 member states, and automatically complies with all EU legislation and regulation. But even with unfettered access, Britain still maintains a trade imbalance with the majority of its major EU trading partners. For example, Germany, the UK's top trade partner in the EU, accounts for 15% of UK imports, but only 10% of UK exports. Out of our top five EU trading partners, only Ireland buys more from the UK than the UK buys from them.

In total, 45% of UK exports go to the EU, whilst 53% of the UK's imports come from the same bloc – the EU is obviously very important to the UK economy. Based on ONS and World Bank data for 2015, exports from the UK made up approximately 6% of goods and services imported into the EU27.

Interestingly, the UK has been diversifying its geographical focus for a number of years already. Exports to the EU have stagnated since 2011, and imports have been falling steadily since 2013. This shows that companies have been increasing their global focus even in advance of the EU Referendum. For those that are continuing to focus on Europe, there are some important considerations.

THE CHANGING RISK PROFILE OF EUROPE

Given that the EU is a major trading partner for the UK it is likely to continue to be an important focal point for companies taking their first steps in the international market. There are, however, a number of indicators which point to a change in risk profile for many European countries.

Companies looking to trade with countries across Europe may need to manage their risk

ADRIAN WALKER

Managing Director
Head of Global Transaction Banking

THE CURRENT STATE OF PLAY

Country	% source of UK Imports[2]	% destination of UK Exports[2]
Germany	15.0%	10.0%
France	6.1%	5.9%
Netherlands	7.5%	5.7%
Ireland	3.1%	5.5%
Belgium	5.0%	3.8%
Italy	4.0%	2.2%
Spain	3.4%	2.9%

Source: 1 Lloyds Bank Business in Britain Survey, January 2017
Source: 2 World Integrated Trade Solution (WTO/World Bank/UNCTAD/UNSD/ITC), 2014 and 2015 data

more proactively and/or reconsider the credit profile of the various member states of the EU27.

Of the UK's top 10 EU trading partners, 3 are currently on the cusp of being sub-investment grade. Taking Italy as an example: with a BBB-rating they are just investment grade, but a further deterioration is possible, given the recent political events, and the ongoing banking sector problems and continued weak growth (over the last two years, average growth has been 0.25%)[3].

Italy remains a valuable market for the UK, however, so instead of deeming the risk as unpalatable, companies may consider using traditional Trade Finance instruments such as Collections, Letters of Credit or Guarantees to help manage counterparty credit risk and supplier performance risk. These tools are well established, and also permit enhanced working capital management, either directly via financing, or through the negotiation of preferential payment terms.

It is also important to remember that the EU's perception of the UK may also change. EU trading partners may prefer to revert to traditional Trade Finance measures.

Generally speaking, as UK companies shift their export focus outside the EU, it is likely that they will have to deal with greater counterparty risk. Traditional Trade Finance techniques may help circumvent this issue to some extent.

EXISTING EU TRADE AGREEMENTS

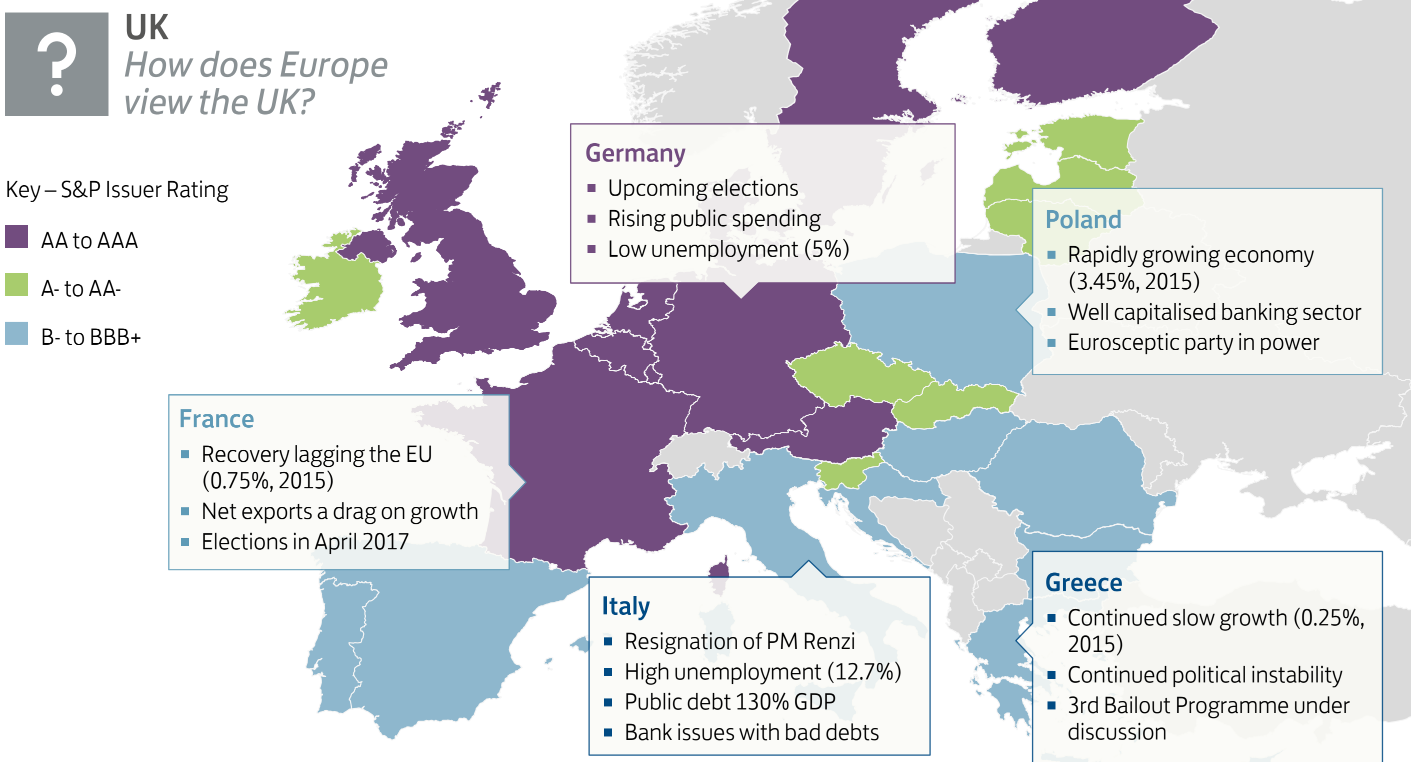
The EU has successfully negotiated a number of preferential trade agreements, but its main strength is in the custom union enjoyed within the bloc itself (see diagram). Outside the EU, there are still a number of key trade partners where no agreements exist (e.g. China), or where negotiations have been slow (e.g. the Transatlantic Trade and Investment Partnership with the USA). Any reduction in access to the EU will have significant impact on the UK, and it remains to be seen what trade deals the UK will be able to negotiate separately. The simple average 'Most Favoured Nation' tariff that the EU imposes on imports is 5.3%, far higher than trade-heavy nations such as New Zealand (2.0%) or even the US (3.5%)[4].

An additional potential hurdle is non-tariff barriers, such as differing trading standards. Currently, as the UK is part of the EU, these are not an issue within Europe because we work from the same standards and regulations. However this may well become an obstacle in the future in Europe and may present a challenge when trading with other parts of the globe.

FREE TRADE AGREEMENTS

So what does a Free Trade Agreement (FTA) between two countries typically look like? If we look more closely at the Comprehensive Economic and Trade Agreement (CETA), which is in the process of being implemented by Canada and the EU, it is intended to

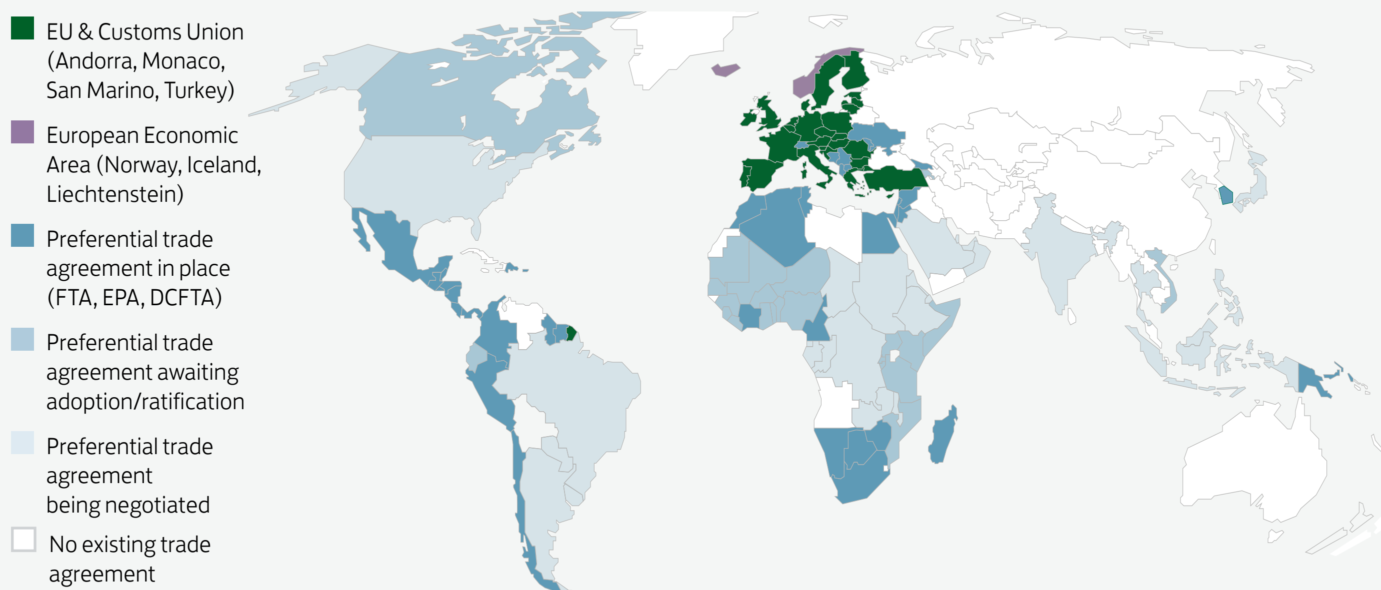
INDICATORS OF POTENTIAL SHIFTS IN RISK PROFILE



KEY POINT As markets price in increased political, societal and financial risk across the region – now is time to consider mitigants for increased exposure to counterparty risk.

CURRENT TRADE AGREEMENTS UNDER THE EU

The EU has a wide range of existing trade agreements, and plan to strengthen their position in the Asian and Pacific regions. To this end they are: requesting mandate for Australian/New Zealand FTA negotiations, setting ambitious targets for China, and aiming to start new FTA negotiations with Indonesia and the Philippines.*



*Source: http://ec.europa.eu/trade/policy/in-focus/new-trade-strategy/

directly boost trade by removing 99% of existing customs duties. This reduction will operate across a broad range of goods, but as with many trade negotiations, certain industries continue to be protected. In the case of CETA, the agreement does not include all agricultural products (some of which, like chicken and turkey meat, are deemed 'sensitive'). Within agriculture, the biggest winners in the EU will be those trading with Canada in 'Processed Agricultural Products' (e.g. wines and spirits, soft drinks, and confectionary), which today attract duties of between 10% and 25% of the product value (ad valorem), and will soon be zero. Some agricultural products that are deemed sensitive, but marginally less so than, say, chicken and turkey meat, will be subject to annual quotas e.g. Canada will allow EU to export 17,700 tonnes of cheese per annum.

Notably, 100% of industrial tariffs will be removed, which, according to EU data from 2009-2011, will save EU exporters some EUR470m annually, and Canadian exporters some EUR158m.

Another important element to the negotiation of trade agreements is removal of so-called 'Technical Barriers to Trade' (TBT), which are generally technical regulations that can be very hard for exporters to comply with (e.g. size, shape, ingredients etc.), and often requires extensive testing of products.

Finally, services are another important element of any trade agreement, but often the most difficult to unpick. In the case of CETA, the agreement includes commitments on both sides with regards to so-called 'discriminatory measures' and 'quantitative restrictions' on service-related activity, and broad regulatory measures for key service industries (e.g. telecommunications and financial services). For example, under CETA, Canada guarantees to EU financial service providers that its existing framework will not become more restrictive for the provision of insurance, reinsurance, intermediation, and portfolio management.[5]

Ultimately, negotiation of a free trade agreement is a complex and time-consuming affair, and CETA alone has taken 7 years of careful discussions, and risked being derailed at the last moment. That being said, there are lots of nations out there using normal WTO trade rules which elect to apply very low tariffs for all their trading counterparties, and independently organsie their own FTAs – a good example is Singapore, which applies an average tariff of just 0.16%.

Source: 3 World Bank national accounts data, and OECD National Accounts data files, from the World Bank, World Development Indicators – 2014 and 2015 data

Source: 4 Most Favoured Nation (MFN) is a principle of the WTO by which nations are not allowed to grant special favour to certain partners in terms of tariffs, it is hence a base-rate tariff (all data from the WTO, 2014 and 2015 data)

Source: 5 http://trade.ec.europa.eu/doclib/docs/2014/december/tradoc_152982.pdf

Tariffs at a glance:

How does a tariff work?	Import duties, aka customs or tariffs, are taxes on foreign goods being brought into a country. Under the WTO agreement, "Most Favoured Nation" (MFN) is a status that denotes the minimum tariff allowed to be levied against a nation. Discrimination of countries through tariffs is not normally allowed under this agreement, though exceptions are made in the case of FTAs and in order for members to choose to aid developing countries' exports.
Who pays it?	The "importer of record" is responsible for ensuring goods comply with law, duty entries are filed, and relevant duties are paid (unless the invoice specifies another party). Generally, this will be the shipping provider or broker who will pay the duty and VAT for the importer, and then not relinquish the goods until they have been reimbursed.
Who charges it?	Local customs authorities charge the duty.
When is it paid?	Duties are generally due as soon as the goods are declared to customs.
What are tariff levels based on?	Import duty can be ad valorum (based on value of goods) or specific (based on other measures such as weight). The base number on which the tariff is calculated varies by country, it may be the price paid, or else price paid plus additional costs such as shipping and insurance. Generally, the rate of the duty is based on the Harmonised System (HS) of product classification – a system developed by the World Customs Organisation (WCO). It describes a good's characteristics through 6 digits which denote: chapter, heading and subheading. In addition to this, WCO members are allowed to subdivide beyond the 6 digits in classifying their tariffs.

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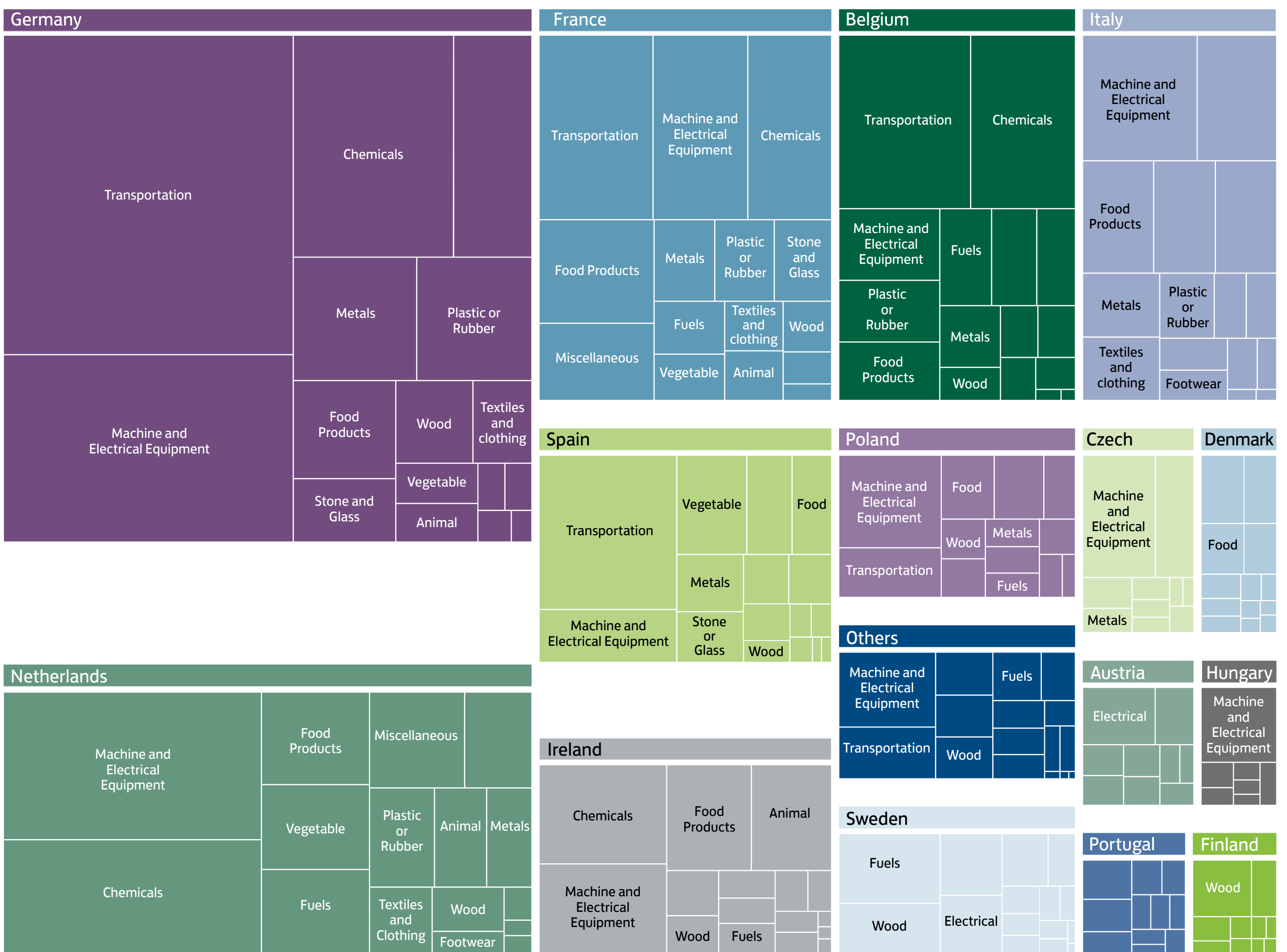
The opportunities for British exporters

Europe will continue to play a significant role in the future of British exports, and there are a range of opportunities out there across each member state. For companies, it is important that they pick the market that is right for them, and play to their strengths, whilst taking the opportunities at hand to expand their focus beyond Europe too.

EU TRADE IMPORTS 2015



Source: http://wits.worldbank.org/detailed-country-analysis-visualization.html

Size shows sum of Import Trade Value. The marks are labeled by Partner (group) and Product Group Description. The data is filtered on Partner, which keeps 27 of 211 members.

How is Brexit impacting you?

Not quite ‘business as usual’

In the six months since the EU Referendum, businesses have started considering how best to position themselves for an uncertain future. We continue to receive feedback from a wide range of customers. Some concerns are felt generally across all sectors. Others may be very specific – to a sector, a region, or even a particular client. We invited some clients to share their thoughts on what the vote to ‘Leave’ has meant to their businesses.

GENERAL THEMES – RESILIENCE

Not many organisations would have wished for the degree of uncertainty under which everyone is currently operating. However it’s clear that most clients are ‘just getting on with it’ – demonstrating a determination to thrive in a less benign environment.

FX IMPACT

The exchange rate changes were the main immediate impact of the Brexit vote. Some of the main implications were obvious, but others were less so.

The increasing cost of goods sourced abroad was felt very quickly and businesses struggled to either pass on the price increase or absorb them and compress their margins. The amount of variation in the duration and degree to which businesses had hedged their FX exposure also became evident. Indeed the true impact on many businesses’ underlying strength may still be masked by FX hedging which is still to roll off.

One less obvious or possibly unanticipated FX impact is the number of UK businesses which have become potential acquisition targets for overseas buyers. Low sterling-denominated enterprise values combined with substantial private equity liquidity globally are pointing to more activity in this area. Consequently liquidity and access to capital are high on many companies’ agendas with CFOs needing to work more closely with the investor bases in order to be prepared to defend any unwelcome overtures.

DIVERSIFICATION

Although the shape of future trade restrictions or limitations is far from clear, many firms are already shifting their focus. They are concentrating harder and sooner on geographic diversification, not only considering the markets for their products, but also the sources of their materials and labour.

Key issues raised are not immediate other than currency.

University sector: triple impact. EU Research grants uncertain, EU students (access) and EIB funding (threatened).

Retailers are thoughtful about the effect on consumer spending of the inflationary impact of more expensive imported items.

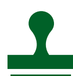
...a word of caution, some particularly well ‘FX protected’ businesses with prima facie healthy EBITDAs may be masked by favourable FX in the near term...

IAN MURDOCH, MILLER HOMES, UK HOUSEBUILDER

- Brexit process is likely to result in more modest increases in GDP over the medium term
- Fundamentals of the UK housing market – pent-up demand, purchaser confidence and affordability levels – continue to remain positive
- This is particularly the case in our regional markets
- We have grown our business in a measured and sustainable fashion in recent years
- We plan to continue with this strategy

VITO PILADE, VALEFRESCO, SALAD PRODUCE GROWERS AND IMPORTERS

- Since the Referendum, "exchange rate, what's it doing?, where's it heading?" are the words which send shivers round our organisation
- The drop in sterling versus the euro has made produce from suppliers in Europe at least 10% more expensive
- Do we absorb the loss, renegotiate customer prices or pass on the extra 10% to consumers? We are not sure yet. We are working tirelessly to find a reasonable compromise
- Today's business world is twisting and turning, trying to reinvent itself at an alarming rate. External influences are so unpredictable it makes planning extremely difficult. We are trying to be more self-sufficient so as to minimise influences outside our control
- One way of doing this is protecting our crops with poly tunnels to minimise the need for imports from abroad. This line of thinking has accelerated post-Brexit and is now a major priority
- We are also working with customers with the aim of developing product lines which grow in the UK climate, minimising the need to depend on imports
- Staffing is a very interesting topic. We are a seasonal business and rely very heavily on migrant workers. The free movement of migrant workers has benefitted our business model immensely over the past several years
- The post-Brexit position is still very unclear. We may return to a worker visa system which was very restrictive and inflexible, potentially damaging our ability to produce crops at a competitive price
- It would be unfair to say the coming years post Brexit will be a disaster. What is certain is they will be very challenging, changeable and unpredictable. The only way to mitigate these conditions is to be open-minded, flexible and be willing to change if needed



Legal and regulatory issues

Although six months have passed since the EU Referendum result, little progress has been made in determining what the future might look like once the UK has departed the EU. However more analysis has been done to understand how the future might be shaped. Understanding the genuine constraints and limitations which determine how business is done – and how these might change – is key.

The Great Repeal Act

Once Article 50 has been triggered, the UK remains part of the EU, and the current regulatory and legislative regime applies until we formally leave – either within the 2 year period anticipated in Article 50 itself, or within a longer period if that is agreed between all parties (the UK and the EU27).

However, as things stand, EU Directives are already part of UK law, but EU Regulations and guidance, which today have direct effect, would technically fall away as soon as the UK formally leaves the EU.

In order to avoid having sudden loss of legislation across many different fields, the UK government has already proposed to temporarily transpose all the existing EU legislation into the UK's legislation. Over time, the UK will have the opportunity to review which of the legislation it wishes to retain and which it would prefer to replace.

Depending on the outcome of any negotiations, it is likely that there will be little material change in both financial and non-financial regulation, given the need for the UK to adhere to Single Market rules in order to retain any kind of equivalence or access. Assuming we leave the EU, the UK would have no direct influence over formulating /designing the rules going forward.

THIRD-COUNTRY EQUIVALENCE IN FINANCIAL SERVICES REGULATION

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.

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 the immediate aftermath of the vote to leave, third-country equivalence was a key focus for many firms in the financial services industry, and firms across the UK more broadly, as it was hoped that this may be a means of gaining access to the European Single Market once the UK had left the EU.

In a case where equivalence is successfully agreed, the EU relies 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

However more recently equivalence has been seen as a less attractive option, and not likely to form the foundation of a strategy for accessing the European Market. The drawbacks with this approach are thought to be two-fold:

- the process to achieve equivalence can be complex and time-consuming
- the equivalence determination can be withdrawn unilaterally by the EU at relatively short notice

What is Passporting?

Broadly speaking, passporting allows a firm which is established in one part of the EU carry out business in any one of the other 27 EU states. The concept applies in all forms of business, but is particularly significant within financial services because of the global reputation of London as a financial services centre.

BRANCHES AND SUBSIDIARIES

UK-based firms or international firms with a subsidiary established in the UK are able to carry out permitted financial services activities across the EEA from the UK or via a branch in the EEA without the need of an additional subsidiary based in the EEA. Providing that all host nation authorisations in the EEA state in question (in this case the UK) are met, then 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 framework for passporting originates in the Treaty for the Functioning of the EU (TFEU) (also known as the Lisbon Treaty) The Single Market Directives clarify the rights and freedoms within this framework.

Thinking specifically about banks, branches are much easier and cheaper to establish than subsidiaries. Branches may conduct business in their own name, but are still acting on behalf of the parent company – it is not a legally separate entity.

Subsidiaries on the other hand are entities incorporated in the host country, and must meet all the relevant statutory provisions. In the case of a bank, this would mean that all the usual banking requirements, such as minimum levels of capital, must be met and complied with. It also means having a greater number of more senior employees, fully capable of taking decisions for the subsidiary locally. It should be noted that the legal and regulatory requirments vary from jurisdiction to jurisdiction, even within the EU.

Source: **6** https://www.handbook.fca.org.uk/handbook/SUP/App/3.pdf

This example specifically addresses banks, but similar principles apply to other types of business. Since the EU Referendum vote outcome, many financial services businesses have been reviewing various possible outcomes with respect to the treatment across the array of products and services.

In order to passport across Europe a firm needs to have a subsidiary located somewhere in the EU. It is not permitted to passport out of a branch.

Significance for UK as the financial centre of Europe

The UK, and London in particular has benefitted from the ability of firms to gain full access to the European market without the need to establish separate independent subsidiaries elsewhere in Europe. London was already a leading financial centre, but the ability to be in London and access Europe from the same location has proved to be an attractive proposition for banks from all over the world. This will fall away when the UK leaves the EU.

Passporting is significant for 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.

BUSINESS PLANNING

Many businesses are preparing contingency plans for when the UK leaves the EU. With so little information available regarding the eventual nature of the relationship between the UK and the EU, many businesses are planning for the worst outcome. For many this would be interpreted as a 'Hard' Brexit where the UK retains none of its current access to the Single Market, working in the hope or expectation that the eventual solution may not be as harsh. The principles for the analysis required are the same regardless of the type of business involved.

UNDERSTANDING THE WORK FLOW

The key to understanding the impact of the change in the UK's legal framework with Europe and the rest of the world is to understand each step of a company's transactions. Are the circumstances of these transactions dependent on a rule or regulation which might change? For example will you still be able to import your raw materials? Would there be a tariff? Will you still be able to sell your products into your existing markets?

NEW LOCATIONS?

Many businesses are anticipating the need to establish a subsidiary somewhere in the EU 27 in order to continue to do existing business in Europe or to service the needs of clients in the UK in their European businesses going forward.

Issues to consider when assessing potential locations:

- The local regulations and regulatory authorities
- The ease of setting up a new entity
- The local tax position
- The availability of business premises and suitably qualified staff
- The commercial terms for suitably qualified staff – is this likely to increase if lots of companies relocate to the same place?
- Employment law
- Other local infrastructure – housing/schools/transport
- How good are the broader transport links?
- Are your competitors relocating to the same place? Is this an advantage or a disadvantage?
- Would existing staff be happy to move to this location?
- Is the country's membership of the EU stable?

Clearly this is a field which will occupy a great deal of time and thought in the coming months and years, with various conclusions developing as the analysis is carried out in greater depth.

Conclusion and next steps

2017 promises to be another interesting year. Across Europe the political environment will continue to evolve. It remains to be seen whether the UK will trigger Article 50 as expected towards the end of March 2017.

Businesses will continue to develop their understanding of how to adapt to operating in an uncertain environment and consider how they might modify their strategy depending on the ultimate outcome of the Brexit negotiations. The trading environment may well be challenging but will undoubtedly also bring opportunities.

Lloyds Banking Group's primary objective remains that of being a source of objective and practical information. We will continue to deepen our appreciation of how the challenging environment is impacting clients in order that we can better assist them as they adjust to new and uncertain circumstances.

We encourage you to be involved in the debate. As the situation develops we welcome your thoughts and questions. In the first instance please contact your Relationship Manager. We look forward to receiving your feedback.

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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
Clifford Chance	Law firm	Will the UK remain in the EEA despite leaving the EU?	Dec 16
Allen & Overy	Law firm	Article 50 litigation–The Supreme Court appeal hearing	Dec 16
Deloitte	Accounting / consultancy	Deloitte CFO Survey Q4 results	Dec 16
House of Lords		Brexit: financial services	Dec 16
PWC	Accounting / consultancy	UK economic outlook	Nov 16
Eversheds	Law firm	Brexit Legal Challenges	Nov 16
EY	Accounting / consultancy	EU referendum update	Nov 16
Boston Consulting Group	Consultancy	Will Brexit Hurt, Or Help, Your M&A Plans?	Nov 16
ONS		UK Trade Data October 2016	Oct 16
Clifford Chance	Law firm	Brexit comment in the High Court moves the market	Oct 16
Oxford Economics and EY		Making Brexit work for UK Insurers	Oct 16
Slaughter and May	Law firm	Exit negotiations, trade deals and the rules on political lobbying	Oct 16
CEPS	Think tank	EU Financial Markets Access After Brexit	Sept 16
Hogan Lovells	Law firm	Brexit: What will this mean for derivatives transactions	Sept 16
Clifford Chance	Law firm	The way forward for multinationals	Sept 16
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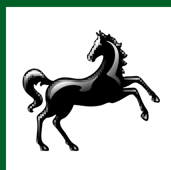

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