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4 Things A Brexit Vote Could Mean For Business

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OVERVIEW

On 23rd June 2016 the UK is holding a referendum to determine whether or not Britain remains part of the European Union. In the lead-up to the referendum uncertainty is on the rise, and concerns about a possible Brexit have led to a weaker pound and volatility on UK stock markets. The uncertainty of the situation, and its potential for disrupting business is not something that businesses can, or should ignore.

The UK is Europe's second largest economy and the world's fifth largest as measured by GDP, according to the International Monetary Fund. It is an important global hub for industry and technology. But Britain holds an even more strategic position within the global economy as a center of trade and finance. So the potential risks of a change in its status have important implications for the way companies protect their assets and businesses finance their activities, fund pensions, manage their people and operate their supply chains.

IN DEPTH

Should a majority of Britons vote to leave the EU, there will be many possible scenarios for how this could play out. For example, could Britain opt for the Norway option of participating in the Single Market through the European Economic Area (EEA), but with no influence on policy? Or will it seek a Swiss-style relationship with its European neighbors where bi-lateral arrangements replace membership in the EU and other European trade blocs? Beyond near-term uncertainty, each of these scenarios carries a variety of unknown longer-term consequences for businesses that operate in Britain and the EU, and possibly for the global economy as well.

- **What does it mean for capital markets?**

The Bank of England (BoE), Britain's central bank and main interest rate setting body, has been among the most outspoken opponents of Brexit. The BoE's Financial Policy Committee warned last month in a statement that "heightened and prolonged uncertainty" due to a Brexit had the potential to drive up interest rates for a wide range of assets, including loans to businesses. The BoE governor, Mark Carney, specifically drew attention to the possibility of raising the base rate, currently at 0.5%, in order to suppress inflation due to a weaker pound and protect the stability of the financial system.

But a recent poll of economists in the UK found that 17 of 26 surveyed believed the Bank of England would have to lower, not raise interest rates in the event of an exit from the EU. Meanwhile, Carney's predecessor as governor, Mervyn King, said the economic costs of leaving the EU are being exaggerated. Without taking sides, King said that the lead-up to Britain's referendum decision to join the EU in 1975 produced similar hyperbolic warnings, but that in the end, it didn't dramatically change anything.

Any change in interest rate policy would have an immediate and potentially significant impact on the pound, as well short- and long-term investments in debt. Institutions that manage large portfolios of these investments, such as pension funds, insurers and reinsurers would need to consider the impact of Brexit on their company's asset base, solvency and their ability to meet obligations. "That so much is unknown about how the UK will engage with the EU after a potential exit is a challenge for sterling and financial markets." notes Tapan Datta, Head of Global Asset Allocation at Aon Hewitt.

Currency and capital market volatility would not be the only area of concern for businesses – it also extends into the regulation of capital markets. Solvency II, an EU directive that harmonizes rules governing the amount of capital that EU insurance companies must hold to reduce the risk of insolvency came into effect at the start of this year after prolonged negotiations. Following Brexit, EEA insurers buying reinsurance from UK reinsurers could be impacted.

- **What does it mean for trade and tariffs?**

Peter Sutherland, first director general of the World Trade Organization (WTO) believes that losing access to the EU single market would be a major setback for the UK because all of its trade agreements would need to be renegotiated one by one. This would include 27 EU member states, some of whom will likely be in no hurry to allow businesses operating from the UK to enjoy the low tariffs and unencumbered trade access it has now. A related possible side-effect of leaving the EU could be a reduction in Foreign Direct Investment (FDI), of which about half comes from the EU. This could lead to lower productivity, output and wages in the UK. The London School of Economics also noted that the UK financial services industry, the largest recipient of FDI, could be undermined by restrictions on the single passport privileges it currently enjoys.

But Brexit supporters say it all depends on what kind of deal the UK was trying to strike, noting that there would be at least two years to negotiate new bi-lateral trade agreements before having to invoke Article 50 of the Lisbon Treaty, which provides for members leaving the EU. Business for Britain, which campaigns for exit, estimates that at worst, tariffs would cost British exporters just £7.4 billion a year and says the UK would save enough on EU membership fees to be able to compensate exporters for that. Michael Gove, the Pro-Brexit UK Justice Secretary, even supports leaving the EU's tariff-free bloc, stating that the UK's financial services sector would "thrive" in this new environment.

- **What does it mean for freedom of movement?**

A considerable level of uncertainty surrounds the possible impact of a Brexit on cross-border benefits. Currently, a British passport entitles the holder to move freely within the EU and enjoy many of the benefits of the host country. But leaving the EU could bring back border controls, movement restrictions, the loss of local benefits and privileges as well as the imposition of additional taxes on Britons serving in cross border business positions. According to the Brussels-based economic think tank Bruegel, these restrictions could extend to tightening residence rules for non-EU family members of EU citizens, denial of EU citizens residence on national security grounds or if they do not have the resources to live in the destination country. It could lead to other material business concerns, including the indexation of exported family benefits to the local living costs of the residence country, and limiting in-work benefits for newly arrived workers.

A significant focus of the pro-Brexit camp has been on taking control of the UK's borders to stop what they describe as uncontrolled immigration from EU member states. Another concern is mounting deficits at the state-run National Health Service (NHS) amid rising demand for its services.

- **What does it mean for freedom of goods and services?**

A UK departure from the EU could have a significant impact on the supply of goods, access to skills and people, and economies of scale because of the high level of cross-border integration that exists between the UK and the EU. UK Chancellor George Osborne recently warned that it would mean "services that make up 80% of our economy cannot do business freely with Europe, and the integrated supply chains that are a feature of our advanced manufacturing face customs barriers for the first time in half a century". The credit ratings agency Moody Investor Service recently warned of additional trade barriers, delayed investment decisions, regulatory changes and curbs on migration to and from the UK should the country exit the EU.

But Matthew Elliott, chief executive of the Vote Leave campaign, cited the same Moody's report to argue that a new trade deal could be negotiated with the EU, and that as a result there would be no new trade barriers, no change in UK jobs and no change in the UK credit rating.

Britain's thriving service economy, and particularly its financial services sector owes much to existing free trade arrangements with the EU. Insurance and reinsurance alike have been significant beneficiaries of the EU's Freedom of Services Directive, so businesses will need to consider how third party judgements on credit risk may change if Brexit occurs.

Captive insurance, where the insurer is owned and controlled by those whose risks it covers, is one example of a business that may be affected. "While few captive insurers are located in the UK, the ability to deliver insurance policies to and from other EU countries could be impacted," notes Charles Winter, COO & Head of Risk Finance at Aon Global Risk Consulting. However, "Any potential Brexit may fundamentally change how such risks are underwritten and mitigation plans will need to be drawn up," Winter says.

For all of these scenarios, it is worth noting that should Brexit occur, there is a still a two-year notice period before any UK exit from the EU goes into effect – more than sufficient time to modify insurance policies for example. It has been suggested that the actual negotiations could take considerably longer than this. While this could prolong the period of uncertainty on each of these essential matters, it would also bring more time for businesses to make the necessary structural adjustments and allow negotiations on a new relationship between the UK and the EU to reach satisfactory conclusions.

TALKING POINTS

"The likelihood of at least some disruption to economic conditions, trade and foreign investment flows is likely to be enough to weaken sterling further and for equity markets to come under renewed pressure. Gilts will fare better, with nominal yields broadly unchanged and index-linked gilt yields falling." – Tapan Datta, Head of Global Asset Allocation, Aon Hewitt.

FURTHER READING

- The UK's EU referendum: All you need to know – BBC News, April 19, 2016
- Exclusive Brexit poll: With one in five still not sure how they'll vote, Its all to play for – The Daily Telegraph, April 26, 2016
- Gibraltar rock-solid in commitment to British membership of EU, FT.com, April 19, 2016
- EU Referendum: The pros and cons of Britain voting to leave Europe – The Week, April 1, 2016
- What Brexit means for business, QBE, April 1, 2016
- Brexit – Considerations for insurance and reinsurance companies, Aon Benfield, April 27, 2016

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