Policy briefing

November 2016

Navigating Brexit

Summary

At the time of writing the High Court of Justice has ruled that the Government does not have the authority to pull the UK out of the EU without the authorisation of parliament. The ruling is of constitutional and political significance and has serious implications - not just on the Government's timetable for leaving the EU, but on the nature of the withdrawal too. The process will not formally begin now until MPs are happy with the terms of any future deal. The Government has announced it will appeal the High Court's decision, with a further hearing to take place at the Supreme Court on 5 December and a ruling expected in early January.

This briefing provides members with an update on:

- The Great Repeal Bill, Article 50 and the High Court ruling
- The current position of the UK Government and EU institutions approaching the negotiations that are still due to commence by the end of March 2017
- Scrutiny of the Government's conduct
- The economic impact of the UK's decision to leave the EU so far
- The risks and priorities for the insurance sector and wider financial services approaching negotiations.

The Great Repeal Bill, Article 50 and the High Court ruling

Prime Minister Theresa May announced in her speech to the Conservative party conference on 2 October that 'Article 50' of the Lisbon Treaty would be invoked no later than the end of March 2017 to initiate the two year bargaining period which would result in Britain leaving the EU. In the same speech the Prime Minister also declared details of a 'Great Repeal Bill', which will end the EU's legal supremacy in the UK by converting all EU requirements into British law as soon as the Britain exits the bloc. The legislation will also end the jurisdiction of the European Court of Justice in the UK.

Other than insisting there would be no 'running commentary' of preparations and the oft-repeated slogan that 'Brexit means Brexit', the Government has been keen to emphasise that it will not 'show its hand' prior to negotiations – lest its strategy be compromised in any way. Ministers had rejected what they had dismissed as attempts by parliament to micromanage negotiations, despite a report from the House of Lords European Sub-Committee asserting that it was 'inconceivable that these negotiations should be conducted by the Government without active parliamentary scrutiny', and the Opposition's demand of answers to 170 questions on the detail of the Government's plan to leave the EU. But as of 4 November, unless there is a successful appeal to the High Court ruling, the Government's negotiating terms must now face parliamentary scrutiny in the form of a bill before initiating the UK's departure from the EU. Parliament's role will not be to set the negotiating position but to establish national priorities before negotiations begin. It is hoped the debate will offer an opportunity to bring much-needed scrutiny, transparency and challenge to the process and terms of the divorce.

Brexit scrutiny

Sir Keir Starmer has been appointed as the Shadow Brexit Secretary. Otherwise parliament will channel its scrutiny of the Department for Exiting the EU through the newly appointed 21-strong Brexit Select Committee of MPs whose three key tasks, as outlined by Chair Hilary Benn, will be to 'minimise business uncertainty; balance control of free movement with continued access to the EU market for UK goods and services; and find a new way to co-operate with our European neighbours on security, defence and foreign affairs.'

> **"Some uncertainty is inevitable and cannot be resolved until the negotiations have been concluded, but if other uncertainty is the result of conflicting messages or a lack of clarity about the plan, then this is bad news for business and for the UK as a whole."**
>
> **Hilary Benn, Chair of the Brexit Select Committee**

What is known about the negotiating terms

The High Court ruling of 4 November has renewed pressure on the Prime Minister to reveal her favoured set of 'bespoke' deals or map of broad objectives for the 6 industry sectors that the Government has emphasised as being of strategic importance to the UK economy - financial services, life sciences, tech, car manufacturing, aerospace and the creative industries. Leaders of these sectors are also understood to be those with who Chancellor Philip Hammond and Brexit Secretary David Davis held their first roundtable discussions as part of the Government's 'national consultation' to inform the negotiating mandate.

Davis has reiterated the Government's four-point plan for Brexit negotiations (build a national consensus; put the national interest first; minimise uncertainty; deliver parliamentary sovereignty and supremacy upon withdrawal); and the current four strategic aims of the negotiation strategy:

1. Bring back control of laws to parliament
2. Bring back control of decisions over immigration to UK
3. Maintain strong security cooperation with the EU
4. Establish the freest possible market in goods and services with the EU and rest of the world.

> **"There is clearly no mandate for a deal that involves accepting the existing arrangements governing free movement of people from the European Union, but we do not accept that there is a binary trade-off between border control and access to the single market for goods and services."**
>
> **David Jones, Minister of State for the Department for Exiting the EU**

The view from the EU

The structure of the EU's negotiating team has become clearer, with the European Commission's Chief Negotiator Michel Barnier in place to lead negotiations. Barnier is former Commissioner for Financial Services and will be familiar to the City of London due to the legislation he oversaw to install caps on banker's bonuses, which the UK was outvoted on in 2013. He is also a notable critic of 'Anglo-Saxon' finance. But the political steer of his position will be provided by the European Council, so it will therefore be the task of the Council's Didier Seeuws to corral the remaining 27 member states into a single position to provide the EU's mandate. Meanwhile, the European Parliament will use the threat of its veto to ensure its Brexit co-ordinator, former Prime Minister of Belgium and current leader of the 'Alliance of Liberals and Democrats for Europe' (ALDE) political grouping, Guy Verhofstadt, and the Parliament's Conference of Presidents are directly involved in the negotiations from the start. Influential voices within EU institutions have been intransigent in rejecting advances to begin preparatory talks before the UK has formally resigned from the EU - sticking steadfastly to the principle of 'no notification, no negotiation'.

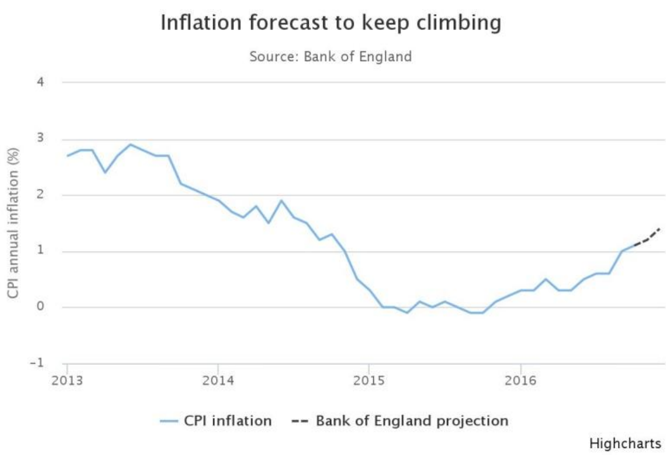
> **"The basic position of all the institutions in Europe is very clear: The four freedoms are bound to each other. The internal market is based on four freedoms - not three, or two."**
>
> **Guy Verhofstadt, Chief Brexit negotiator, European Parliament**

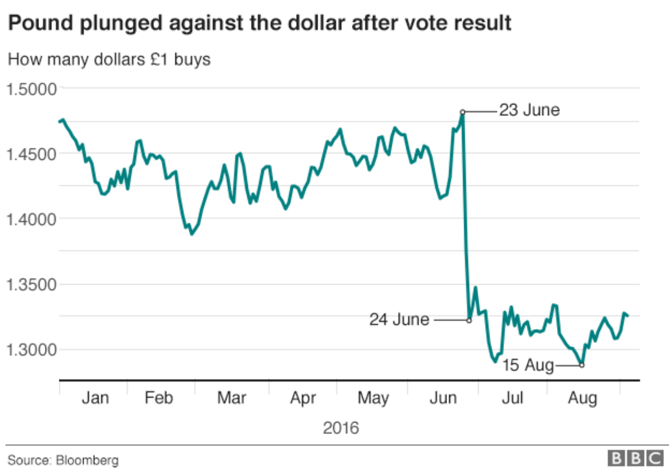
Ultimately the depth of co-operation permitted at EU level will be driven by politics and the preferences of powerful political actors in both the UK and the remaining EU member states. The latter have commenced their own discussions about the future direction of the EU and the stance to be taken towards the UK. At the informal Bratislava Summit in September, leaders and officials were united in their shared view that the four fundamental freedoms of the EU - labour, capital, goods and services - are indivisible in practice. Further emboldened by the ascendance of an anti-establishment candidate to the American presidency, it is widely understood that it is the spectre of strengthening populist or Eurosceptic movements in upcoming elections on the continent over the next 12 months which is driving this conviction in the four freedoms as defining the EU's institutional integrity.

What has been the economic impact so far?

> **"... [The High Court ruling] is an example of the uncertainty that will characterise this process. The negotiations haven't even yet begun, there will be uncertainty, there will be volatility around those negotiations as they proceed, and I would view this as one example of that uncertainty."**
>
> **Mark Carney, Governor of the Bank of England**

Although indicators suggest that the economy has so far held up well in the face of the vote to leave the EU, it is still too early to gauge long term impact. According to analysis from the Office for National Statistics, the 'pattern of growth continues to be broadly unaffected following the EU referendum' so far, but the consultancy firm PwC expects 'Brexit to exert a long, slow drag on growth, rather than giving the economy a short, sharp shock'. Senior economists at Berenburg bank maintain that the resilient post-referendum performance - where third-quarter GDP (July-September) rose by 0.5% driven by a service sector that grew by 0.8% - 'does not say anything about the UK's ability to perform outside of the EU'. The performance of the service sector - owing much to strong consumer spending and





retail sales figures - off-set falls in other industrial groups as construction contracted by 1.4%, agriculture by 0.7% and manufacturing by 1%.

The value of sterling has fallen considerably since the referendum - by 18% against the dollar to levels not seen since 1985, and by 15% against the euro. That the pound tumbled in reaction to Theresa May's party conference speech where the Prime Minister appeared to prioritise control over immigration above retaining tariff-free single market access, but then completed its best week against the dollar since 2009 as the High Court insisted on the parliamentary scrutiny of Article 50 activation, is evidence of the volatility of the currency markets which is likely to continue against the backdrop of elections that could demonstrate the strength of anti-establishment movements across the continent – as well as in the aftermath of the US presidential election.

The currency's weakness has been met by the announcement from the Bank of England that it would keep interest rates at a record low of 0.25% and would drop plans to cut them further in the near future. The Bank forecasts that inflation will rise from 1.3% this year to 2.7% by the end of 2017 as the effects of the weaker pound feed through to consumers, hitting household disposable incomes. This inflation warning has been tempered with the projection that economic growth will be much stronger in the near-term than previously forecast.

As far as confidence is concerned, a report commissioned by financial services company Hitachi Capital and conducted by the Centre for Economic and Business Research and YouGov indicates that a third of all UK businesses have abandoned or postponed investments totalling £65.5 billion as a result of the vote to leave the EU. The survey of senior British business decision makers cited the fall in the value of the pound, uncertainty over the UK's future membership of the single market and domestic-economic health as the dominant drivers for this hesitancy. If left unresolved, the report authors expect that these factors will continue to impact upon planned investments for 2017 and beyond.

Financial Services

> **"If sovereignty on immigration is the anchor of the Government's strategy, and that's what you want as the British people, then you have to accept that... you will not get a financial services agreement. You can get, with skilful negotiation, pretty much open physical trade."**
>
> **Philip Hildebrand, former head of the Swiss central bank**

The biggest hint yet of the Government's wider approach to Brexit negotiations - other than a commitment to assuring the greatest degree possible of free access to European markets and limitations placed on the free movement of people - is revealed in the deal it struck with the carmaker Nissan to commit to building new models in Sunderland, and the extension of the guarantee by Business Secretary Greg Clark to other UK-based car manufacturers. The detail of the agreement has not been shared with the public. However, it is evidence that ministers are preparing to compartmentalise trade negotiations sector by sector - an approach that will inevitably create winners, losers and tradeoffs. It is therefore incumbent on the insurance, financial planning and wider financial services sectors to identify the risks and opportunities that the UK's exit from the EU may bring.

Source: TheCityUk: 'Key Facts About the UK as a Key Financial Centre'

The Treasury will be responsible for leading negotiations in relation to financial services. Chancellor Philip Hammond and Economic Secretary Simon Kirby will be in no doubt of the importance of the sector to the economy - contributing almost

12% of total UK GDP, £67 billion a year in tax revenues and directly employing more than two million people. But it is also the public that representatives of the industry must convince that its broad socio-economic contributions are nationwide, reaching far beyond the City of London. Shadow Chancellor John McDonnell's recent accusations that the Government is preparing to favour a 'banker's Brexit' and the City of London in negotiations feeds into a narrative that seeks to discredit the financial services as existing at the expense of the wider economy. Of course this couldn't be further from the truth - two thirds of the jobs in financial and professional services are outside of Greater London, about 160,000 people are employed in Scotland and more than 54,000 in Wales. Major employers include Citigroup in Belfast, Standard Life in Edinburgh and Aviva in Norwich. The £67 billion generated by the sector in tax is equivalent to the entire education budget and close to double the transport budget. Research by the management consulting firm Oliver Wyman for TheCityUK estimates that severe restrictions on the UK's ability to trade with the rest of the EU would result in 35,000 financial-services jobs being at risk, along with as much as £5bn in tax revenues - which could be doubled by the knock on effect to the sector's network of interconnected businesses, suppliers and associates.

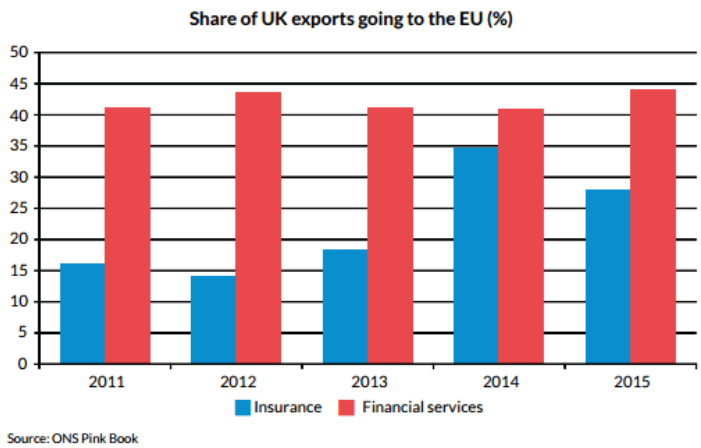
The priorities of the UK insurance market

Although large sections of the UK insurance and long-term savings industry are entirely domestic and retail and are less likely to be directly affected by Brexit, it is important to note that there will be others - such as Lloyd's of London where the EU accounts for 11% of gross premiums written by the London Market - for which the course of negotiations will have a profound impact. The insurance sector as a whole must speak with one voice approaching negotiations so that it is not diluted by the wider financial services agenda, or overshadowed by other sectors that are more unified. This will be vital if the industry is to clearly articulate what it would like to see in a future UK-EU relationship.

The key negotiation objectives for the insurance sector that have been identified by the different bodies representing the market can be found in the 'Useful Links' section at the end of the briefing. There is a consensus regarding the top five priorities, which are discussed in a little more detail below.

Single market access and passporting

The 'passporting' system enshrined in EU legislation permits banks, insurers and asset managers headquartered in the UK to sell their services freely without authorisation or regulation across the EU single market, and enables the same financial services based in Europe to sell services to customers in the UK and access to the global financial centre that is London. Equally non-EU companies can set up an office in London, Europe's main financial centre, and from there conduct all of their business on the continent.



Passporting works differently for some areas within the financial services compared to others as market access between the UK and EU relies on a patchwork of regulations and principles, where different sectors trade on different terms. The insurance industry is, in fact, is less reliant on European markets. In 2015, 28% of insurance exports went to the EU, compared to 44% for the financial services as a whole. The majority of insurance services provided in other countries are also done so via separately capitalised local subsidiaries, which are not reliant on the passport. However, the ability to passport in and out of the UK is extensively used by wholesale General Insurance and some long-term savings providers, for example, while the Lloyd's of London insurance market is also a major beneficiary of current regulations that allow the pool of underwriters based in London to serve clients across the EU. The requirement to set up separate branches or subsidiaries in each EU member state, or to select an EU state to utilise passporting from there, would undermine the model of clustered capital and expertise that has secured the position of the UK insurance market as the largest sector in Europe.

The insurance sector is keen to ensure that the passporting debate is not viewed entirely through the prism of international wholesale banks (where around a fifth of annual revenue is estimated to be built on access afforded by passporting) but reflects its importance across parts of the insurance sector too, and especially to Lloyd's of London.

Transition arrangement

An interim settlement covering the period between leaving the EU and a final agreement on trade and market access is essential to avoid a 'cliff-edge' that could plunge the UK into legal, trading and financial uncertainty – if, as seems increasingly likely, both the UK and EU are unable to reach an agreement on both the terms of exit and a future relationship by spring 2019. In such a scenario, passporting rights and regulatory approval to provide services, for instance, would disappear overnight with nothing to replace them. A transitional agreement to preserve financial and economic stability would allow the industry greater time to plan and bridge the gap between the end of the Article 50 negotiating period and the conclusion of talks on the future UK-EU relationship.

What is clear is that the industry needs maximum certainty about the prospects for future market access and possible transitional arrangements as soon as possible. Firms will not be able to risk this uncertainty to their business operations.

A regulatory environment appropriate for the UK market

To continue the free flow of business between the EU and the UK, it is vital that the regulatory regimes between the two remain comparable regardless of the settlement which is negotiated. Additionally, the continuation of robust regulation and governance will help to attract capital investment, and uphold London and the UK as centres of regulatory excellence, expertise and the highest standards.

Regulatory 'equivalence' - which extends limited access to non-EU jurisdictions that have rules deemed equivalent by the European Commission - could mitigate some of the potential damage caused by the loss of single market membership, but is at best a partial solution and not a permanent way forward for the largest insurance market in Europe. Equivalence does not cover the full range of financial services regulations, is applied for and granted by the Commission, can be revoked at short notice, becomes irrelevant when the regulation it mirrors moves on, and most importantly, the UK would have accept standards it has no say over. It could, however, form the basis for a transition arrangement before a more comprehensive and permanent bespoke deal is agreed.

Protection of existing EU employees and a pro-skills migration policy

The insurance market is in agreement that if freedom of movement is to be restricted, a future migration policy must not inhibit the recruitment and employment of high-skilled professionals in the sector from both within and outside the EU. Although the Chancellor Philip Hammond is on record as saying to the House of Lords Economic Affairs Committee that he could not conceive of any circumstances in which immigration controls would be used to prevent financial services from moving highly-qualified staff between different parts of their businesses, the sector is anxious that any move to usher in a uniform reduction in immigration across the UK must be tempered by practical proposals regarding access to non-UK migrant workers.

Strong focus on regulatory dialogue and international agreements in non-EU trade

Much of the public focus on possible trade deals has so far been focused on goods. The sector calls on the Government to ensure that financial services are also considered at the heart of new agreements, as there is a strong appetite within the industry to develop new relationships with non-EU insurance markets, such as with India and

China. The UK sector is uniquely placed to lead this agenda given its existing links to global trade, particularly through the London Market.

Managing post-Brexit risk for insurance firms

Importantly, all existing regulatory requirements (as well as those due to be introduced) will remain in place until the UK formally leaves the EU. Clearly there are significant implications for the insurance market, both directly in terms of access to European markets and to talent, but also indirectly as the macroeconomic, competitive, and regulatory environments evolve. Areas of General insurance in particular are highly governed by or closely linked to European law and practice - such as motor, travel and health - as is the whole regulatory regime derived from Solvency II. Insurance services with considerable EU operations will have to consider how the future development of EU regulations and directives will be affected without the UK's influence. UK companies will need to prepare themselves for how leaving the EU may affect the talent pool in the sector, and review how they might be able to develop more at home, or recruit further afield.

The Chancellor's remarks to the House of Lords Economic Affairs Committee that the City shouldn't be 'hung up' on old ways of conceptualising the UK's relationship with the EU, and that the Government was looking at 'other options beyond passporting', would suggest that areas of the sector that conduct cross-border operations should prepare for some level of disruption. In the wider financial services landscape, Anthony Browne, the Chief Executive of the British Banking Association has warned that 'most international banks now have project teams working out which operations they need to move to ensure they can continue serving customers, the date by which this must happen and how best to do it' and that their 'hands are quivering over the relocate button'. Lloyd's of London Chief Executive Inga Beale has suggested that in order to maintain its position in a post-Brexit landscape, contingency plans for the London Market have explored the possibility of establishing branches in individual EU countries or an EU-wide subsidiary.

Although many restructuring options are plausible, none are quick fixes. The timeframe to plan and implement new business models is likely to take between one and two years given the regulatory, tax or legal approvals needed, and the volume of applications expected could slow this further. Organisations will be building on impact assessments to engage in more sophisticated scenario analysis, and plans will need to be flexible to adapt to the course of negotiations. It will also be an opportunity for firms to consider if their business models are fit for the future.

Useful Links

The response from the Insurance sector

Association of British Insurers (ABI) has set out five priorities to 'make the best of Brexit':
http://blog.abi.org.uk/2016/09/five-priorities-to-make-the-best-of-brexit/
and published an 'EU Exit EU legislation mapping exercise document':
https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2016/EU%20exit/EU%20legislation%20mapping.pdf

British Insurance Broker's Association (BIBA) has asked Government to consider 11 points affecting brokers and their customers during Brexit negotiations:
https://www.biba.org.uk/press-releases/biba-asks-government-consider-11-brexit-points/

London Market Group (LMG) have published their 'Actions for Government post referendum':
https://www.airmic.com/sites/default/files/technical-resource-items/LMG%20post%20referendum%20messaging%20for%20Parliamentarians%2013.07.16%20FINAL%20(002).pdf

Other links

'Brexit and Beyond: How the United Kingdom might leave the European Union', A report by The UK in a Changing Europe for Political Studies Association:
https://www.psa.ac.uk/sites/default/files/Brexit%20%26%20Beyond_0.pdf

'Giving Meaning to Brexit' by Andrew Tyrie MP for Open Europe:
https://www.airmic.com/sites/default/files/technical-resource-items/LMG%20post%20referendum%20messaging%20for%20Parliamentarians%2013.07.16%20FINAL%20(002).pdf

'The impact of the UK's exit from the EU on the UK-based Financial Services sector', Oliver Wyman:
https://www.thecityuk.com/assets/2016/Reports-PDF/The-impact-of-the-UKs-exit-from-the-EU-on-the-UK-based-financial-services-sector.pdf

'How the UK's financial services sector can continue thriving after Brexit', by Stephen Booth and Vincenzo Scarpetta for Open Europe:
http://2ihmoy1d3v7630ar9h2rsglp.wpengine.netdna-cdn.com/wp-content/uploads/2016/10/0627_Digital_Pages-Open_Europe_Intel-Thriving_after_Brexit-V1.pdf

'Brexit: parliamentary scrutiny', House of Lords, European Union Committee 4th Report of Session 2016-17:
http://www.publications.parliament.uk/pa/ld201617/ldselect/ldeucom/50/50.pdf

'Why Europe wants a hard Brexit to hurt', by Charles Grant, Director of the Centre for European Reform:
https://www.theguardian.com/commentisfree/2016/oct/07/europe-hard-brexit-hurt-british-trade-deal

'Brexit politicians are putting us on a fast track to financial jeopardy', by Anthony Browne, Chief Executive of British Bankers Association:
https://www.theguardian.com/commentisfree/2016/oct/22/brexit-threat-to-british-banks

'Key Facts about the UK as an international financial centre', TheCityUK:
https://www.thecityuk.com/assets/2016/Reports-PDF/Key-Facts-about-the-uk-as-an-international-financial-centre-2016.pdf

'Brexit & the City: The important role of financial and professional services across the UK' by Mark Boleat, Policy and Resources Chairman, City of London Corporation:
http://www.newstatesman.com/politics/uk/2016/10/brexit-city-important-role-financial-and-professional-services-across-uk

Appendix

Figure 1: A possible timeline for negotiations

Source: Chartered Insurance Institute

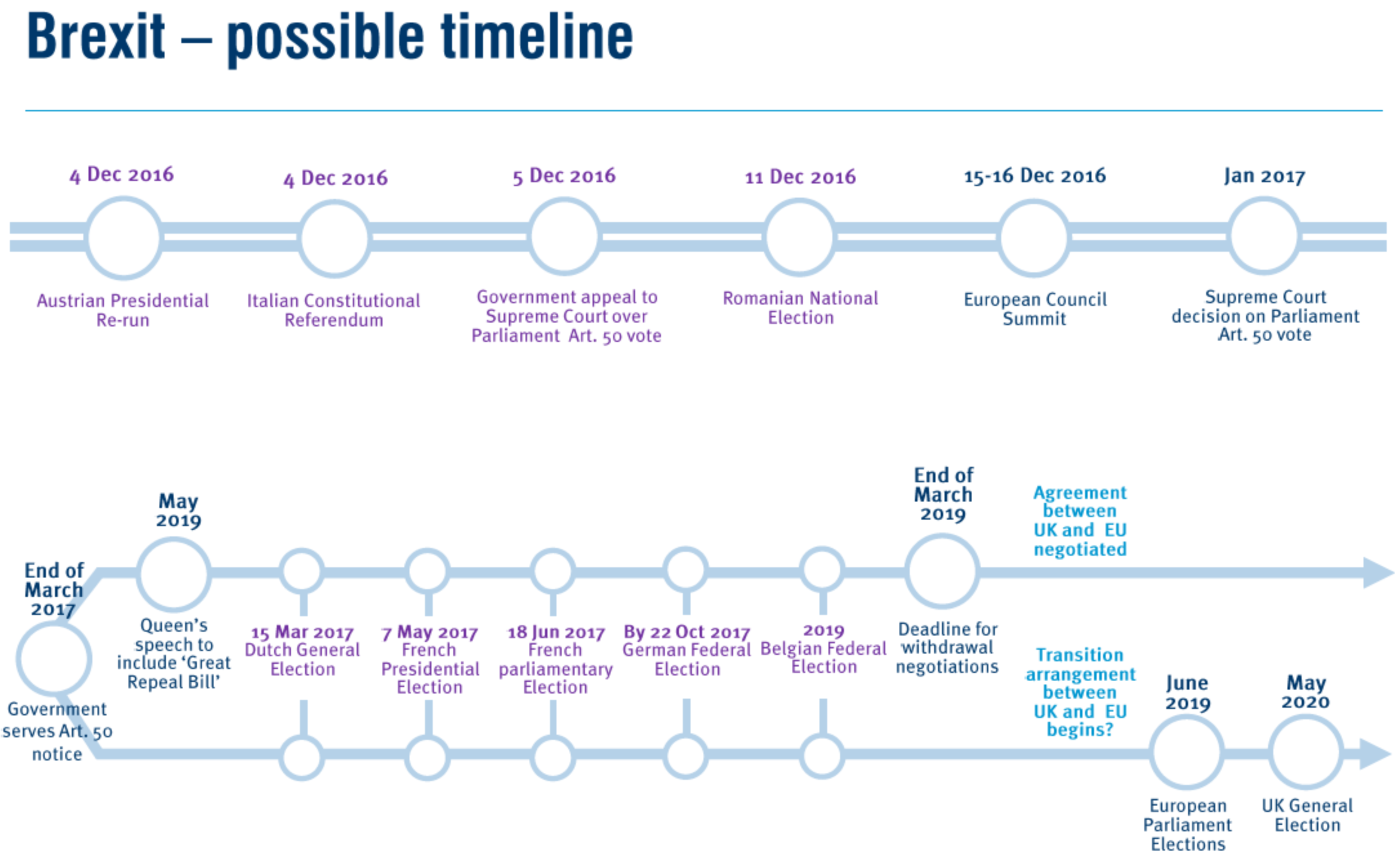
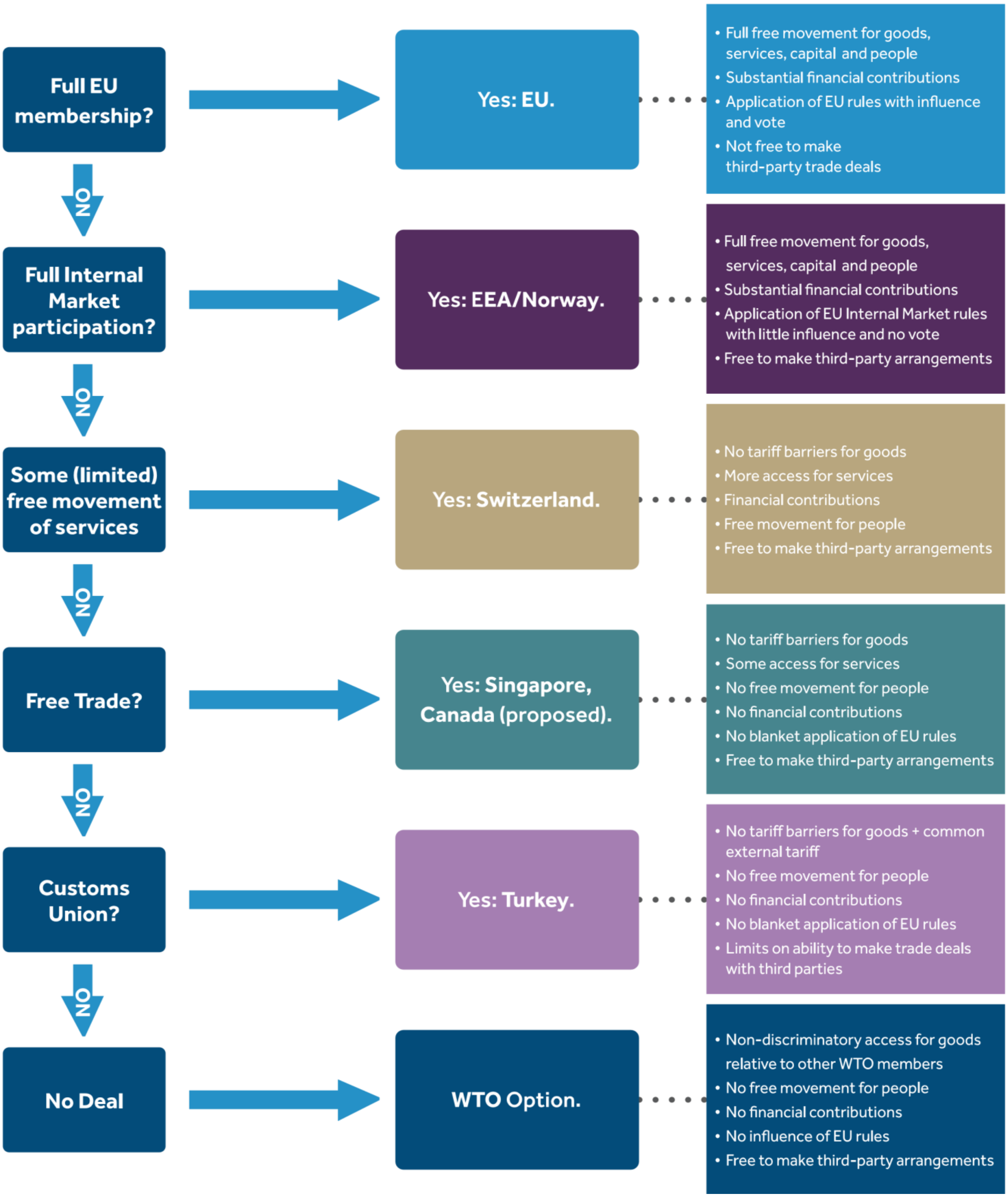


Figure 2: Existing 'off the shelf' models for the UK's future relationship with the EU

Source: Political Studies Association



Lawrence Finkle
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