COUNTDOWN TO BREXIT

A REPORT FROM QBE BUSINESS INSURANCE

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Introduction

The public has expressed a preference for Britain to leave the EU and we must now work on the basis that the UK will be exiting the EU and potentially the single market some time before 2020.

While on the surface nothing structural has changed yet, the immediate effects of the vote have been widely felt. Sterling hit a 31 year low against the dollar and the FTSE suffered an immediate drop. The market rebounded but some of Britain's largest companies continue to feel the brunt of foreign exchange volatility. GDP growth forecasts are less positive and inflation is set to rise.

The devalued pound will make life more expensive for all of us and puts immense pressure on those businesses that rely on imports. There is always an upside however and for those who export this could well be a period of opportunity.

We are facing a period of unprecedented uncertainty whilst our political leaders determine how to approach the situation. Even when Article 50 is invoked it is unlikely there will be much clarity as there will then be a period of extended negotiations.

In the meantime, we must all prepare for a world where the UK is outside the EU in some way, a challenge which applies not only to UK businesses operating within the EU but also to those EU businesses with activities in the UK.

In terms of the coverage and service QBE provides our customers, it is business as usual while the UK remains a full member of the EU. In the background however we will refine our contingency plans as negotiations evolve, particularly with regard to passporting to ensure we maintain full continuity of service whatever occurs.

The aim of this report is to help businesses navigate through the uncertainty. Whilst we cannot map out every implication within every business sector in the UK, we can provide a guide how to create your own 'impact map' for your business, and also give some guidance around the likelihood and the effects of the multiple outcomes that are now under consideration.

Risk Managers have a critical role to play during Brexit planning. Risk management teams will be working on the front line alongside CEOs, COOs, CFOs and Boards to model and plan for Brexit.

This paper is a follow up to an original document, *What Brexit means for business*, published in April 2016. That document was based on a series of interviews with experts in a variety of fields; from law, accountancy, regulation, insurance and economics, and it is their expertise that has supported the writing of this piece and that you will find summarised below. As ever, in a highly uncertain situation, most of what is included here remains opinion, rather than proven fact, and should be read in that light.

Richard Pryce
Chief Executive Officer,
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What departure will mean

The EU began life as an enhanced Free Trade Agreement. Starting with the European Coal and Steel Community and subsequently the European Economic Community, The European Union was formally established in 1993 following the Maastricht Treaty. It was set up to help reduce tariffs and encourage business dealings between European trading partners. Key arrangements for business that come from the EU include:

- **the existence of a single market**; there are no tariffs or other barriers limiting the export of goods and services to any country in the EU
- **the free movement of capital and services**, supported by the system of 'passporting' which allows financial services, including insurance (in which the UK is the EU's leading player) to be bought and sold (broadly) without restriction across the EU
- **visa-free migration of people within the EU**
- **access to EU Free Trade Agreements**, which reduce trade tariffs with 53 non-EU countries around the world, and connects us to the World Trade Organisation.

There is an intense and prolonged period of negotiation on the horizon, both formal and informal, whereby the UK government will identify which of these agreements it is determined to retain, and which it is prepared to sacrifice. The European Council will be carrying out a similar exercise on its side and ultimately some form of compromise will need to be struck. We look at the various models later in this report but in summary there are a range of scenarios from the highly unlikely UK remain, to an equally remote break-up of the EU itself. Negotiations don't stop with just the EU, as global agreements will need to be put in place to replace those that exist as part of EU membership.

Unfortunately for the UK's negotiating team, the EU's key players have already agreed and clearly stated some hard-line principles that will shape this process.

After the EU summit of June 28th—29th 2016, European Council President Donald Tusk made clear that Britain faces a choice between single market access and the power to control EU migration – and cannot have both. He stated via his official Twitter account that "access to the single market means acceptance of all four freedoms. No single market à la carte". (The four freedoms are the free movement of people, goods, capital and services within the EU).

German Chancellor Angela Merkel, in a speech to the German Parliament in July 2016, repeated the same view. "We will ensure that the negotiations will not be run on the principle of cherry-picking. We must and will make a palpable difference over whether a country wants to be a member of the family of the European Union or not... the four freedoms are indivisible." Informally, the Council has also agreed that "access to the internal market requires retaining the jurisdiction of the European Court of Justice to settle disputes and a contribution to the EU budget roughly equivalent to what is paid today."

Whilst the four key players, Merkel, Hollande, Juncker and Tusk, have all stated the EU's agreed stance, there have been some attempts to soften the mood in advance of the triggering of Article 50. President Donald Tusk told Theresa May in mid-July "we need an orderly, calm Brexit, ... a 'velvet divorce'", whilst Jean-Claude Juncker told a press conference "We have to engage in negotiations. And I'm not doing this, how I could say, in a hostile mood."

In summary, the EU is emotionally divided, as best expressed by President Donald Tusk, who, whilst stressing that "maintaining the closest relations is equally important", also stated: "it is equally important to send today a strong message to the whole world that Brexit... is just an incident and not the beginning of a (disintegration) process".

The Norwegian Model

Norway is a member of the European Economic Area, but not the EU. This means that Norway has full access to the single market, but must adopt EU standards and regulations with little influence over these, and is unable to impose immigration restrictions. It also means that Norway must contribute towards the EU budget.

The issue for politicians contemplating this model is that, whilst it would be temptingly easy to follow this well-trodden path, delivering us continued access to European trade and markets, the Norwegian model does not allow the UK the freedom to manage the movement of people which was a central issue of the referendum debate.

In the words of respected Eurointelligence economist Wolfgang Munchau: "The EEA or Norway option is utterly inflexible. You cannot negotiate a bit less market access for a bit less freedom of movement. If you choose the EEA, there is in fact not much to negotiate."

The Swiss Model

Switzerland has had some success in building a two-way deal with the EU, which essentially allows it to access certain selected parts of the European market in return for accepting EU legislation in relevant areas as well as making contributions to the EU budget. The results have been patchy. So, while Switzerland has gained some access to the financial services marketplace in Europe, it is currently locked in its own dispute with the EU over the free migration of people – a dispute ironically triggered by a referendum in Switzerland a few years ago. Without a vote or influence within the EU, it has proved difficult for Switzerland to get its view heard in these sorts of disputes. Dr Gregor Irwin, the Chief Economist of Global Counsel, comments that "with something like the Swiss model, or a British version of the Swiss model, how insurance would be treated is far from clear. The transition would be messy."

The Canadian Model

An entirely different approach would be to strip the relationship with the EU back to its trade-based roots. The EU is in the process of ratifying the most far-reaching trade deal with Canada that has ever been created, and it is possible that the UK could aim to replicate this sort of relationship. Such an agreement would not easily allow the continued passporting of financial services, however, and it would certainly mean the end of visa-free migration across Europe. But only this radical model will give the UK control over the free movement of people and liberate it from the dictates of the European Court of Justice.

This is the most challenging option for the UK to negotiate. It would require fresh agreements on almost every area of interaction between the EU and the UK, from fishing rights to farming subsidies. It would require years of negotiation, and a large team of experienced trade negotiators – which the UK has yet to assemble. In addition, the Canadian agreement has recently hit issues, in that it is proving problematic to get all EU countries to ratify the treaty via their own parliaments and this needs to occur before it comes into force. It is now likely that it will be some years before the Canadian trade deal is ratified, which creates the possibility of a long period of uncertainty for the UK too.

Which approach is preferred?

Ashoka Mody, former Deputy Director of the International Monetary Fund's European and Research departments, believes that the compromise models of semi-detachment – Norway and Switzerland – that would leave the UK as a member of the European Economic Area (EEA), but not the EU, have been effectively rejected because they presuppose "free movement". In his view "It would be to fly in the face of the vote to accept essentially the same terms the UK has now, but without a seat at the decision-making table."

Wolfgang Munchau of Eurointelligence has his own alternative view. "The most straightforward option, and the one I favour, is membership of the European Economic Area. The quid pro quo would be full acceptance of the EU's four freedoms, including the most important one: the freedom of movement of labour. Britain would also have to pay in to the EU's budget."

Munchau proposes, like Ashoka Mody, that the other option for the UK would be a bilateral free trade agreement – the Canadian model. But he does not favour it. In his view "this is not to be confused with single market access. Under a bilateral free trade agreement, the City of London would inevitably lose passporting rights. There is no way the EU would allow UK-based companies post-Brexit to undertake financial transactions into the EU. Even Germany would not accept this. A bilateral agreement would allow for the free flow of goods and some services. But it is clearly not the same as being part of the single market."

Strangely, it is not yet apparent that the EU has recognised the level of its own passporting issues with regards to a UK exit. The UK offers hugely advantageous resources for all EU financial and professional services. For example:

- all ten of the EU's top law firms are headquartered in the UK
- London processes 78% of the EU's forex trades and 59% of international insurance premiums
- 85% of hedge fund assets and 64% of private equity funds under management in Europe are managed in London

But in spite of this, most commentators agree that the UK will have a choice between retaining the passporting of financial services and other single market advantages, and allowing the free movement of people. Put simply, the Government and Parliament will have to choose between sacrificing the single market, and the desire to control borders (and therefore the free movement of people), which was such a key populist part of the campaign.

Wolfgang Munchau is particularly stern on this point, concluding: "there will be a direct trade-off between passporting, available in the EEA, and control over immigration, possible under a free-trade agreement. The UK can have one or the other, but not both. Nor can it have a portion of both. It will have to make a political choice. Maybe it will be possible to sequence the two. Britain could opt for an EEA treaty, and then go for a free trade deal later. That might be a compromise — though it might require trust, and may fail for that reason."

Ashoka Mody agrees: "there is no sign whatsoever that an EEA deal minus free movement would be on offer from the EU".

In summary, all sides are currently still struggling to reconcile the central issue of allowing the UK to continue to trade freely with the EU, without permitting the free movement of EU citizens into the UK. At present the 27 remaining members of the EU are talking tough and are not looking to compromise on these points. The history of the EU's relationship with Switzerland, where this has also been a long-running issue, demonstrates their history of inflexibility on this point.

In conclusion. Formal negotiations have not yet begun, and fresh ideas for compromise may come to light, but at present there is a fundamental difference between the EU and the UK's wishes for future cross-border trading. Unfortunately, when planning for Brexit, you cannot assume that the government will work this out and "it will all be OK". History tells us this is not often the case. Instead it is critical to consider realistically how you will be impacted by a complete loss of the single market. On the flip side, you also need to consider how your labour force will be affected by the imposition of a points-led visa system for immigration. Both of these are likely outcomes of Brexit.

Timetable for departure

A Member State's right to withdraw from the EU was introduced by the Lisbon Treaty and is contained within Article 50 of the Treaty on European Union. Article 50 sets out the procedural requirements including the negotiation of an agreement setting out the terms of withdrawal and defining the Member State's future relationship with the EU. Critically if no agreement is concluded within two years, then unless the period is extended, their membership of the EU ends automatically.

The government has already published a 28-page document entitled "The process for withdrawing from the European Union". This sets out the formidable challenges that lie ahead in the departure process. Whilst we in the UK are currently pre-occupied with our own preparation for negotiating exit, it is worth remembering that things are infinitely more complicated on the EU side of the fence. For a start, the European Council first of all has to draw up and then agree unanimously the guidelines for the Commission to negotiate the withdrawal agreement. This requires the 27 remaining Member States to agree unanimously a set of negotiating priorities before they can begin negotiations.

Further down the line, once a deal is agreed it would need to be agreed by 20 out of 27 Member States, and it would also have to be approved by a majority of the European Parliament's 751 MEPs. In addition, Article 50 does not specify how much the withdrawal agreement itself should say about the future relationship between the EU and the departing Member State. Any plans for a future relationship would have to be put in a separate agreement, negotiated by a different team alongside the withdrawal agreement. Article 50 does not specify whether these negotiations should be simultaneous or consecutive, and, as the government's own document puts it: "this would be a matter for negotiation".

With that said, the UK and the EU will need to be on speaking terms. They will still be partners in NATO, the G7 leading economies and the G20. There is still hope for mutual respect and future cooperation between the sides.

Processes for negotiating withdrawal from the EU (Article 50, TEU) and for negotiating a new agreement under the Treaty on European Union (TEU) [2]

Withdrawal agreement from the EU Article 50 (Treaty on European Union)

1. European Council (excluding the UK) agrees by consensus guidelines for the EU's negotiation
2. Possible further stage where the European Commission submits recommendations to the Council of the European Union and the Council (excluding the UK), by enhanced qualified majority voting, authorises the opening of negotiations and apppoints negotiator
3. European Commission undertakes negotiations
4. European Parliament consents to the withdrawal agreement by a simple majority
5. Council of the European Union (excluding the UK) agrees to withdrawal agreement by enhanced qualified majority voting

New agreement with the EU (excluding the UK)

1. European Commission submits recommendations to the Council of the European Union
2. Council of the European Union agrees the opening of negotiations, and appoints negotiator/special committee. Voting procedure in the Council depends on what the agreement covers, but a detailed agreement would likely need unanimity
3. European Commission undertakes the negotiation, in conjunction with negotiator/special committee
4. European Parliament is either consulted on the new agreement or has to give its consent, by a simple majority, depending on what the agreement covered
5. Council of the European Union agrees to new agreement. Voting procedure in the Council depends on what the agreement covers, but a ambitious agreement would likely need unainimity
6. Individual Member States ratify the final new agreement nationally if it is a mixed agreement

[2] Qualified majority voting is a system used for EU Member States to reach an agreed position. Under the Lisbon Treaty, a majority must include 55 per cent of countries, representing 65 per cent of the total EU population. But Article 50 of the Treaty on European Union stipulates that the voting rule to be used is that set out in Article 238.3(b) of the Treaty on the Functioning of the European Union, which requires 72 per cent of Member States (i.e. 20 out of the remaining 27 Member States) comprising 65 per cent of the EU population.

Brexit: analysis of impacts on businesses

It is easy to underestimate the all-pervasive influence of the EU on the UK economy. This is true within insurance too. Sean McGovern, former General Counsel of Lloyd's, put it succinctly: "We say it often enough, hear it often enough, we trade in it every single day without a second thought. Let's face it. We take the existence of the European Single Market for granted." It is hard to imagine our working lives without it.

So how can UK businesses reset for the disappearance of this long-term partnership? How can we organise for an unknown future relationship, not just with the EU, but also elsewhere internationally, and what will the impact be on corporate risks?

The rest of this paper looks at how to plan for the future, and gives guidance on navigating through uncertain times. We start with a summary, business area by business area, supplied to us by experts in each field, of the impacts of Brexit in the areas of:

- people and staffing
- taxation
- business accounting
- regulation
- business planning and costs
- import/export (or international trade)
- insurance.

People and staffing issues

Recruitment challenges

The free movement of labour across the EU has been in place for over forty years now. Many UK businesses rely on large numbers of EU workers in their labour force, and this is true of both skilled and unskilled workforces, from accountants to agricultural workers.

To give an idea of the scale of the movement that the visa-free situation has created, here are a few eye-watering statistics. There are over 1.5 million British citizens living in other countries in the EU, over half a million European students studying in the UK, and to pick the largest migrant nationality of all, over a million Poles living in the UK[1]. Net migration from the EU to UK has more than doubled since 2012.

What will happen to these people is of course a hot topic politically, and it is also immensely stressful for the millions of people who now feel uncertain about their future in the UK or elsewhere in Europe.

However, whatever the rhetoric and the anxiety around the point, in this case a happy ending is very much on the cards. It is highly likely that even if the UK's final arrangement with the EU sees the end of visa-free migration, there will an exception made for those who are already in-country, under the commonly used EU principle of 'grandfathering'. Lawyers Clyde & Co believe "people from other EU countries living in the UK or UK nationals living abroad, will not be made to go home."

In the longer term, the government can "choose to align EU immigration with the [existing] non-EU points system".[2] In this case the balance of migration will skew heavily towards the skilled workers who have the points to get a visa, and away from unskilled workers, who mostly won't. So while our accountants will still very likely be able to recruit qualified talent from across Europe, albeit with an increased level of paperwork and administration required, UK businesses that rely on large pools of unskilled migrant workers are likely to find themselves with some large gaps to fill, and raised labour costs.

As lawyers Clyde & Co neatly summarised: "if the labour market becomes ever tighter and the ability to employ a range of people, be they low-paid, unskilled, or skilled is reduced, and there are restrictions around that, it is only going to increase costs… You're just restricting the labour market."

Employment law

In writing this section, we relied in large part on an interview given by Heidi Watson of Clyde & Co, to whom we are most grateful.

Heidi Watson points out that "a lot of our employment laws are derived from Europe, including really big ones like our discrimination laws and entitlement to maternity pay".[3] The question then arises whether we can expect that all of these laws will be repealed. Interestingly, "UK Governments historically dragged their feet in implementing discrimination and family friendly laws until forced to do so by the EU". So some might assume that the UK will want to find a way to extricate itself from them.

In spite of this, Heidi believes "it is highly unlikely that we are going to see a sudden repealing of employment rights. There are some which are just now way too engrained in our society, rights which we British are proud of and now identify with, discrimination and family friendly rights being really good examples of that" In fact, the UK is now leading the way in Europe over some family friendly policies such as shared parental leave.

So don't expect to see a wholesale repeal of employment regulation.

There are some other areas, however, where Heidi does believe Brexit may bring some changes in employment laws. These include Working Time regulations. "The UK has always had an opt-out on the maximum working week and it has been under pressure from the EU ever since then to give that up. The Conservative Government will likely be delighted to see an end to the maximum working week, and some of the case law we have seen develop from Europe around the taking of holiday when sick may be attacked by a future UK Government."

Giving agency workers employment protection was, according to Heidi "really unpopular with the UK Government, who fought strongly for some limitations including a delay of 12 weeks before full protection is in place" In her view, it is possible that the Conservative Government might seek to repeal this law, which has always been seen as a constraint on the ability of business to access a flexible source of labour.

If we do not see immediate changes, over time these laws could still be eroded to fit with a future UK working model. And finally, the European Union has been keen to implement restrictions on bankers' bonuses following the financial crisis. Given the strength of the UK financial services sector, there was intense pressure from the UK against the imposition of the bankers' bonus cap. This would appear to be an immediate target to disappear post-Brexit.

Having said that, as usual with employment laws, they are intensely political so it is almost impossible to predict the future direction of regulation which will be influenced considerably by the UK government of the day.

In conclusion, plan for people change. Ask your HR team to look at how and from where they recruit your labour force to understand if your labour costs will rise, and whilst you can look forward to some relief from EU employment legislation, don't expect a roll-back of equality rights.

Health and safety law

In terms of the implications in respect of health and safety, Clyde & Co believes this will be minimal with few regulations repealed. Since the Piper Alpha disaster in 1988, the UK has been at the leading edge globally on health and safety issues and regulation. Indeed, following the Macondo incident in the Gulf of Mexico the US government report cited the UK health and safety regime as the gold standard. As a result of the above, the UK already has in place a robust and sophisticated health and safety regulatory regime which has not necessarily been triggered by intervention from the EU by way of directive. That is not to say that there has been no impact from EU regulations, the offshore safety directive which led to changes in the safety case regulations is a good case in point.

Regulation

All our experts shared the same clear view about the impact of Brexit on regulation. Clyde & Co put it most bluntly. "We are very much mistaken if we think that regulation is going to be reduced by Brexit." The reasons for this are twofold.

1. For the UK to maintain access to EU markets in the most highly regulated industries (e.g. financial services) it will need to demonstrate that it continues to regulate in the way that Europe requires. For financial services firms this means that Europe-wide structures such as Solvency II and UCITS are almost certain to remain in place whatever happens. In fact, Capital Economics points out that countries such as Bermuda and Switzerland have gone to "great lengths" to replicate Solvency II and UCITS in order to persuade the EU to allow them to access Europe's financial services marketplace.
2. Secondly, rolling back legislation is costly and often raises more questions than it resolves. None of our commentators believed the UK government will have any interest in setting up a programme to roll back regulation within financial markets, for example.

Andy Moore, Partner at PwC told us: "We have already implemented a regulatory framework for most things, particularly in financial services and in reality it is going to cost more for us to undo it and to come up with something that is different than to keep it."

Instead, much political energy will be focused on ensuring continued access to European markets in regulated areas. Inga Beale, CEO of Lloyd's, has stated in a letter to managing agents: "We have prepared for this outcome and we will be putting into action a contingency plan to ensure that Lloyd's can continue to access its key European markets."

In conclusion, expect very little change in the regulatory environment, particularly in financial services, including insurance. More likely, is that the UK will wish to demonstrate its continued commitment to Europe regulatory regimes in order to continue to get access to this valuable sector, where the UK is a recognised European and global leader.
There has been much discussion on the validity of various contract terms following Brexit. In practice, it is likely that this would largely be addressed by the withdrawal agreement in order to ensure legal certainty. However, clients would be well advised to review their existing contractual arrangements, in particular terms that refer to EU legislation or territorial definitions, in order to ensure that any potential implications can be addressed at an early stage.

Taxation implications

In writing this section, we relied on advice given by Ian Smith, Head of Tax for QBE European Operations, and Mike Stalley, Chief Executive of indirect tax experts FiscalReps, to both of whom we are most grateful.

Severing the linkages which exist between the EU and the UK will result in a surprisingly small number of likely changes to taxation in the UK, as shown below.

VAT and other indirect taxes

Over the last 40-odd years of EU membership, UK tax law and the EU's impact on the UK taxation system have interacted to quite a complex degree. There has always been a tension between the desire of member states to develop their own tax systems and the EU desire to create a level playing field, and that is most obvious in indirect taxation, particularly VAT and excise duty.

As Ian Smith told us "on exiting the EU, the UK will no longer be constrained by the EU VAT rules, including a directive which harmonises the approach to VAT across the EU." (There are similar controls around excise duties and other indirect taxes including Insurance Premium Tax, IPT).

Post-Brexit we will be able to set our own VAT rate, and will be able to depart from some of the tax measures in the EU which the UK government dislikes. There are also a number of court cases going through the EU Court of Justice to do with indirect taxes. Those judgements, when they reach different conclusions to legislation in member states, often require member states to amend legislation to come into line with that judgement (for example in how multinationals account for VAT and costs as they occur and how they spread them out across different countries). Put simply after Brexit the UK government and courts will be able to determine what will be exempt from VAT and what will not.

Other indirect taxes likely to be affected by this renewed UK sovereignty include the tax charge on the raising of capital. At present the EU Capital Directive prohibits member states from taxing the raising of capital, something the UK government wishes to change.

Currently the UK is also locking horns with the EU over the imposition of Financial Transactions Tax, which the UK believes is anti-competitive as far as the City of London is concerned. It is now highly unlikely this will be implemented in the UK.

Insurance Premium Tax (IPT)

Mike Stalley of FiscalReps told us "Insurance Premium Tax rates are increasing globally." Ian Smith also commented that "the UK IPT rate has been low compared to the rest of the EU for some time. Outside the EU there may be less pressure to join the level playing field, and this could provide benefits for UK insurers that would be passed on to clients."

Direct Taxes (corporation and income tax)

According to Ian Smith "the direct taxes will see less activity on Brexit as they are already set at a UK level".

Income tax is already very much left by the EU to its member states, who each deal with it as they see fit. No change should be expected to income tax as a direct result of Brexit, and the same applies to corporation tax. However, we will no longer be required to amend tax laws where EU directives and court judgements are inconsistent with UK law, and this might prevent some of the regular changes that currently occur across industries.

State Aid Rules

The EU State Aid Rules direct that a government cannot give financial or tax advantages in a way that distorts competition. According to Ian Smith "State Aid has already been controversial, for example the UK's recent tax deal with Google."

Once outside the EU we could conceivably provide very specific targeted tax benefits to certain sectors without the fear of an EU reprimand. But we will also lose our right to complain if the EU does something that impacts one of the sectors that we were trying to protect. It is therefore reasonably likely that the desire to maintain some form of free trade zone with the EU will ensure that the State Aid Rules will continue to be respected.

In conclusion, the impacts on our tax system of Brexit are lower than might be expected. Any changes that might occur also need to be balanced against what the final settlement with the EU looks like. If, after Brexit, we remain closely tied to European markets, any UK government will see it as being in its best interest to run taxation rules in parallel with European taxation regulation.

Accounting and business incorporation requirements

In writing this section, we relied on an interview given by Andy Moore, Insurance Practice Partner at PwC, to whom we are most grateful.

Taking the easy question first, the outlook post-Brexit for day-to-day business reporting and accounting is very straightforward.

All reporting and accounting standards are already set at a global, not an EU level – the International Financial Reporting Standards, or IFRS. Andy Moore, Partner at PwC confirms that "the accounting standards that we use in the UK have been broadly harmonised with International Financial Reporting Standards." These reporting structures will not come under pressure for change.

However, in terms of business structures and incorporation, particularly for multinational businesses, the questions are much larger, and they are seismic in nature for the multinational financial services businesses, which make up a large part of the UK services economy.

At present it is possible for a UK financial services business to have a single headquarters in Europe, to report to a single regulator, and to conduct business in every other country in Europe via branches. This is known as the hub-and-spoke model, and according to Andy Moore of PwC "it is liked by companies for its efficiency, and the fact that it allows them to keep all their capital reserves in the centre", rather than allocated and held in individual countries. It is made possible by the EU's passporting regime, which is based in turn on the rights of Freedom of Establishment (FoE) and Freedom of

Services (FoS), which guarantees the right to provide business services on a cross-border basis to everyone within the European Economic Area (EEA).

On our exit from the EU, only the least likely option, the Norwegian Model, (in which we remain members of the European Economic Area) will allow the maintenance of passporting. As a result of the likely loss of passporting, many international financial services companies who use the UK as their headquarters, as well as many UK businesses who trade across Europe, will need to amend their corporate structures, including rethinking their countries of incorporation, places of reporting for tax and regulation, and the location of their headquarters. This is a drastic change, and the implications of it need to be considered by every international business in the UK.

Of course, a further impact of this will be felt by EU suppliers of manufacturing materials to domestic businesses. If you are a UK manufacturer, reliant on European parts, post-Brexit you cannot assume that your supplier will be able to continue to import freely into the UK, and certainly not at the same cost, as Andy Moore told us. "People need to understand not just the direct impacts, but the indirect impacts, so not just what are your customers and suppliers, but beyond that first level, then looking at onward impacts. So you might have a supplier who is UK-based, but they may source some of the underlying components of what they make from the EU. So it might not be a first order effect, but it might be a second-order effect. People can't plan simplistically and must look through the whole chain."

In conclusion, every company in the UK needs to plan for Brexit by getting a clear picture of where its supply chains come from, and what will happen to them post-exit. International companies also need to work through a plan for incorporation which will allow them to trade internationally post-Brexit, no matter which model the UK adopts. Scenario planning is critical in this area.

The effects of removing EU Free Trade Agreements

No area is more contentious than that of the EU's Free Trade Agreements. The EU itself began life as a free trade zone, and as The Economist said recently "The trickiest issue for a post-Brexit Britain will be how to maintain full access to the EU's single market, the world's biggest."[4] Why is it so critical? Because at present the EU takes almost half of Britain's exports.[5]

Further, the EU itself has negotiated a string of no less than 53 Free Trade Agreements with non-EU countries to help EU companies trade with countries outside the EU. Britain will no longer be party to these deals and will now have to try to replicate them, something described by The Economist as "a huge challenge given its lack of trade negotiators and the length of time even simple trade talks take."[6]

The UK will also have to try to build up its own global links to replace the ones provided by the EU, for example resuming, if possible, its own direct membership of the World Trade Organisation on the same basis as its terms via the EU. However, this would need to be agreed by all 161 members of the WTO – another area where negotiation skills would be critical.

So "the worst-case Brexit scenario would be one in which the United Kingdom fails to negotiate a free trade agreement with the European Union."[7] If it transpires, British exports to the European Union will face the latter's common external tariff (sometimes called the 'World Trade Organisation option'). Britain will be subject to the same tariff as the European Union charges other non-member countries, and this will broadly mean a tariff of 4% on average on all goods shipped within the EEA.[8] However, this does vary, and in some areas the tariffs are much higher, as shown in the table below:

Sector	Current EU import tariffs (as applied to non-EU importers)	% of UK production that is exported to EU
Food, Beverages and Tobacco	20% and higher	60.5%
Cars	10%	35%
Chemicals	4.6%	56.6
Machinery	1.7% - 4.5%	30.7%
Aerospace	Zero tariffs	44.6
Financial services	Zero tariffs but EU market access regulations prevent access without agreement in place	41.4%
Insurance		18.4%
Professional services		29.8%

Source: OpenEurope

In addition to new tariffs exporters will face some other additional costs, such as complying with the European Union's rules of origin, a series of regulations designed to prove that a product originates in the country it is imported from. However, these factors have been described as an inconvenience rather than a major barrier to trade.

In the short term, all exporters must hope that the Government manages to negotiate an agreement with the EU to mitigate the tariffs from their particular industry. There are some positives that may emerge once the UK is beyond the likely messy exit from the EU, and able to focus on the global stage. Once Britain loses the restrictions imposed by EU membership, "it may well be able to negotiate better agreements than those reached by the European Commission", according to Capital Economics, who also point out that "Switzerland ... has had more success establishing free trade agreements than the European Union." They also point out that Switzerland, free to negotiate alone and with its own priorities at heart, has achieved a Free Trade Agreement with China, something the EU has yet to deliver.

It was suggested by several of our experts that Britain could even benefit from the situation by introducing a unilateral free trade policy, a radical solution that, it should be said, has not yet been suggested by any politician.

In conclusion, it is a worrying time for exporters. There are some possible upsides, but all the positives are a long way down the track, and meanwhile, what immediately faces exporters is a situation of volatile foreign exchange, potentially followed by higher export tariffs and increased paperwork.

The economic effects

Although the UK remains a member of the European Union, and will do so for the next two years at least, Brexit has created immediate challenges for some firms. For British businesses, there are two major issues: the falling exchange rate, and predicted reduced economic growth.

The British pound has fallen heavily against both the US dollar and the Euro since the Brexit vote, increasing the cost of imports for businesses. But has UK GDP growth been impacted? Brexit almost immediately, in fact, caused the largest downward revision to the Bank of England's GDP forecast since the Monetary Policy Committee (MPC) was formed. By August following the vote, the UK central bank had cut its forecast for growth in 2017 to 0.8%, from 2.3%.

On this basis the Bank of England quickly decided it needed to take decisive action to protect the UK economy, stating that: 'following the United Kingdom's vote to leave the European Union, the exchange rate has fallen and the outlook for growth in the short to medium term has weakened markedly.'

On August 4th 2016, Governor Mark Carney announced a package of measures including:

- a 25 basis point cut in interest rates to 0.25% (the first rate change since March 2009)
- a new 'term funding scheme' (TFS) designed to ensure that banks pass the rate reduction on to the real economy
- the purchase of up to £10 billion in corporate bonds
- an expansion of the asset purchase program for U.K. government bonds by £60 billion to a total of £435 billion.

The Bank of England expects this package to help the UK avoid a full recession. Mark Carney has said he does not expect the British economy to enter recession, stating that "by acting early and comprehensively, the MPC can reduce uncertainty, bolster confidence, blunt the slowdown, and support the necessary adjustments in the UK economy." He also said "all of the elements in this package have scope to be increased."

All of the above measures are designed to help the economy weather the two critical issues of a falling exchange rate and reduced economic growth which the Bank of England identified as the major challenges to UK businesses over the coming months, and throughout the uncertain period before a Brexit agreement is confirmed. At the time of writing, it is yet unclear how effective this economic package will be.

Longer-term changes to business costs

Alongside the impact of macro-economic conditions, businesses also need to consider the longer-term structural changes to costs after Brexit.

These can be very broadly split into four areas:

1. Increased costs for exports, via increased tariffs
2. Increased costs for imported goods and raw materials, via increased tariffs and sterling deflation
3. Increased costs for labour, if free movement of people is removed
4. Increased operational friction and costs, as a result of higher levels of bureaucracy and reduced freedom of international trade

UK businesses will need to get to grips with the likely import and export tariffs that will be imposed not only in their own sector, but also on any imported materials they rely upon. The table in this document (page 9) is just a starting point. Businesses also need to consider if they will face a skilled and manual staffing shortage, and how they can recruit to minimise this. With over 3.3 million EU nationals living in the UK, the potential impact of restricted movement on the labour market could be pronounced.

Furthermore companies need to examine where they may face increased operational challenges, such as the need for new import-export licenses, longer lead times on deliveries to or from the EU and beyond. They also need to be prepared for a significant uplift in the level of administration required if the single EU system splinters into a variety of differing documentation, licensing and transport requirements for international destinations.

In addition some industries have their own specific issues, and the CBI has particularly highlighted three areas of the economy that are exposed by Brexit, as follows:

Education – where large numbers of foreign students may lose the right to attend UK universities, and where an average 15% subsidy from the EU will also be lost.

Fintech, creative and digital industries – this is a rapidly growing area of the economy, and one where freedom of movement is important, as it draws on a large international workforce. Many digital firms are innovative and rapidly growing. They are particularly vulnerable to economic shocks, increased costs of labour and possible regulation changes.

Financial services – for all the reasons outlined elsewhere in this document, this is an industry vulnerable to contraction upon our exit from the EU. Insurance is of course part of this, and the next part of this document looks at how Brexit will affect insurance and insurers.

[1] Sources: Dr Gregor Irwin, Capital Economics, Lloyd's of London
[2] BREXIT: the impact on the UK and the EU, March 2015, Global Counsel
[3] Heidi Watson, Clyde & Co
[4] The Economist: The Brexit Delusion 27 February 2016
[5] Capital Economics and Woodford Investment Management: The Economic Impact of Brexit February 2015
[6] The Economist: The Brexit Delusion 27 February 2016
[7] The Economist: The Brexit Delusion 27 February 2016
[8] There are some variants on this number, for example, according to Capital Economics, car parts are subject to a higher level of tariff, of up to 10%

Specific insurance implications

Effects on insurers and reinsurers

For insurers and reinsurers, the vote for Brexit has had two different, but equally important effects.

Firstly, Brexit has the potential to cause some business disruption for the insurers themselves.

Many insurers and reinsurers located and regulated in the UK are able to distribute their products throughout the EU by using the rights of freedom of establishment and freedom to provide services from one state to another within the EEA—the concept of passporting or cross border. The ability of insurers to passport in to other Member States and provide financial services to customers has been a crucial development for businesses.

The UK Government is being encouraged to make it a priority to retain passporting, and although the rhetoric from Europe is currently hard-line, suggesting that the EU will insist that the UK cannot maintain passporting without offering freedom of movement for workers, this stance may shift once EU negotiators start to analyse the increased costs involved for their own financial services participants at the lost opportunity to passport into the UK.

It is currently estimated that around 200 UK financial services firms passport into the EU. However, over 700 firms from elsewhere in the EU use the passporting system to access London's financial centre, and this may provide a powerful negotiating tool for the UK.

In the event passporting does cease, insurers and reinsurers will need to use an existing, or establish a new legal entity within the EU in order to continue to provide services to their customers. In the worst case scenario where the insurers and reinsurers affected have to establish new legal entities, these companies will face some additional costs and disruption, for example in terms of duplicating regulatory resources and compliance in both the UK and EU.

Secondly, on the regulatory side, it now seems unlikely that Solvency II will be impacted, at least in the short term, simply because, for at least the next two years we will remain subject to the EU regulatory regime. While the Solvency II framework is not expected to change, it will need to be enacted into UK law if the Government decides to replicate it.

Effects on insurance buyers

In the long term, insurance buyers will undoubtedly be affected by what happens to those who provide their insurances. In the short term, they also need to consider the effect on the insurance cover itself. Here there is better news. Our experts told us that short-term policies should not immediately be impacted, including the mandatory classes of employers' liability and motor insurance.

The two-year EU notice period, not yet triggered, will give both insurer and insured the time to amend one-year and most three-year policies on renewal, rather than require them to be reviewed and rewritten in a hurry. Similarly, for three-year insurances that do extend past any Brexit notice period, the notice period still gives the insurer and insured time to plan for and make any amendments needed.

However, as David Kendall of the British Insurance Lawyers Association pointed out, long-term policies such as life insurance are a different matter. He commented, "I suspect this will impact on life insurers... depending on [the EU] relationship we end up in post-Brexit. So if passporting was to end completely, for life insurers [it is] potentially quite a serious thing as it is a much more long-term business than annual or three-year general insurance policies."

Ultimately, "Brexit might add a layer of complexity to insurance policies, as different licensing regimes do create issues that may need to be reflected in contracts, whereas passporting is simple, tested and low cost."[9] Barbara Riggs, our commentator, notes that "QBE is accustomed to changes in insurance regulation which require wholesale changes to be reflected in all policy documentation and such changes can be implemented quite rapidly if required."

For multinational companies seeking insurance protection across multiple international locations, it should be cheering to note the positivity with which our experts contemplate the post-EU underwriting environment, something that is perhaps due to the global nature of the London market. Barbara Riggs told us "we write plenty of insurance contracts covering risks outside the EU already." Subject to the appropriate regulatory permissions, such insurance contracts could still be written even though "a new regulatory regime would be likely to have an impact on policy provisions. We would seek to address this in the policy drafting. Not all the provisions commonly in use in multinational wordings have been considered formally by the courts which creates more risk and adds a layer of complexity – for example how the cover operates in territories where the programme leader does not hold a licence."

[9] Barbara Riggs, Head of Policy Wording, QBE European Operations

London as an insurance centre

A further issue that will affect business insurance and reinsurance going to other cities is the likely continuance of London as a global insurance centre. The UK is the world's third largest exporter of financial services and insurance products.

The possible loss of business to other cities proved a divisive topic among our experts who held widely varying opinions.

Andy Moore of PwC was one of several experts to question the future of London as a financial services centre outside of the European Union "I think the future of the City of London does become questionable. It could well lose critical mass if we end up with another EU financial hub." Most of the experts interviewed believe that Brexit will see organisations moving people and/or companies out of the UK. With that said, much of the louder rhetoric on this topic has died down since the vote, and there currently appears to be more moderate talk of company adjustment rather than wholesale relocations.

The official word from Lloyd's of London before the vote was that "in the event of a vote to leave, we would work with the UK Government and EU Institutions during any negotiations to retain market access for Lloyd's and the London Market and create as much regulatory certainty as possible." Lloyd's are clearly prepared to defend their patch, and have been active in liaising both with the market and with the Government since the Brexit vote outcome was revealed.

Risk management

At the beginning of this report we stated that risk management is at the heart of Brexit planning, and this is true at both a macro ('what are the overall risks for our business?') and a micro ('how does this change our business insurance requirement?') level. Having taken most of the document to cover the macro side of the issue, it is worth considering the micro side. How will you need to change your insurance risk profiling and planning?

Brexit will complicate the task of risk management. Risk managers will have to deal more on a country-by-country level, or at the very least on a UK vs EU level. Some large international risks, reinsurances and layered insurances that have traditionally passed through the London market may now need to access the market in a different way, depending on whether it continues to be possible to passport insurance purchases into the London market.

There will also be new considerations to discuss with your broker or insurer around the legal implications of Brexit on your business and its insurances. For example, if there are restrictions on the availability of traditional sources of labour from the EU, how will construction projects be affected by the likely changes in visa regulation? Risk managers will have to carefully consider the consequences of this, especially on large projects.

It is not possible for us to map in one document every single change to every risk on every type of insurance, but broadly, your risk profile will link to the amount of international exposure your business has, and the amount of regulation (whether health and safety or financial) that your business is exposed to, and you should use this for the starting point of planning, as well as the basis for discussions with your insurer and/or your broker. We hope this document also assists you in your planning.

Claims

It is worth noting that none of our experts could find many significant impacts from Brexit on existing insurance claims, or on future claims from existing insurances. Andy Moore of PwC, (who have a claims consultancy practice), noted that there could be some individual impacts on long-running complex claims disputes with an international dimension, although he did point out that "one would hope that in most policies there would be a definition of where legal disputes will fall and should be managed from."

Otherwise, it was the conclusion of our experts that business insurance buyers can continue to have confidence in their ability to claim on existing and future policies.

In conclusion, as Clyde & Co told us, those who buy insurances with an international dimension need to plan for a more complex insurance-buying world post-Brexit, but insurance provision will continue to be available without significant interruption from experienced global insurers like QBE

Preparing your business for Brexit

"...companies were more prepared for the Millennium bug than for Brexit."

Dr Gregor Irwin

All companies should now be focused on preparing for the world outside the EU. Overall "The first rule of thumb is any business that is both subject to a reasonable amount of regulation and which trades with the rest of Europe is going to be directly impacted," says Dr Irwin. His organisation, Global Counsel, is working with a number of clients to model their plans post-Brexit, and he suggests the following first steps to help any business start to understand how its world will look post-Brexit.

1. **Start at the end**. Put together at least three scenarios for your firm, based on what the end point in the UK/EU relationship might look like. This should include the three models outlined in this report, together with any significant variants that will critically affect your business (e.g. the effect of the loss of passporting, the effect of a Scottish devolution).
2. Understand the impact of each scenario. What are the **primary exposures** of your business to Europe and how will these change in each situation?
3. **Look through the supply chain**. What are the secondary exposures of your business to Europe? What raw materials might increase in cost? Do any of your UK buyers export your products into the EU?
4. Ask yourself the question '**how do we get there?**' How exactly will short-term volatility, reduced economic growth and a possible lack of credit impact your business, and how can you mitigate this?
5. **Look for opportunities**. All change brings opportunities, and now is the time to identify and plan for these, along with the risks.

Think too about your **customers**. Two years is a short amount of time, and when they come to buy again, they will soon want to be reassured that you will be able to continue to provide your goods and services to them at a comparable cost and in an equally convenient way. If you are selling a product with a long shelf-life, you may only have one trouble free repurchase before your customer starts to worry about buying again, and go window-shopping for other options for sourcing your product. Communicate with customers now, let them know what you are planning, be honest about what is likely to happen. Don't leave them in the dark – it will be far too easy for them to wander off if you focus on your internal problem-solving, rather than on the customer's own concerns.

Once you have identified the issues for your business, there are some further **planning principles** to apply. First, size up the problem, using the steps above. Then:

1. Look for solutions, but don't just aim for a sticking-plaster solution – think bigger. Is this a chance to solve other structural or supply chain problems that exist in your business? **Don't just bolt on a quick fix**, but take the opportunity to look and see if you can use this as a chance to 'clean house'.
2. Don't just make a defensive plan. **Have an offensive plan** in place too, and give it the same level of focus as the defensive one.
3. **Simplify, don't complicate**. Don't overlay a new level of complexity in order to continue to do business. Consider starting back at base – how profitable is your international business? How much can you afford to spend to keep it? Can you solve other problems at the same time as fixing this issue? Can you sell it? Can you buy something else?
4. There are no sacred cows. Be prepared to **think completely differently** about resources and solutions. Can you source / refocus on Asia or the Americas? Can you simplify your corporate structure? Can you find new suppliers? Can you sell direct into countries you had not previously considered?

Conclusion

In commissioning and writing this report we set out to give UK business owners a sense of what Brexit may mean for the UK business community, and in particular for QBE's business insurance clients. Our aim is to equip you with as many of the facts as possible and to highlight (in a highly unpredictable situation) what changes you will see as we tread the path to a world outside the EU.

As an insurance specialist, we have also tried to set out in some depth how Brexit might affect the UK insurance buyer, and give an overview of its impact on the marketplace as a whole.

Our last objective was to give you some starting points for Brexit planning in your own business area. In the process of interviewing a group of experts on different aspects of the topic, one thing which united them all was the importance of having a risk management strategy and of looking ahead in order to be prepared for what might come. The UK has taken a major decision that will impact all our futures, and we look forward to working with all our clients as we navigate in partnership through the murky waters to come.

Acknowledgements

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Nigel Brook, Partner, Clyde & Co

David Leckie, Partner, Clyde & Co

Mike Stalley, Chief Executive Officer, FiscalReps

Barbara Riggs, Head of Policy Wordings, QBE European Operations

Ian Smith, Head of Tax, QBE European Operations

Further reading

Capital Economics and Woodford Investment Management *The Economic Impact of Brexit February 2015*

Dr Gregor Irwin *www.global-counsel.co.uk/publications/ brexit-impact-uk-and-eu*

Dr Gregor Irwin *www.global-counsel.co.uk/publications/ morning-after-brexit-uncertainty-and-what-it-meansbusiness*

TheCityUK *UK financial and related professional services: meeting the challenges and delivering opportunities*

About QBE

QBE is a business insurer. We understand the risks businesses face and support organisations from a diverse range of sectors in managing and mitigating their risk enabling them to realise their objectives. An A+ rated insurer, we have the appetite and capacity to provide cover for businesses of all sizes.

Cover for all your business needs

Our extensive product range includes:

- Accident and health (including commercial PA and business travel)
- After the event insurance
- Commercial combined
- Commercial crime
- Contractor all risks/EAR
- Energy – offshore and onshore
- Entertainment and leisure industry
- Environmental impairment liability
- Financial and professional liability (cyber liability, directors' and officers', professional indemnity)
- General liability (employer's liability, public liability, tradesman)
- Marine
- Motor Commercial (inc fleet, haulage, bus and coach, motor trade)
- Pharmaceutical and medical
- Political risk and terrorism
- Product guarantee and recall
- Product protection
- Property
- Reinsurance
- Scheme underwriting facility
- Specie
- Surety/bonds
- Trade credit
- Warranty and GAP

Risk management

Effective risk management is a feature of all successful organisations – and it's one of our key underwriting considerations. We work closely with businesses to improve their systems and processes; minimising their exposure to risk and helping to reduce the frequency and severity of any losses.

We stand by our claims

Inevitably, claims do occur. That's when businesses really discover the value their insurance company delivers. We pride ourselves on our positive attitude and proactive approach to claims management. Our claims teams have a deserved reputation for the professional, efficient and sympathetic way they work with brokers and clients when losses are incurred.

Local knowledge

UK underwriting offices: London, Belfast, Birmingham, Bristol, Chelmsford, Glasgow, Leeds, Manchester and Stafford.

France: Paris, Lyon, Nantes, Strasbourg, Bordeaux

Germany: Düsseldorf and Munich.

Belgium: Brussels

Denmark: Copenhagen

Italy: Milan

Spain: Madrid

Sweden: Stockholm

To find out more

For more information about QBE and how we can help your business, please visit our website www.QBEeurope.com

Get in touch

Visit www.QBEeurope.com
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