JLT

BRITAIN'S VOTE TO EXIT THE EU

ISSUES THAT MATTER

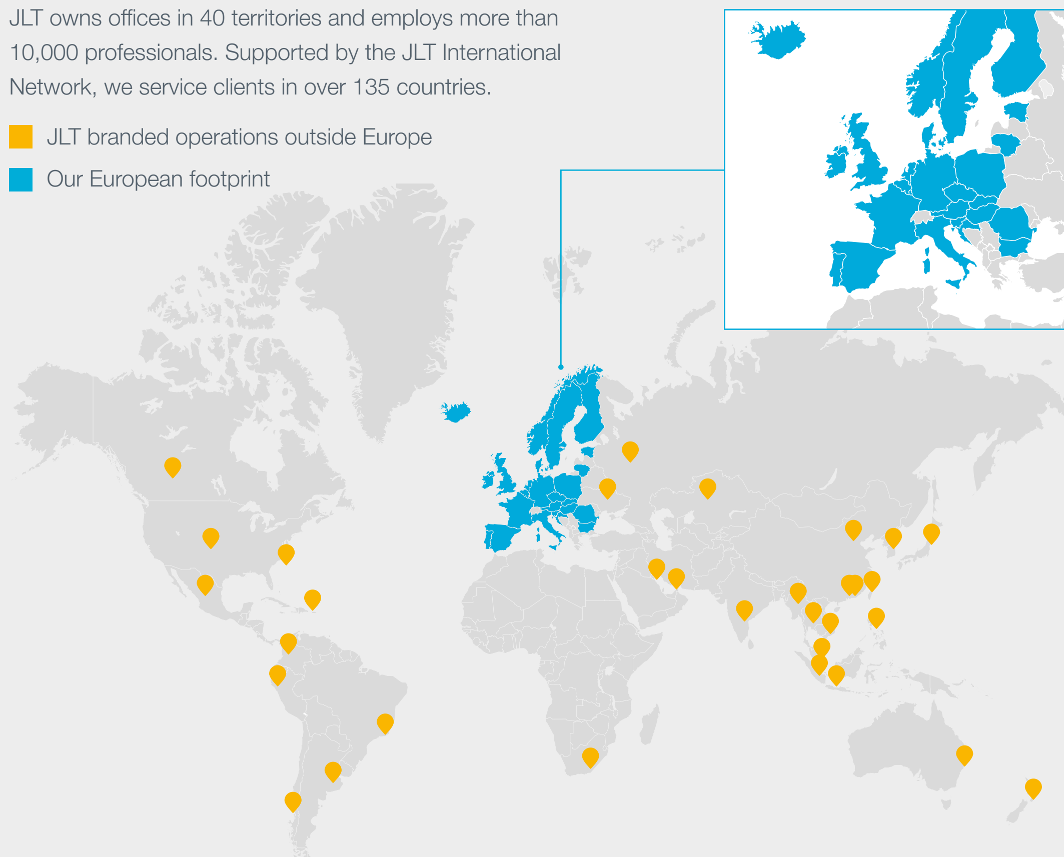
4 JULY 2016

CHANGE READY

JLT has the right capabilities in place to help you manage the changes we review in this paper, effectively, wherever in the world you operate. While these changes in Europe may create uncertainty, JLT is a strong global company with deep specialty capabilities on every continent, and a strong and growing presence in the world's emerging economies and insurance hubs.

JLT is a significant player in the London Market and will continue to work closely with regulators, our trading partners in the London Market and at Lloyd's.

We have specialist knowledge and deep experience in helping our clients manage and adapt to new situations, responding to changes both simple and complex. We excel at bringing the world's sharpest insights to enable strong fact-based decision making and to deliver the most effective solutions to all of our clients.



JLT owns offices in 40 territories and employs more than 10,000 professionals. Supported by the JLT International Network, we service clients in over 135 countries.

BREXIT
MANAGING THE CHALLENGE

As markets and businesses digest the result of the UK's referendum on 23 June, a more settled picture of the short and long-term effects is coming into view.

CONTINUITY

You will have seen discussion of many different scenarios flowing from the UK's decision to leave the European Union. We do not as yet have a firm view on which outcome is most likely, but while some clearly imply more effort to manage than others, we do not see a crisis scenario. The guidance to avoid reflex decisions holds true - nothing changes yet, and business carries on as usual.

For now, the greater risk comes from uncertainty on financial markets, and its consequential effect on the decision-making of companies, investors, central banks and others. This is unhelpful for major investments, somewhat raising the likelihood of a technical recession in the UK and placing some strain on the weakest links in the Eurozone.

Our Credit, Political and Security team do not see contagion or a domino effect arising from this temporary stress – the fundamentals remain as robust as they were on 23 June, when markets were relatively buoyant.

We further note that volatility is two-sided – while it creates real stresses, it can also open up new opportunities for those not adopting a fully defensive posture.

WHY DOES BREXIT MATTER?

1. London is Europe's financial centre, the location that global financial service companies conduct Euro clearing and other core operations. If and when the UK exits the EU or its single market (EEA), some of these processes might shift to the continent.
2. The UK is one of three European heavyweights and a main contributor to the EU's finances. If it completes Article 50 exit, this puts the future of the EU under scrutiny and is likely to force the pace of change within that institution.
3. Globally integrated processes reliant on the UK's legal status as an EU member will need thorough review, a potentially time and value-consuming process.

ARTICLE 50, EXPLAINED

Added to the Treaty of the EU on 1 December 2009, Article 50 grants members an orderly means to leave the Union. It states: *Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements*. The article specifies a two year sunset period, from invocation to the date that the treaties of the EU will no longer apply. During the period, the departing state remains a full member of the Union. The leaving state may propose an extension to the period, dependent on the agreement of the remaining members.

THE LONDON MARKET BUSINESS AS USUAL

The London Market is a world-leading insurance hub, with deep and broad capabilities and a unique role in global capital markets. While challengers such as Singapore, Dubai and Miami are growing on emerging market trade, market participants continue to support London for features including a deep talent pool and a robust body of case law, which potential alternative hubs cannot yet replicate.

Financial Services companies with significant operations based in the UK have been preparing for a Brexit scenario since the UK general election last year, in some cases earlier. Their response (contrary to rumours of immediate 'corporate flight') has been calm and measured.

The UK's Financial Services sector employs 2.2m people, of whom two thirds are outside London, spread from Edinburgh to Exeter and Cardiff to Norwich. For its skills base, its timezone, its infrastructure, its language, its quality of life for international colleagues, its legal system and its policy support, the UK remains an exceptionally attractive place from which to conduct financial services business.

There may be a differential impact on London's many types of Financial Service – we do expect some minor erosion of London's position as some Fund Managers and some Banking services move aspects of their operations.

But against a background of changes driven by regulatory developments and less favourable macroeconomic factors (to which companies were already adapting their structures with or without this result) Brexit does not appear likely to result in material changes in operating methodology for the vast majority of UK financial services organisations.

WHAT HAPPENS NOW TO POLICIES WRITTEN IN LONDON?

For now and throughout the two year (minimum) negotiating period, the UK will continue as a regular member of the EU and the European Economic Area (EEA), otherwise known as the single market. The London Market will continue to deliver risk solutions in a business as usual fashion.

In particular, Lloyd's and the London Market will continue to operate under the framework of Solvency II, meaning that no renewals or policies in existence will be affected by the referendum result. Policies, whether single or multi-year, continue to be legally binding and claims will be dealt with in the normal way.

The market remains well capitalised to pay any major claims and will not be adversely affected by the fluctuations of sterling, due to good currency matching discipline covering assets against claims reserves, and capital against exposure.

PASSPORTING RIGHTS

Currently an insurer licensed within the EU is able to insure risks within the EEA and issue one policy within the EU to insure risks within any other EU country. Following Brexit, in 2018 or later, the UK will either have to negotiate to retain the rights to issue EU valid policies from the UK, or it may be necessary to issue separate policies for UK and EU risks.

The UK permits UK risks to be insured from outside the UK (on a "non-admitted" basis*), other than statutory policies (such as Employers' Liability, Motor Liability) that must be insured within the UK with a UK-licensed insurer. The UK will need to decide if it would continue to permit non-admitted insurance.

Some European countries already require EU issued policies for the risks insured in that country and do not permit these risks to be insured in a non-EU country. It is likely that UK insurers

* 'Non-admitted' means 'operating independently of a given nation's insurance laws and protections'.

with EU licences could (continue to) issue valid EU insurance following Brexit, so the impact on administering corporate insurance programmes may not be significant in terms of cost or resource.

IS THE LONDON MARKET PREPARED?

The London Market is committed to maintaining its ability to service the European market and to support clients with operations in one or more EU nations. For example, Lloyd's is taking immediate steps to defend its position against the risk of the loss of single market passporting rights for financial services, within the EU.

> *"We think there is no credible alternative to the London market for European specialty insurance."*

Rufus Hone, KBW analyst's note, 30 June

For perspective, it is worth noting that among listed Lloyd's insurers (for whom numbers are available) the proportion of premium received for continental European risks is in a range between low single digits to a maximum of 15% of their book.

Lloyd's has, and will continue to have, more significant global trading links beyond Europe – notably Canada and the US– which are unaffected by the changes in arrangements between the UK and the EU. Lloyd's total GWP is £26.6bn, 47% of which flows from the US and Canada.

These are not EU-negotiated relationships, but bilateral links secured by a dedicated and highly experienced team at Lloyd's with insurance markets around the world, for which Lloyd's has a long history of delivering world-class risk solutions.

GRANDFATHERING

It is impossible to relocate the full suite of capabilities and the skills base of the London Market elsewhere, in anything approaching two years – assessments suggest it might take 10 years to achieve such a move in full. There is therefore a powerful mutual interest for both EU members and the UK Government to safeguard economically vital financial services for which EU members currently depend on London.

While Lloyd's and other participants are working on their contingency plans, we might therefore expect governments to be supportive of proposals to grandfather in some existing arrangements, e.g. temporary passporting rights, to smooth the transition. A number of different approaches are open to the negotiating parties.

UK AND EU OPERATIONS
VOLATILITY AND ITS IMMEDIATE EFFECTS

While there was uncertainty in the lead-up to the UK referendum, the final week pre-vote saw a surge of confidence among market participants that the result would be Remain. The Leave win has caused a shock, with extreme swings as markets attempt to price the new scenario. This process has further to run.

MARKET VOLATILITY

Volatility has had a detrimental impact on financial markets and sterling, which has had a knock on effect on a wide range of commercial projects and activities, as well as on pension funds and pension fund deficits. The UK economy now faces at least two years of uncertainty as trade deals are renegotiated and we can expect volatility to continue throughout.

As a free-floating currency, sterling offers the UK a significant natural hedge against some of this volatility, dropping the price of British assets and contributing to the competitiveness of its export businesses. However for businesses dependent on a measure of predictability to plan major investments, volatility on top of the world's pre-existing uncertainties is unhelpful. Governments at G-20 and EU levels will be pressing hard to settle as many of the unanswered questions as possible.

For our clients across the world, whether of JLT's Insurance Broking, Reinsurance or Employee Benefits services, your primary concern may be to establish that London's financial infrastructure remains robust despite volatility, and secondly, that we have the capability to source alternatives as and when they become more relevant to your specific needs. On both points, we can provide positive reassurance.

It is widely accepted that central banks and regulators learned a useful lesson from the debt crisis of 2008. This has been demonstrated in the capital adequacy of UK banks, with ten times the resources they had eight years ago, and in the Bank of England's rapid and effective response to settle markets on 24 June under Mark Carney's clear leadership.

Further, while the scenarios considered above are on balance negative, they relate mainly to the short to medium term. We believe it is far too early to discern the long term implications of Brexit.

DOING BUSINESS IN THE UK – ALL CLIENTS

From a legislative perspective there will be no immediate change. All the EU legislation that has already been transposed into UK law will continue to apply in the same way as it does now until such time as it is repealed or reformed by the UK Parliament.

This includes:

- Solvency II
- Insolvency and the Pension Protection Fund
- Scheme funding requirements
- Cross-border schemes
- Pension aspects of TUPE
- Investment regulations
- Data protection

There are a number of reasons that companies investing in compliance with EU regulatory frameworks such as Solvency II will not stop doing so. They are already deeply invested in these frameworks; achieving compliance establishes an equivalence standard that the EU seeks for trading partners in so-called third countries; and most such changes will come into force well before any likely exit date for the UK.

Whilst the wholesale unravelling of those areas that derive from EU law is unlikely, in the longer term, there could be some modifications.

For example, just in the field of employee benefits the UK might restore a broad exemption from TUPE for pension rights, revert to sex based annuity factors, amend the cross-border funding regime or remove some of the restrictions on pension scheme investment.

Certainly, nothing will happen overnight. Any proposed changes would go through consultation and therefore there would be opportunity to provide input and time to adapt to any eventual changes.

While uncertainty continues, a few strategic investment decisions are being put on hold – for example, the expected investment in a third runway at London's key airport, Heathrow, has been delayed until the governing Conservative Party has selected its new leader and Prime Minister.

Further, the UK has historically been the second largest recipient of funding from the EU's European Fund for Strategic Investment (EFSI), and in 2015 took EUR5.5bn of loans from the European Investment Bank. It seems likely that these sources of funding for infrastructure investment will now cease, and the UK Government may now look for new partners and sponsors for such investments.

PROTECTING YOUR SKILLS BASE

For organisations with European employees working in the UK, or UK employees working in Europe, prudent companies will now task HR teams to identify and offer support to those affected.

In the UK, statistics suggest that approximately two thirds of EU employees in the UK have been resident for more than five years, giving them an automatic "permanent right of residence" under current EEA regulations. The same EEA regulation will apply for all EEA countries for UK expatriates.

We would expect this to be a priority area for Article 50 negotiations, and that all governments will aim to accommodate citizens' existing living arrangements and property rights, not only expats with 5+ years residency.

AN INITIAL CHECKLIST

- [ ] Does your business require any of the following to move freely across UK/EU borders?
    - Employees
    - Goods
    - Services
    - Capital
    - Payments
    - Data
- [ ] Do your internationally mobile employees need reassurance on next steps?
- [ ] Does your business trade in the UK under the material protection of any of the following:
    - EU patent
    - EU trademark
    - EU appellation
    - EU protections for open completion, e.g., in public sector or defence contracts
- [ ] Does your UK-based organisation materially rely on any of the following:
    - EU loans
    - EU grants
    - EU subsidies
- [ ] Do you have sight of any material risks arising for businesses in your supply chain?
- [ ] Will you have sufficient legal capacity to assess changes to regulations and contracts?

IMPLICATIONS FOR RISK & INSURANCE CLIENTS

Volatility itself, as we say, is the key risk to attend to in the short-term. You may find it timely to consult with your adviser to check your position on the following matters:

- **Currency fluctuation -** While sterling is weakened, prudent companies will remain aware of their policy limits and sub-limits. Policies with limits in sterling which cover foreign jurisdictions may need to be reviewed to ensure sufficient coverage is in place
- **Policy definitions -** Where the term EU is used within your insurance coverage, consideration should be given to its definition. For example territorial limits will need to be considered once the exit is complete.
- **Premium taxes -** Premium taxes within the EU are due in each country where there is an insured risk regardless of where in the EU the insurance policy is issued. It seems unlikely that this would change following Brexit.
- **Multi-national programmes -** Where programmes are placed in London and provide cover to EEA territories, this is permitted under the EEA's freedom of service rules. In case the UK loses EEA access, London Market participants are defining new solutions for multinational clients. In coming years the location of insurers may become an increased consideration at the time of placement.
- **Insurer security –** JLT's Group Security Committee actively monitors insurers on clients' behalf. We note S&P Global Ratings' comment on 24 June that insurance is less exposed to rating actions due to Brexit than other financial service sectors.
- **Project Policies -** Similarly such policies placed in the London insurance market for projects in the EU could be defined as non-admitted in coming years. For those projects with, for example, a multi-year construction period, it is important that the broker continues to keep a close watch on developments in coming years.
- **Captives -** Captive insurance companies domiciled within the EU that have demonstrated they meet Solvency II requirements are likely to be unaffected. Captives domiciled outside the EU are not subject to Solvency II.
- **Pricing -** It is too early to know whether Brexit will affect pricing. In recent years the key drivers of pricing have been insurer's access to cheap capital, and a relatively benign period without significant insured catastrophic losses. The systemic, macro-economic dynamics affecting capital markets are likely to remain the key determinant of insurance pricing, against which a UK/ Brexit factor will not be significant.
- **Reinsurance -** Similar issues will apply to reinsurance clients however reinsurance clients and markets tend to be more global in nature which should allow for an orderly transition within the sector once the picture becomes clear. JLT Re, given its global footprint will continue to deliver effective solutions for clients in the location that is best suited to their needs.

Longer-term impacts will of course only become clear as the UK's Brexit deal takes shape through negotiations, following the invocation of Article 50. We will maintain a close watch on the risks of increased import costs, the possible imposition of tariffs, and reduced access to labour markets.

IMPLICATIONS FOR INVESTMENT & EMPLOYEE BENEFITS CLIENTS

INVESTING

There are a number of larger macro economic factors in play, which would be material to the proper management of UK pensions and investments, with or without Brexit. For example, since our scan of the horizon at the beginning of the year, we have seen:

- A reduction in gilt returns and expected 20 year gilt spot rates at future dates. This reflects the fall in yields over the first quarter as the market priced in the further pushing out of base rate rises. Brexit adds impetus to this dynamic.
- UK inflation expectations increased slightly as the effect of previous energy price falls subsided and wages started to increase. Brexit adds a new driver to these UK inflationary pressures, with weaker sterling driving up import prices.
- Slight reduction in the forecasts for risky assets; equities, diversified growth funds and UK commercial property. This change reflects the number of headwinds in the global economy over the first quarter. Brexit adds an additional source of headwinds to this list.

We expect any technical recession that might arise in the UK following the vote for Brexit will be mainly as a result of reduced inward investment due to uncertainty.

In the case of this negative scenario of increased equity volatility and a reduction in equity returns we would expect diversified growth funds to outperform developed equities over the next three years, a reversal in relative forecasts since 31 March 2016.

We expect returns for emerging market equities to come in, slightly, although we believe them to be favourable compared to developed equities.

Muted returns over the previous five years mean that we believe emerging market equities represent good value. This would perhaps be helped by the Fed's adopting a looser path on monetary policy. However, in a more stressed economic scenario for the US, emerging markets are likely to suffer. There are many other unknowns, chief amongst them being the Chinese policy response towards a strengthening dollar and yen.

UK EMPLOYEE BENEFITS

Pension Trustees should be consulting their investment advisers to identify any investment risks and determine whether their investment portfolio remains appropriate, particularly any assets which are invested in another EU Member State.

Trustees of Defined Benefits (DB) schemes should also assess the potential impact of Brexit on the employer's covenant and any guarantor relevant to the scheme. If they consider their sponsor, guarantor or contingent assets to be at heightened risk, they may need to seek additional security for the scheme.

DB scheme deficits have increased due to their exposure to reduced gilt yields and the current adjustment to earnings expectations across a range of assets. Trustees should consult their scheme actuary to determine whether it is safe to rely on current funding assumptions.

Until the shape of the UK's exit has been determined, the legislative implications for UK pension schemes are unclear. However in the short term trustees and sponsoring employers need to consider what steps they can take to mitigate the impact of continued market volatility on their scheme.

Communication is vitally important to the successful administration of schemes. Trustees should also issue an announcement to members telling them about the measures they are taking in response to the possible impact of Brexit on their scheme.

LOOKING FORWARD

Contingent capital – insurance – plays a core role in the global capital markets that underpin all economic activity. Whatever the specific shape of the new settlement between the UK and the European Union, all parties in the negotiations will be aware of the need to maintain stable access to these vital economic resources. So while there is uncertainty over the precise shape that our services will need to adopt across the UK and EU, we can be confident that services will continue.

With the resignation of the UK Prime Minister, David Cameron, and the UK's Commissioner in the EU, Lord Hill, political uncertainty remains over when, and if, the UK will invoke Article 50 and begin the process of exit. At the time of writing, the EU's stance towards negotiations likewise remains a work in progress.

The UK civil service has established a Brexit unit under Oliver Robbins, reporting to Cabinet Office minister Oliver Letwin. Position papers are in development now for the incoming Prime Minister to consider and develop the UK's negotiating position. With our partners in the London Market, we will take every opportunity to inform and support that process towards a constructive outcome, on behalf of our clients.

There are two significant elections approaching in Europe in 2017, in France and in Germany, during which those seeking to influence the direction of the new EU will have an opportunity to do so. This might feed further instability – equally, it may give voices promoting stabilisation a window of opportunity to influence the target model. Like many of our multinational peers and clients, we will seek opportunities to inform and support those political processes wherever possible.

For our clients in all other centres of activity, in the US and Canada, in Latin America, the Middle East and Africa, across Asia, Australia and New Zealand, we continue to fight your corner as we drive the development of the robust capabilities of the London Market, as well as through our wider operations and market relationships in continental Europe and worldwide. We stand ready to support you, whichever solution fits your needs best.

FUTURE EU LEGISLATION

Whilst it may appear there will be no requirement for the UK to implement future EU legislation, this will depend on the terms negotiated for the UK's exit and the nature of the UK's post-Brexit relationship with the EU.

If the UK remains in the EEA under a model similar to the Norwegian relationship, then adoption of EU legislation may still be required for interaction with Europe.

For example, EEA membership would mean the revised Institutions for Occupational Retirement Provision Directive ("IORP II") would almost certainly apply to the UK, but the UK would no longer be in a position to influence its terms.

Similarly the UK may still have to comply with the EU's new data protection rules, the General Data Protection Regulation (GDPR), which comes into force in May 2018.

The UK's Information Commissioner's Office has said that "if the UK wants to trade with the Single Market on equal terms we would have to prove adequacy – in other words UK data protection standards would have to be equivalent to the EU's GDPR."

Not being part of the EU would, however, mean that the UK will no longer be bound by rulings of the Court of Justice of the EU.

We note that some EU developments of which the UK has been an opponent, such as the Financial Transaction Tax, might now accelerate.

INNOVATION AND OPPORTUNITY

As we noted at the outset, disruption is not only a destructive process. We do not believe it is necessary here to rehearse the several downsides with which you will already be familiar. There are new opportunities that arise for a UK that stands at one remove to EU governance arrangements.

These include:

- **Advanced regulation -** The FCA, acknowledged as a world leader among regulators in supporting innovation – for example, Project Innovate's Regulatory Sandbox, Advice Unit, and Innovation Hub – is a differentiator that underpins London's appeal to global financial services.
- **Cultivating innovation -** Free from restrictive EU regulation, the UK Government may have greater agility to support entrepreneurialism in financial services, boosting the potential of London as a FinTech hub.
- **Tax environment -** The UK as a member of the EU has been under pressure to remove certain tax reliefs, such as VAT reliefs, supportive of financial services. These pressures are likely to be removed under new arrangements, and positive incentives such as the UK Chancellor's proposed reduction in Corporation tax will give additional cause for global corporates to favour London and the UK.

We therefore expect that regulatory risk under the Brexit settlement will be low.

HERE TO HELP

There will be continuing volatility and uncertainty in markets and in the political sphere, but one signal is clear – there is no cause to rush into decisions, and many reasons to study, watch and wait.

We will continue to take all factors into account when considering the optimal risk solutions and markets to support you in achieving your strategic goals. As a global company headquartered in London, working in close cooperation with market participants at the heart of these unfolding events, we stand ready to apply our insight, our expertise and our entrepreneurial spirit to all your challenges, to help you respond effectively to the new political and economic landscape in Europe.

For advice in specific sectors, products and services, please do get in touch with your JLT partner.

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