MARSH

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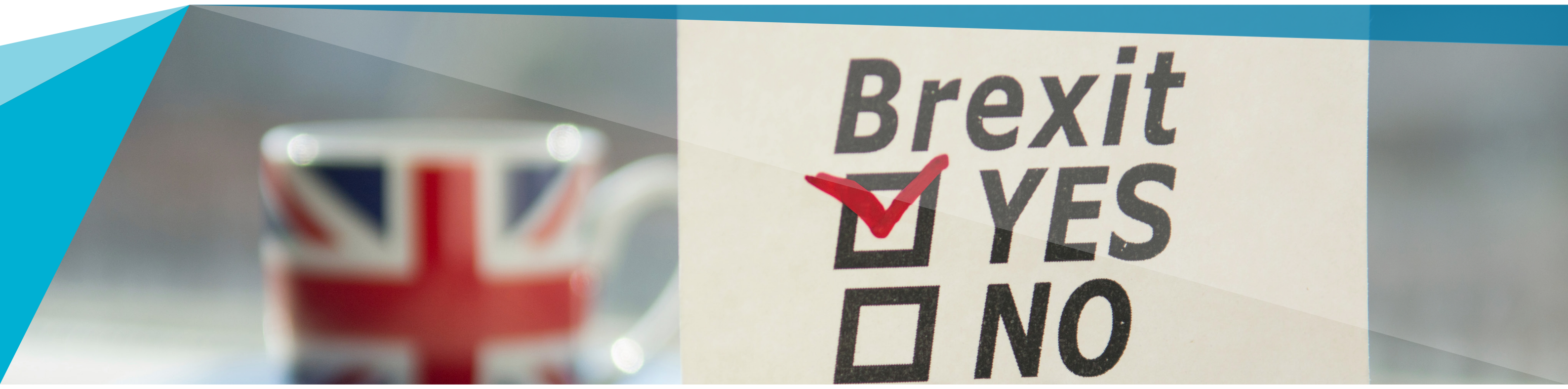
BREXIT: DEVELOPING RISKS FOR FINANCIAL INSTITUTIONS



The United Kingdom (UK) voted to leave the European Union (EU) on June 23, 2016; however, until June 2018 at least, the UK will remain a part of the EU while possible scenarios for a new relationship are explored. For financial institutions with operations in the UK and the EU, this means entering into a prolonged period of uncertainty, until the final impact of the "leave" vote on these financial services operations is known.

Plans and responses to the changes will therefore have to be carefully phased in line with the emergence of a clearer picture. Nevertheless, financial institutions should begin to identify all potential risks resulting from the UK vote and make preparations to track their development over the next two years.

Marsh's Financial Institutions Practice has identified the following potential short- and long-term risks to financial institutions.

SHORT-TERM RISKS

CURRENCY DEPRECIATION

Both the UK and the EU witnessed a drop in Sterling and the Euro, respectively, and were downgraded by key rating agencies in the immediate aftermath of the UK referendum. Downgraded ratings are likely to mean that the UK and other EU countries will encounter higher borrowing costs in global financial markets. This may have the effect of slowing economic growth, depending on each country's existing economic conditions.

Any financial institutions trading or holding funds in Sterling or the Euro will have felt an instant impact due to the weakening of these currencies. Funds held in Sterling or the Euro will have lost value and markets trading in them are likely to be unbalanced. In addition, transfers of funds in and out of the UK and EU may prove disadvantageous, at least in the short-term.

HIGH LEVEL OF UNCERTAINTY

Over the next two years, the UK Government is tasked with realising the wishes of the electorate and triggering Article 50 to commence the UK's exit from the EU. Consequently, clarity over the freedom of UK-EU trade in financial services may be slow to emerge.

Political and economic uncertainty in the UK is likely to slow inward investment and economic growth. UK-based financial institutions must endure this, making their own growth more challenging.

LONG-TERM RISKS

REGULATORY UNCERTAINTY

The Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), in partnership with the UK Government, have worked hard to build a regulatory framework that pre-empts and then implements the legislation passed down by the EU.

As it stands, EU directives, such as Solvency II and the Markets in Financial Instruments Directive II (MIFID II) are raised by the EU but must be implemented by UK law. As such, the existing laws passed in the UK to comply with directives will stand unless the UK Government acts to repeal them. On the other hand, EU regulations, such as the Capital Requirements Regulation, are directly applied to all EU firms, so have not been implemented in UK law.

While there is no suggestion that the UK would seek to break significantly from the regulatory path set out by the EU, the UK Parliament will not be compelled to comply with any further EU directives once Brexit terms are finalised. If the UK Parliament wishes to retain rules passed down through EU regulations, it must enact UK legislation to keep them in place.

Again, this will be subject to the rules of the final deal struck. However, in theory, the FCA and the PRA should have more freedom to tailor the regulatory regime in the UK to suit the UK financial services environment.

Financial institutions must continue to monitor the regulatory environment closely, accepting the possibility that the UK may not follow the exact path laid out by the EU. This introduces an element of uncertainty into the long-term regulatory outlook.

ACCESS TO THE EUROPEAN ECONOMIC AREA (EEA)

It is unclear whether UK financial institutions will be able to maintain their "passporting" rights, which currently allow them to access the European Economic Area (EEA) without setting up local branches in each country. If this ceases to apply to UK financial institutions following Brexit, the management at each institution will need to consider how best to retain access. The same applies to EU financial institutions wishing to retain access to the UK market. The terms of the final deal struck between the UK and EU following Brexit will define the level of access to EU markets that financial institutions can expect.

LOCATION

Uncertainty over the long-term nature of bilateral trade between UK and EU markets means it is prudent for financial institutions to reconsider the impact of their geographic footprint.

Each financial institution with cross-border UK-EU operations must begin to assess the costs and risks associated with potentially restructuring, relocating, and/or arranging appropriate licences in the event that the UK-EU trade deal does not permit the access desired.

Many financial institutions have stated that they may move jobs to the EU following the Brexit vote. However, a change of location brings potential political, economic, and cultural risks that must be assessed and managed.

In particular, those financial institutions that manage risk using a captive will need to understand the implications of the captive's domicile. Data management procedures, including the location of data centres and whether these are to be governed by the EU General Data Protection Regulation (GDPR), will also need to be reviewed.

PEOPLE

There is a possibility that Brexit may result in constraints on the free movement of people between the UK and the EU. Therefore, the most pressing impact for UK-domiciled financial institutions will be on the workforce already in place, many of whom are EU-born. While EU-born employees in the UK will see no change to their rights before June 2018, their long-term future is unclear at this point in time. Financial institutions will need to understand the risk this poses for business continuity.

Even if a financial institution were not to suffer greatly from a loss of EU workers, tighter rules on EU immigration could result in a scarcity of skilled workers in the UK both now and in the future. The squeeze on expertise is only likely to intensify over time.

Marsh's Financial Institutions Practice will support clients by monitoring these risks and working with them to understand the potential impacts on an individual basis. In order to ensure clients have access to the best possible information, the Financial Institutions Practice is committed to producing sector-specific guidance over the next two years.

Should you have any questions, please email: national.enquiries@marsh.com.