THE UK CHOOSES BREXIT
CONSIDERATIONS FOR COMPANIES

THE NEW RISK ENVIRONMENT
CORPORATE STRATEGY IMPERATIVES
WORKFORCE DISLOCATION
EXECUTIVE SUMMARY

The UK electorate has opted for “Brexit”, mandating the government to begin the process of leaving the European Union (EU). Once Article 50 of the Treaty on European Union has been invoked, there will be a significant transitional period (possibly two years) in which the UK government will negotiate with the European Council on the terms of the withdrawal. It is possible that the establishment of trade agreements with non-EU countries will take even longer.

In the light of considerable uncertainty, companies will need to monitor the negotiations closely, factoring the impact of different regulatory and market scenarios into their investment plans. These should appreciate possible opportunities as well as challenges. Leaders will also need to communicate effectively with their employees, who will want to understand how they might be affected. Below we set out some of the key areas for attention as a clearer picture of future arrangements emerges.

AREAS FOR ATTENTION

- **THE NEW RISK ENVIRONMENT**
  - Protect against stress on capital and credit positions resulting from market volatility and possible negative GDP impacts
  - Monitor economic and political contagion in other markets, and the associated business consequences

- **CORPORATE STRATEGY IMPERATIVES**
  - Consider the need to restructure UK operations, in the light of negotiations on passporting arrangements and tariffs
  - Analyse likely changes in regulatory regimes on capital requirements and operational constraints, to inform industry consultations

- **WORKFORCE DISLOCATION**
  - Anticipate UK labour market constraints (faster than regulatory change and trade deals) and impacts on competitive pay levels
  - Review cross-border implications for employee healthcare, and also pension scheme performance and risk management

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After months of fierce debate and a policymaking hiatus, the UK electorate has voted in favour of leaving the European Union (EU). While the broad direction is set, companies will still face considerable uncertainty until the UK’s exit strategy is defined and trade negotiations (including the trans-border movement of people) with the EU and other countries are completed. Drawing on perspectives from our operating companies, we look at three interrelated challenges that should be uppermost in the minds of company leaders: the economic and political risk environment, corporate strategy imperatives, and workforce implications.

By way of a backdrop and to illustrate the uncertainty, we briefly describe four possible Brexit scenarios (not all of which are equally likely), with a particular focus on the UK’s relationship with the EU.

The UK becomes part of the European Economic Area (EEA). As an EEA country, the UK would have access to the single market. EU regulations and directives would still apply, the UK would still contribute to the EU budget, and it would not have an independent immigration policy. This scenario is likely to have the lowest impact on the economy and trade.

The UK enters into a bilateral integration treaty with the EU. This would involve some UK access to the single market, although not full access for goods and services. It is expected this scenario would have a moderate impact on the economy, trade, and immigration.

A tariff-free trade agreement is made between the UK and EU. The UK would have its own immigration policy and an independent trade policy with likely implications for the trans-border movement of people. This scenario would provide some access to the single market and would probably have a moderate impact on the economy.

The UK makes no access agreements and trades with the EU as a third country. If only World Trade Organization terms apply, the UK would trade with the EU in a similar way to countries like the US, and UK immigration policy would become independent. This scenario would likely have the highest impact on the economy and the lowest likelihood that the UK would be able to trade under the single market.
THE NEW RISK ENVIRONMENT
Short-term volatility and protracted uncertainty

Let’s not forget that the UK is the first nation state ever to leave the EU. The lack of historical precedent, along with the significant arguments to Remain advanced by expert bodies, suggest that UK markets will see significant volatility over the rest of 2016 as the shock is absorbed and sentiment fluctuates in response to political and economic announcements. Sterling may come under severe pressure, the stock market may sag, and UK property prices may tumble as domestic and foreign investors fear a significant shock to the UK economy.

The Bank of England will implement contingency plans, including additional auctions of sterling to ensure the banking system has sufficient funds to operate in the event of turbulence. But decisions on interest rates or quantitative easing will be guided by a view on the strength of “countervailing forces” on the economy, and the possibility that a fall in the value of sterling alone might provide a sufficient stimulus for the economy by making UK exports more competitive.

All the same, it is widely feared that heightened uncertainty will dampen the immediate outlook for GDP growth, as households defer spending on major purchases and companies postpone investment projects and recruitment plans. Regulatory uncertainties may deter foreign direct investment to the UK in the short term – in the months running up to the vote, IPOs and private equity deals withered and corporate credit demand softened. How long this might last is a critical factor: while the formal exit process from the EU may last two years, it is not inconceivable that the negotiation of trade deals with the EU and other countries (covered to date for the UK by EU trade arrangements) will take substantially longer.

Finally, there are the risks associated with economic and political contagion. A fragile global economy may be further battered by the spill-over from GDP impacts, trade agreement uncertainties, and investor sentiment. Moreover, the success of an agenda that only a few years ago was scarcely conceivable raises the prospect of popular demands in other countries to leave the European Union or, at the very least, to negotiate better terms, thereby potentially undermining the coherence of the region’s proposition to its members and its interface with the wider world. The UK’s decision may also give further impetus to the increased deployment of protectionist measures already observed across G20 countries.
Under the more likely scenarios (based on the aspirations declared by pro-Brexit politicians), global non-EU multinational companies and EU-headquartered firms with sizeable UK operations will need to rethink and possibly restructure their UK operations, given the likely additional cost and complexity associated with accessing EU markets. UK-headquartered firms with global operations, domestic firms, and government bodies will all face tactical challenges, but will be less affected in the medium term.

Some industries will be affected more than others, with the most significant impacts anticipated in financial services, with a particular challenge as to London’s position as a global hub, since it is unclear what will happen to “passporting” rights – the ability of financial services firms based in one EU country to operate in another without setting up a new legal entity. Banks (both UK- and EU-domiciled) may be obliged to set up additional operations or headquarters elsewhere, with revenues travelling accordingly. For example, regulatory demands may result in a significant proportion of capital markets and investment banking revenues currently achieved in the UK migrating to the continent (See Exhibit 1.).
Similarly, the right of insurers and brokers to passport into the EEA could be restricted following the UK’s two-year transition period. Insurers wishing to carry on business in other EEA states may be required to obtain licences, or form a new legal entity based in the state. Equally, EU insurers may need an additional licence to carry on insurance business in the UK, or to form a new UK entity. Writing business through local branches would require local authorization and capital being deposited to support the branch, in certain cases. In advance of full regulatory clarity, some major insurers with UK operations may establish a greater presence in continental Europe, in order to operate more easily under a single licence.

Successor UK approaches to a number of major pan-European regulatory regimes (most notably Solvency II) will need to be negotiated, although it seems unlikely that UK regulators would want to significantly depart from the scope and aims of the established regimes. Insurers may additionally be affected should the Freedom of Services Directive – the right to provide services on a cross-border basis within the EU – cease to apply to the UK. For insurers, this Directive is significant as it means that a contract can be underwritten in an EU member country that is different from that in which the risk is located, and it enables multinational companies to secure locally admitted coverage in multiple EU countries. Additionally, there is a risk that UK legal judgments may no longer be enforceable in the rest of the EEA.

Impacts are, of course, by no means confined to these sectors. It is easy to envisage impacts in other regulated sectors, such as utilities (a possible watering down of current directives on emissions and renewables) and healthcare (more costly and less efficient pharmacovigilance). Less regulated sectors (such as retail) may be more affected by tariffs and other trade deal consequences.

Without wishing to speculate on how much and what is at risk, it is worth recalling the scale of the trading relationships between the UK and other countries. The total volume of traded goods and services between the UK and the EU amounted to £514 billion in 2015 (with the UK having a trade deficit of £68 billion) and those between the UK and the rest of the world amounted to £545 billion (with the UK having a trade surplus of £31 billion).
The concern about immigration that underpinned much of the vote for Brexit will most likely inspire changes to employment and labour market regulation. While the movement of key talent and human resources may be the key concern, there will also be consequences for compensation, benefits, and pensions.

Negotiations will now determine the circumstances under which EU citizens will be able to enter and work in the UK, and the conditions in which EU citizens already in the UK, and UK citizens already in the EU, will be able to continue in their current roles. It is likely that some restrictions will be placed on EU workers within the UK labour market – in the order of two million people, who form a significant proportion of the retail, leisure, and service sectors. New bilateral agreements may be required for those organizations offshoring from the UK into the EU, and employment mobility constraints may influence decisions by non-UK multinational companies as to the viability of having their European headquarters in London.

Restrictions and changes in the UK labour market for key skills, at executive and other levels, will impact on competitive pay levels in the UK. There may also be an increase in costs for UK citizens living and working within the EU. The UK banking sector is likely to seek changes in banking regulation that affect pay. This may bring an end to bonus caps and other EU-sponsored controls, although the Financial Conduct Authority and Prudential Regulation Authority will want to ensure that the direction and spirit of the Financial Standards Board’s requirements continue to be fully met in the UK. Some regulatory changes in the broader market are likely to favour employers, possibly at the expense of a more turbulent employee relations environment.

An end to reciprocity on state healthcare costs for foreign nationals across member states could lead to a lack of state-accessible primary and secondary care for expatriate workers. This would generate concern for mobility teams. There may also be an increase in bureaucracy for expat workers, including the compulsory company healthcare provision. Another corollary of these workforce dislocations is the possibility of changes to how personal data is managed and stored, as separation occurs.

Companies and employees may also be affected through the performance of their pension schemes, as UK, European, and global markets assess the UK’s decision. Increased volatility in gilt yields and sterling may have further impact on pension schemes, which are already facing record liabilities and increasing deficits, at least in part due to nervousness inspired by the referendum. Trustee boards should consider the impact of future possible market moves on scheme funding positions, sponsor covenants, and their financing and risk management strategies.
Similarly, defined-contribution members looking to provide income from their retirement savings should expect greater turbulence. Many people could now see their financial health and their pensions suffer some short-term volatility. While long-term savers may be able to navigate the volatility, those with more immediate needs, whether it is coping with debt repayment or seeking an income for life, may find themselves particularly vulnerable and may have to scale back on their aspirations.

The prospect of market volatility and protracted policy and regulatory uncertainty will hold little appeal for many companies at a time of continued economic fragility. The list of potential actions is long. They will need to be prioritized and sequenced appropriately, as well as reconsidered and adjusted over time.

Now that we have a decision, companies would be wise to review their risk profile and consider the resilience of their planning assumptions to both likely and unexpected scenarios. This should inform decisions on how, where, and when to deploy capital, and strengthen the ability of leaders to engage with policymakers and regulators. An agile approach to planning and management will be essential as national-level negotiations proceed and the shape of the exit becomes clear. Throughout the process, strong communication with employees will be critical for maintaining morale, loyalty, and productivity.

With that in mind, it may be as well to channel some of the optimism of the pro-Brexit politicians about the advantages of taking back control. After all, no one has ever claimed that the EU is perfect, and UK-based businesses may well find advantages in legislation and regulation that is better attuned to UK needs and possibly faster-moving to address urgent issues.
ABOUT

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