

# Further aspects from the UK referendum on EU membership

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# HSBC research views

- **In case of vote to leave**
  - Sterling goes down (20%), gilt curve bull steepens
  - Negative outcome for risky assets, positive for gilts
  - Reaction of BoE to higher import inflation not clear
  - Periphery most at risk
  - Do not foresee impact on UK banks' LCR portfolios
  - UK sovereign credit downgrade is a risk
- **In case of vote to stay**
  - Subject to recovery and Fed, BoE should tighten in May 2017
  - Still see curve flattening trend intact
- **UK autonomous financial structure**
  - Domestic settlement of securities (CREST) not part to Target 2S
  - Domestic payment systems (BACS, CHAPS etc.)
  - Not part of Target 2 (unlike Denmark and Poland)
- **Clearing**
  - Derivatives CCPs (LCH, CME) clear GBP, USD and EUR
  - LCH RepoClear includes most but not all Eurozone government bonds and SSAs
  - LCH.Cleernet Ltd also supports term GC in GBP and EUR
- **ECB vs BoE - Collateral: limited impact**
  - ECB only accepts collateral from EEA issuers if bonds settled in the Eurozone
    - If UK leaves EEA, bonds issued by UK entities could cease to be accepted
    - Gilts are not currently eligible as settled in UK (CREST)
  - The BoE accepts quality collateral from sound issuers irrespective of settlement venue
    - If UK leaves EEA, expect OATs, Bunds and DSLs will remain level A assets
- **Liquidity- ample and measures in place**
  - QE means excess domestic liquidity in UK and Eurozone
  - If needed, BoE has announced 6M LTROS, ECB still has FRFA and LTRO policy
  - For USD funding, BoE and ECB can borrow from Fed at OIS +50bp using swap lines

Source: HSBC Research 'Fixed Income Asset Allocation: Just can't hike' (9 June 2016), 'Brexit Strategies: What if the UK leaves?' (February 2016)

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# The UK's EU Referendum to be held on 23 June 2016

- **The question**

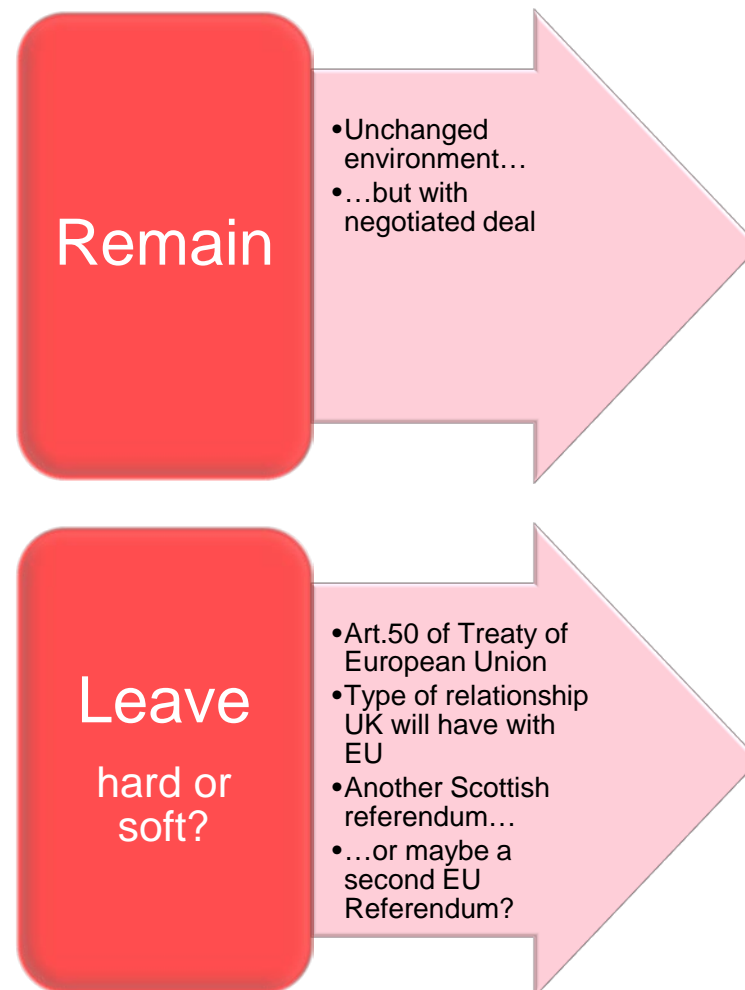
- “Should the United Kingdom remain a member of the European Union or leave the European Union?”

- **Who can vote?**

- British, Irish and Commonwealth citizens who are resident in the UK
- UK nationals living abroad and have been on the electoral register in the UK in past 15 years
- Members of the House of Lords and Commonwealth citizens in Gibraltar
- Apart from citizens of Ireland, Malta and Cyprus, EU citizens will not be able to vote

- **Britain's negotiated 'special' deal**

- Retaining the pound
- Protection for the City of London
- Britain not part of move towards “ever closer union”
- Migrant workers can still send child benefits back to their home country; however they will be at the level of the cost of living in their home country
- Tax credits and other welfare payment rights will be gained gradually by new arrivals



Source: HSBC, BBC website (<http://www.bbc.co.uk/news/uk-politics-32810887>)

# Some aspects to consider if the UK votes to Leave the EU

## • Art.50 of the Treaty of the European Union

- The process for exiting the European Union is covered by Article 50 of the Treaty of the European Union
- Negotiations take place between the EU and the member on an agreement for withdrawal
- All current European Union treaties will cease to apply from the date the withdrawal comes into force or two years after notification
- The European Council and the withdrawing Member State can agree to an extension of this period

## • Notification of withdrawal, when?

- Two-year time frame begins when the withdrawing Member State notifies the European Council of its intention
- The UK Government has published<sup>1</sup> an article entitled '*The process for withdrawing from the European Union*'
- Prime Minister David Cameron has suggested<sup>2</sup> that a vote for Leave would immediately trigger the notification...
- ...however, several other people have suggested that there could be a lag till the notification is submitted

<sup>1</sup> See

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/504216/The\\_process\\_for\\_withdrawing\\_from\\_the\\_EU\\_print\\_ready.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/504216/The_process_for_withdrawing_from_the_EU_print_ready.pdf)

<sup>2</sup> See Prime Minister's Statement on the European Council, Hansard, 22 February 2016, Column 24.

(<http://www.publications.parliament.uk/pa/cm201516/cmhansrd/cm160222/d ebtext/160222-0001>.

[htm#16022210000001](http://www.publications.parliament.uk/pa/cm201516/cmhansrd/cm160222/d ebtext/160222-0001))

## • Another EU Referendum?

- In principal, the EU Referendum is not binding on government
- There have been some suggestions<sup>3</sup> that a Leave outcome could lead to further negotiations with the European Union and thereafter a second EU Referendum

## • What about Scotland?

- If the breakdown of the referendum votes shows that Scotland has voted in favour of Remain, then the prospect of another Scottish Independence Referendum is likely to be raised...
- ...indeed former Scottish First Minister Alex Salmond recently suggested<sup>4</sup> that the Scottish government would seek to hold such a second vote within two years
- If there was a further Scottish independence referendum, an important question what would be the proposed currency for an independent Scotland?

<sup>3</sup> For example see *The Telegraph*

(<http://www.telegraph.co.uk/news/2016/05/17/leading-eurosceptics-raise-prospect-of-second-eu-referendum-as-p/>)

<sup>4</sup> For example see *The Guardian*

(<http://www.theguardian.com/politics/2016/may/26/alex-salmond-scottish-independence-vote-likely-brexite>)

# Relationship models

- **EEA/EFTA**

- Norway, Iceland and Lichtenstein (EEA); Switzerland (EFTA)
- Access to the EU internal market
- Contribution to EU budget
- Immigration restrictions not allowed
- Bilateral accords with EU on certain areas (EFTA)

- **Customs union**

- e.g. Turkey
- Goods but not services
- No contribution to EU budget...
- ...but need to comply with relevant EU regulations

- **Free Trade Agreement**

- Comprehensive bilateral agreements with EU
- Access to EU internal market, but only for some areas
- No influence over EU regulation in these areas

- **WTO approach**

- No contribution to EU budget
- No automatic access to EU internal market

- **Ultimate relationship with EU is critical**

- EEA (and to a different extent EFTA) status would likely allow for many of the current regulatory areas affecting financial markets to remain largely in force
- Most of the other options would imply the UK becoming a 'third country jurisdiction' and hence equivalence assessments and recognition would likely be required relating to various regulatory areas
- Presumably these issues will be a fundamental part of any negotiations the UK undertakes with the EU as part of the Art.50 proceedings or otherwise

- **Areas of potential impact**

- Passporting
- MiFID and other EU Regulations
- Jurisdiction

# Jurisdiction and passporting

## • ECJ ruling on ECB oversight

- On 4 March 2015, the General Court of the European Union annulled<sup>5</sup> the ECB's Eurosystem Oversight Policy Framework in as much as it set the requirement for central counterparty clearing houses of securities to be located within the Eurozone

## • Capital Requirements Directive

- Passporting under CRD, for deposit-taking and lending, is based on domestic authority. Non-EEA scenario, third party banks require new licences in EU jurisdictions. Equivalence under CRD for UK may also be required

## • MiFID II

- Register with ESMA for third country banks to allow them to undertake business with relevant clients in EU, without need for subsidiaries in a Member State; underpinning is equivalence of the third country regulatory regime and this is agreed upon by the EC

## • EMIR

- EU regulation would not apply if UK outside of the EU; however, in line with global commitments then there could be an introduction of EMIR equivalent legislation in the UK

## • Minimum Capital Requirements

- Risk-weighting may be affected if UK became third country under Capital Requirements Regulation. Need for UK to be deemed to have equivalence in capital regime to CRR

<sup>5</sup> See

<http://curia.europa.eu/jcms/upload/docs/application/pdf/2015-03/cp150029en.pdf> and the related full judgement available on the CURIA website

## • Derivatives

- Section 13(b) of ISDA 2002 Master Agreement refers to Convention Court (Brussels and Lugano Conventions)

## • MiFID and passporting

- Cross-border financial business made possible by EU legislation; includes investment services, payments, deposit taking and clearing
- MiFID allows for business throughout the EU without requirement of individual licences in each country
- Third country banks (i.e. non-EU) required to establish an authorised presence in a Member State; several such banks have UK subsidiaries and make use of the EU passporting arrangements to create access point into the EU
- Loss of passporting would also affect implicit protection from discrimination, as it provides a level playing field

## • Non-EEA relationship

- Most non-EEA type of relationships would presumably imply the UK would become a third country for MiFID purposes
- Third countries banks need to be either authorised or establish a subsidiary within a Member State

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## Issues for discussion

1. Are investors hedged against a Brexit vote and what are the most typical hedges?
2. What would be in your view the likely market reaction in the event of a Brexit vote?
3. How should Europe react to a Brexit vote in order to avoid contagious effects in the next days following the vote?
4. If the leave vote on the 23rd materialize will it lead to a Brexit or can the English Parliament erase the population vote?

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