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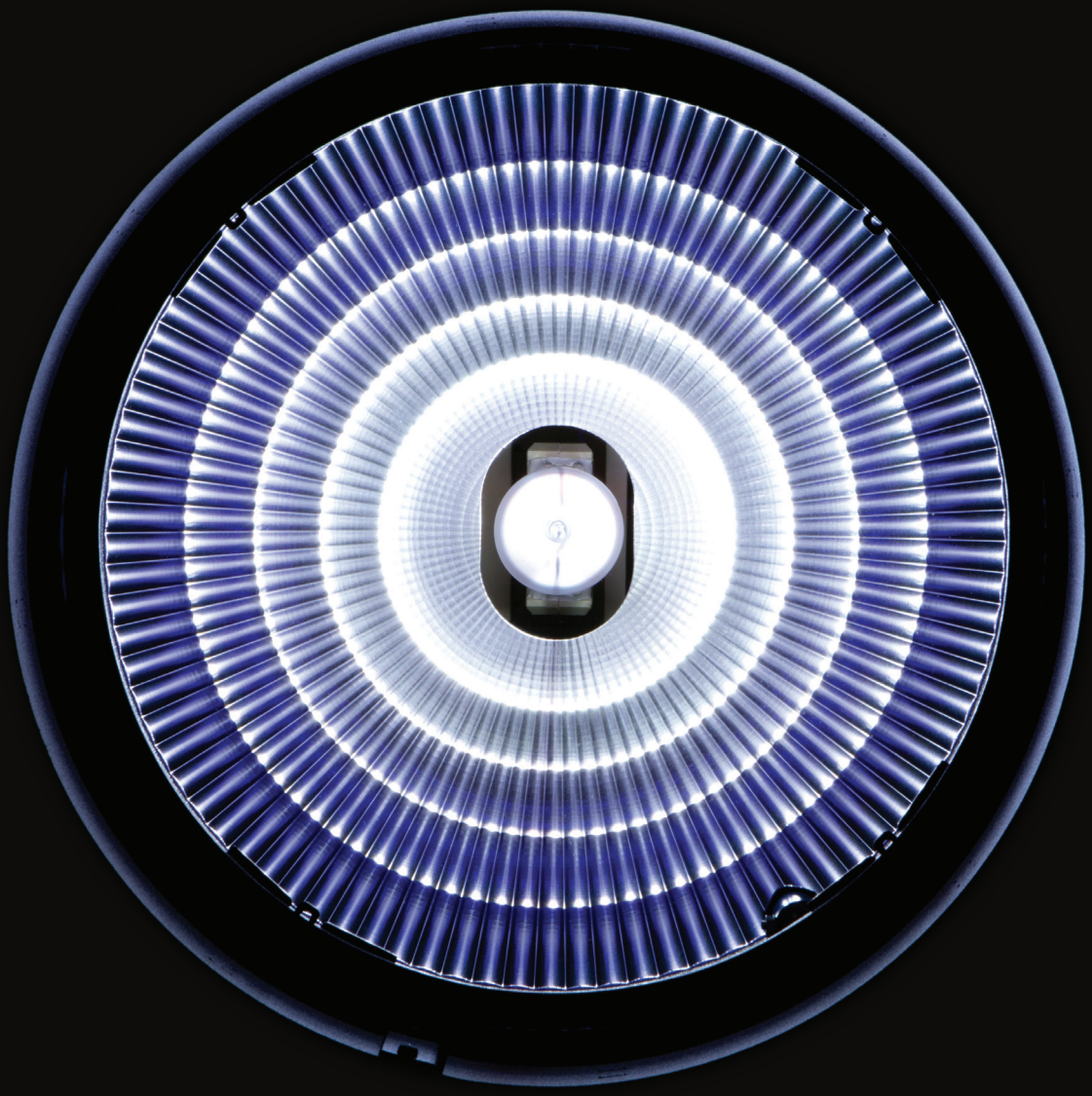


Leaving the EU

What will it mean for banking and the financial services industry?

Special Feature on the UK referendum to leave the European Union

Executive summary

The result of last week's UK referendum on its membership of the EU creates significant uncertainty for the Banking and financial services industry. There will no doubt be much speculation in the coming weeks and months as to the implications for the sector:

- What does Brexit imply for the EU's (and Cyprus') economy?
- What will happen to passporting for UK firms with EU operations ?
- What will happen to EU firms with UK operations?
- What aspects of EU financial regulation will the UK retain, and on what terms?

In immediate terms, despite the fundamental and unprecedented outcome of UK's referendum, it's "business as usual" as far as the regulatory and legal framework that governs Banks and other financial institutions operating in, or transacting with, the UK is concerned. EU legislation will continue to apply while the UK remains a member of the EU, unless there is political intervention to change that.

Banks and other financial institutions operating within, from and into the UK now face a period of market volatility and weakness together with prolonged uncertainty with some of the important details may only be settled towards the very end of the negotiations.

This uncertainty will last until the UK negotiates the terms of its departure which looks likely to be at least two years from when it gives formal notification of its decision to leave. With the expected impact on both the UK and EU's economic growth and the risk of collateral damage to the EU gives European countries a possible incentive to ensure a speedy separation, with the earliest practicable date of exit being at some point in 2018.

To operate successfully in this environment will require meticulous planning, including scenario analysis and, the identification of triggers to activate elements of those plans, and, in some cases, taking early decisions to secure maximum flexibility and optionality for the future.

The answers to these and many other questions will hopefully emerge in due course. In the meantime, we have attempted, through this briefing note, to provide an overview of:

- The next steps relating to the UK leaving the EU
- The different models the UK could select as the basis for its future relationship with the EU
- The expected financial impact on the UK, EU and Cyprus
- Some of our thoughts on how Cyprus Banks and financial firms can best prepare themselves for the uncertainty and opportunities that lie ahead

Introduction

The UK has voted to leave the European Union (EU) (commonly refer to as "Brexit"). Uncertainty in financial markets and among the business community is understandably very high. Today, there are many more unknowns than knowns.
For the time being, some things are certain. From a purely regulatory and legal perspective, today is much the same as before the vote:

- The UK remains a member of the EU, and is unlikely to leave for at least another two years
- EU law continues to apply up to the point the UK leaves the EU
- UK firms will benefit from the same market access they currently have until a formal exit occurs

The immediate political, market and economic events over the next few weeks and months will be difficult to predict or control. Even once the UK Government has formally notified the EU of its intention to leave, significant uncertainty will remain about the negotiations, both in terms of their length and their eventual outcomes.

In this highly uncertain environment, we expect the short-term focus for Banks and financial institutions to be on managing financial impacts and communicating with a broad range of stakeholders (internal and external).

What we know

Giving notice to leave

A "leave" vote does not in itself trigger an exit. The formal trigger is when the UK gives notice to the European Council of its intention to leave the EU under Article 50 of Treaty of the European Union. This will mark the start of formal negotiations on a "withdrawal agreement" that is meant to cover (among other things) the future economic relationship between the EU and the withdrawing country.

Between now and the formal notification the UK Parliament needs to ratify the outcome of the referendum and the UK needs to decide what sort of relationship it wants to have with the EU going forward.

Negotiation period

Once the UK has notified its intention to leave, the UK has two years in which to negotiate a withdrawal agreement that would set out the terms of its new relationship with the rest of the EU and include an entry-into-force provision specifying the exact date on which the UK would formally leave the EU. The formal date of withdrawal will be influenced by the desirability to minimise any disruption to financial and other markets.

At the end of the two year period, if no agreement has been reached, two things can happen:

- The negotiation period can be extended with approval from all the other EU Member States
- If no extension to the notice period has been agreed, the UK would become a "Most Favoured Nation" with trade agreements falling under World Trade Organisation rules. Passporting rights and market access would automatically fall away

It is important to note that during the two year period, all existing EU legislation remains in place, although the UK has no vote on any EU policy matters.

Trade agreements

The two year deadline under Article 50, which could be extended by unanimous agreement, does not apply to trade negotiations. The UK could continue in negotiations on EU trade agreements for many years after Brexit.

If no agreement on trade is reached within the time taken to agree the terms of Brexit, the UK would begin to trade with the EU as a non-member most likely under the rules of the World Trade Organisation, while continuing trade negotiations. That would imply incurring tariffs on a number of goods, with analysis by the LSE suggesting tariffs on UK exports to the EU-27 of about 3.2% on a trade-weighted basis.

Ratification of exit agreement

The final agreement with the UK must be ratified by a qualified majority (20/27) of remaining EU states, representing 65% of the population. The European Parliament would also need to approve the deal and this would require a simple majority.

All things considered, and barring the possibility of a withdrawal agreement being reached in much less than two years or a unilateral UK withdrawal from the EU outside of Article 50, the earliest practicable date of exit will be in 2018.

The new UK-EU relationship: possible models based on precedent

The three broad scenarios for the UK's future relationship with the EU are:

1. **EEA + EFTA (Norwegian model):** this route would see the UK join both the European Economic Area (EEA) alongside Norway, Iceland and Lichtenstein and also the European Free Trade Association (EFTA). The EEA countries have full access to the Single Market and do not contribute to the EU budget, although they are still required to contribute to EEA grants and the funding of specific policy programmes. The EEA option would also leave the UK out of the customs union and require implementation of EU legislation covering the four freedoms - free movement of goods, services, persons and capital (while depriving it of any real influence over development and adoption of new rules).

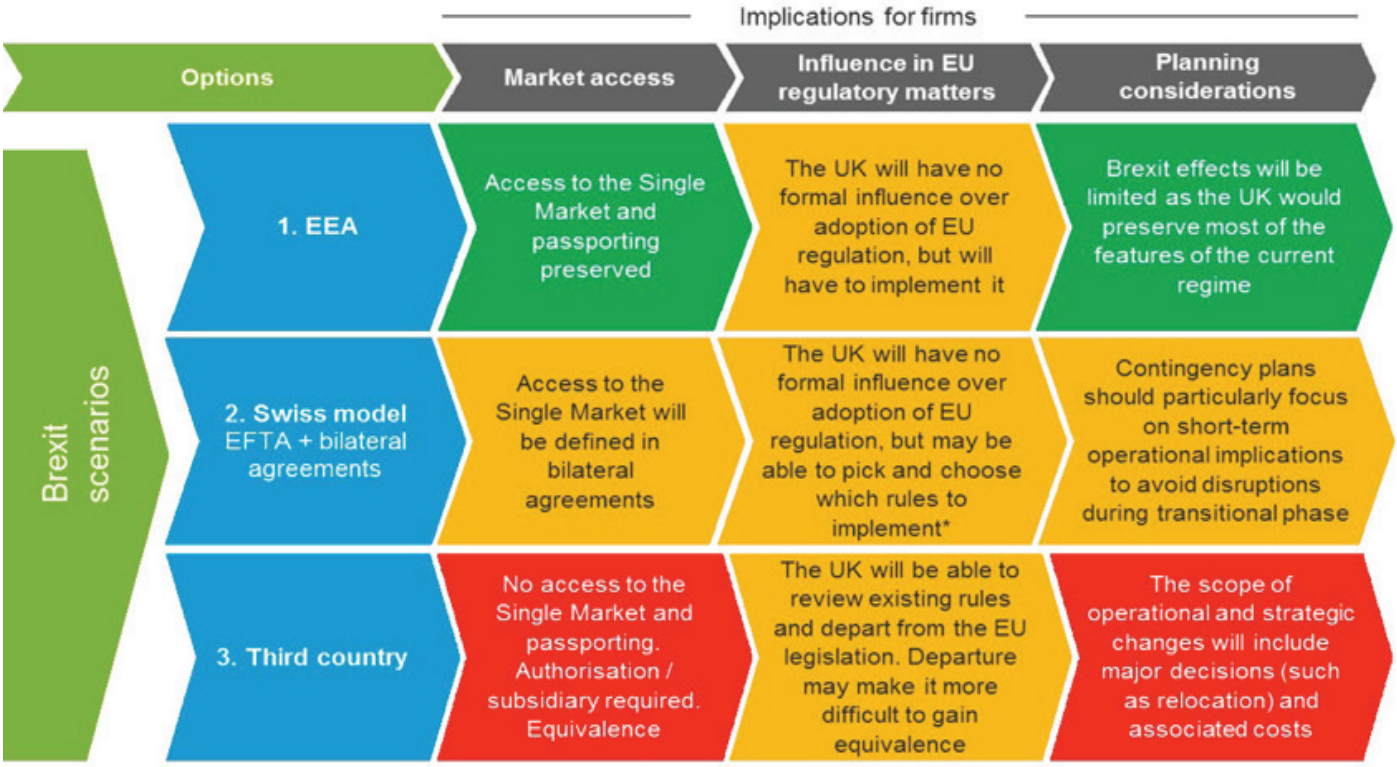
2. **Non EEA + EFTA (Swiss model):** Compared to the EEA option, this route would allow the UK to pick and choose areas where the UK would gain definite benefits from accessing the EU Single Market and would only require implementation of the EU legislation in the areas covered by the bilateral agreements. For those areas of market access that are not covered by bilateral agreements, the UK would need to demonstrate "equivalence" (in broad terms, deemed to be comparable in aims and stringency) with the relevant EU legislation. In both cases, the UK's influence over the development of EU legislation will again be limited.

3. **Opting for a pure third country** regime would mean regaining independence on regulatory, fiscal and other matters. However, at least in the area of financial services legislation, these freedoms may be offset by the need to have domestic regulations which are "equivalent" to EU legislation in order to gain access to the EU's Single Market as a third country. Equivalence is usually granted by the EU on a legislation-by-legislation basis. Experience to date with other third countries seeking equivalence determinations indicates that this could be a lengthy process.

At this stage, the most likely options appear to be the Swiss or third country approach. The EEA model does not deal with any of the fundamental issues that led to the UK holding the referendum in the first place, and in some respects makes them more acute.
While it is too early to be sure about the final outcome of the negotiation, it is clear that – whatever happens – the UK will have much less influence over setting rules for the financial services sector in the EU. Yet the UK may still to a large extent be bound by those rules if its own requirements have to meet the test of being equivalent to those in the EU in order for financial services firms operating from the UK to gain access to the Single Market.

The diagram below summarizes the expected impact for financial institutions for each of the options above.

Diagram 1



** In this scenario, the UK will be able to negotiate provisions of bilateral agreements with the EU, but will have to meet EU standards to be able to benefit from access to the Single Market*

Financial and economic impact

Impact on the UK

In the UK financial services sector the vote to leave the EU has fuelled perceptions of uncertainty and depressed risk appetite. Lower risk appetite is likely, in turn, to lead to a squeeze in business investment and hiring, and a renewed focus on cash and cost control among corporates. Elevated uncertainty is likely to weigh on M&A, IPO activity and inward investment.

Most economists predict that Brexit is likely to lead to a marked deceleration in growth in the short to medium term. The average forecast of economists is for UK growth to slow to 1.4% in 2016 and 0.7% in 2017, compared to a forecast growth of around 2.0% in each year with the UK in the EU. HM Treasury's central view is more pessimistic and forecasts no growth in the next two years. Significant and sustained weakness in sterling would drive inflation higher, with negative effects on consumer incomes and activity. A weaker pound could, however, deliver significant benefits for exporters.

In the medium term much will depend on the pace and success of the government's negotiations with the EU. Here the UK is likely to face a tradeoff between retaining access to the Single Market and ending free movement of people. With greater clarity over time on the UK's new relationship with the EU and the world the dampening effects on growth are likely to diminish.

In the longer term, economic activity will be determined by a combination of the nature of the UK's post-exit trade relationship with the EU and its ability to exploit its newfound freedom to forge individual trade deals with emerging markets outside the EU. The most pessimistic forecaster is the Centre for Economic Performance at the London School of Economics (LSE), which sees the UK economy being 6.3% to 9.5% smaller in 2030 with the UK outside the EU.

In addition to the uncertainty created by the Leave vote, the usual factors of financial conditions, interest rates and global growth will continue to play a considerable role. Strong institutions and an economy that is resilient and highly ranked in international league tables of competitiveness are expected to put the UK in a good position to navigate the changes and uncertainties that lie ahead.

Impact on the EU

The impact of the UK's withdrawal will not be limited to the UK. Economists forecast a spillover economic impact for the rest of Europe, especially via reduced inward investment and trade slowing the nascent EU recovery. Consensus forecasts suggest 1.5% growth in the euro area in 2016 and 1.4% in 2017. The softening in growth is far less pronounced than that forecast for the UK, but the risk of collateral damage to the EU gives European countries a possible incentive to ensure a speedy separation.

In addition, the EU would lose a significant net contributor to the EU budget. This gap would need to be filled either by higher contributions from other states or less spending. The extent to which the UK's net contribution falls outside the EU will depend on the UK's relationship with the EU and the outcome of financial negotiations. The EU would need to either cut spending or increase contributions by other member states, up to a maximum of 5.8% of current levels, in order to make up the difference.

Analysis by the OECD suggests that the countries most affected will be Ireland, Cyprus, the Netherlands, Norway and Switzerland. Eastern and peripheral European economies have the least exposure to the UK. As, also illustrated by Standard and Poor's Brexit Sensitivity Index (Chart 1 below), the countries with closer UK ties, are particularly exposed to Brexit.

Chart 1

Standard and Poor's Brexit Sensitivity Index

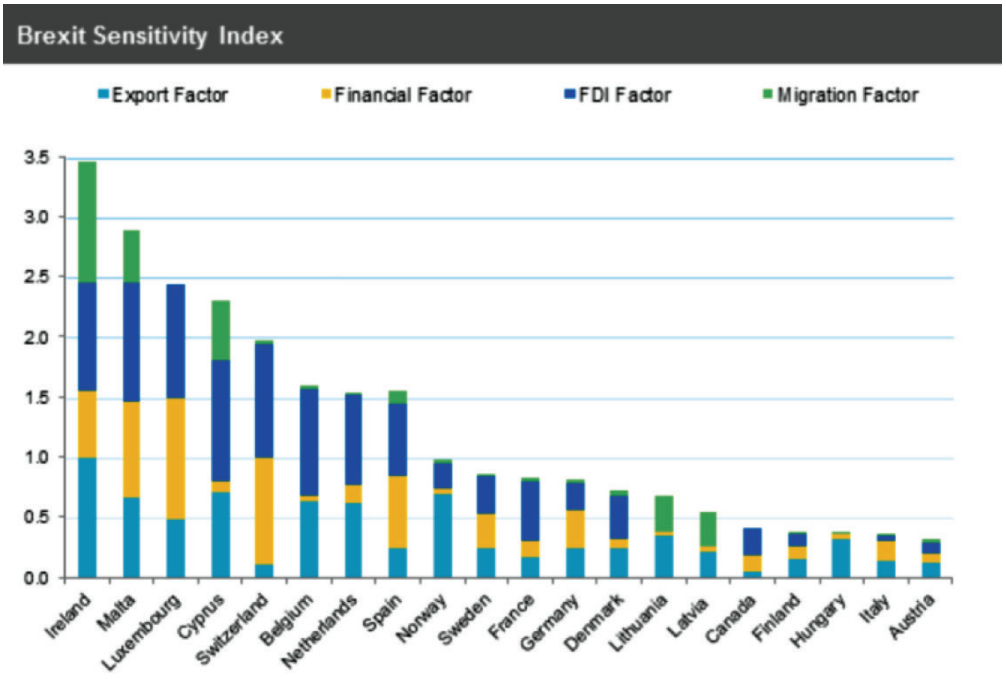


Chart 1 was based on a number of factors where the final score provided to each EU Country is the sum of four data points all normalized and converted into a scale from 0 to 1. Table 1 below summarises how Standard and Poor's allocated a score for each EU country.

[1] Source: Standard and Poor's Brexit Sensitivity Index based on data from U.K. Office of National Statistics, BIS, Eurostat, S&P Global Ratings, United Nations Department of Economic and Social Affairs (2015) – "Who Has The Most To Lose From Brexit? Introducing The Brexit Sensitivity Index"

Table 1

Brexit Sensitivity Index

	Exports to U.K. as a % of GDP	Export Factor	Financial Sector Claims on an ultimate risk basis including derivatives and guarantees (BIS data, % of GDP)	Financial Factor	Inward FDI/GDP (%)	FDI Factor	Bidirectional migration as a % of population	Migration Factor	BSI index (sum of all factors)
Ireland	10.6	1.0	40.3	0.5	5.8	0.9	17.2	1.0	3.5
Malta	7.1	0.7	58.0	0.8	6.3	1.0	7.5	0.4	2.9
Lux	5.3	0.5	73.3	1.0	6.0	0.9	0.0	0.0	2.4
Cyprus	7.5	0.7	8.1	0.1	6.3	1.0	8.5	0.5	2.3
Switz	1.3	0.1	65.1	0.9	6.0	0.9	0.4	0.0	2.0
Belgium	6.8	0.6	3.8	0.0	5.6	0.9	0.5	0.0	1.6
Netherlands	6.7	0.6	11.4	0.1	4.7	0.7	0.4	0.0	1.5
Spain	2.7	0.2	44.9	0.6	3.8	0.6	0.9	0.1	1.5
Norway	7.4	0.7	3.9	0.0	1.4	0.2	0.4	0.0	1.0
Sweden	2.7	0.2	21.9	0.3	1.9	0.3	0.2	0.0	0.9
France	2.0	0.2	10.6	0.1	3.1	0.5	0.5	0.0	0.8
Germany	2.8	0.2	22.7	0.3	1.5	0.2	0.5	0.0	0.8
Denmark	2.7	0.2	6.2	0.1	2.3	0.4	0.8	0.0	0.7
Lithuania	3.9	0.4	2.8	0.0	0.0	0.0	5.1	0.3	0.7
Latvia	2.5	0.2	3.9	0.0	0.0	0.0	4.9	0.3	0.5
Canada	0.8	0.0	10.5	0.1	1.4	0.2	0.0	0.0	0.4
Finland	1.8	0.2	8.5	0.1	0.7	0.1	0.3	0.0	0.4
Hungary	3.5	0.3	4.0	0.0	0.0	0.0	0.2	0.0	0.4
Italy	1.6	0.1	13.2	0.2	0.2	0.0	0.4	0.0	0.4
Austria	1.5	0.1	5.9	0.1	0.6	0.1	0.4	0.0	0.3
MEDIAN	2.8	0.2	10.6	0.1	0.0	0.3	0.5	0.0	0.8

Source: Standard and Poor's Financial Services

A far greater concern for European leaders will be the political impact of the UK's decision. Brexit could create an extended period of uncertainty that damages confidence and the appetite for both domestic and inward investment in the rest of the EU, but perhaps the biggest risk is political contagion from the 'proof of concept' of leaving the EU, with Brexit encouraging disintegrative political forces elsewhere in Europe.

Impact on Cyprus

As illustrated by Chart 1, Cyprus is expected to be one of the EU countries affected the most by Brexit as a result of its close links with the UK. In addition to the possible restriction in free movement of people, Brexit may bring forth wider economic implications for Cyprus:

- The UK is Cyprus' second biggest trading recipient, receiving around 7% of Cypriot exports (circa 1.3bn Euro). The vast majority of Cypriot exports is in services (approx. 20% of the total amount). Further devaluation of sterling, could possibly make such exports less economical
- UK-based banks have borrowed in total the equivalent of over 40% of Cypriot GDP and lent to entities in Cyprus an amount equal to more than 30% of GDP
- Cyprus' economy is significantly dependent on tourism. Devaluation of sterling will further increase travel costs for British tourists. As a result, a decrease in tourism would directly lead to lower revenues and higher unemployment as a long-term effect on the Cypriot tourism industry.

[2] Source: Global Counsel: "BREXIT : the impact on the UK and EU" based on data from Bank of England, IMF WEO, Global Counsel calculations

Not all is lost however. Opportunities may also arise for Cyprus as many UK based Banks and other financial institutions seek to implement their Brexit contingency plans, including seeking to transfer their business or headquarters out of the UK or establish EU subsidiaries which would allow them to continue to use "passporting schemes". Cyprus due to its historical ties with UK could be very well positioned to take advantage of the situation.

Considerations for Cyprus Banks and other financial institutions

One of the most important concerns of Brexit relates to the terms on which Banks and other financial institutions based in the UK will have access to the EU Single Market as well as the reciprocal arrangements (i.e. the ability of firms based elsewhere in the EU to access the UK's markets).

This is important for the strategic direction of firms which currently make the UK their base to provide services to the rest of the EU, either on a cross-border services basis or through the freedom to establish a branch, or even using the passporting regime.

Such firms may either have to establish a new subsidiary in the rest of the EU or transfer business to an existing one there if they wish to have the same rights of access in future. In a similar vein, EU based Banks and financial institutions, such as the ones operating from Cyprus may also need to revisit and amend their trading models and/or the activities which they carry out with UK firms as regimes such as the "passporting scheme" may no longer be available.

Given the uncertainty that currently exists in the markets and is expected to continue for the foreseeable future, we set out below a number of considerations Banks and other financial institutions could consider in order to better prepare themselves for the challenges ahead:

1. **Be ready to respond at very short notice to information requests from supervisors** about the impact of market volatility on balance sheets and customers/counterparties. Although many of the Banks and Financial institutions based in Cyprus have limited direct exposure to the UK, given the speed and size of market reaction, supervisors may be particularly demanding in terms of the frequency and extent of reporting expected of firms. Sudden and significant shifts in market prices and rates will have widespread impacts including on solvency and capital calculations, margin calls and on investor and customer confidence. In addition, the challenge of managing these impacts in the days and weeks to come will put people, processes and systems under significant strain so planning ahead will minimise such strain.

2. **Broaden and deepen scenario analysis and contingency planning.** UK's exit from the EU will transform a financial services firm's relationship with that customer from "within border" to "cross border". This in turn makes the future relationship dependent on the terms on which the UK exits the EU in a way that is not the case today. Banks and Financial institutions should undertake a review of their customer base and that their scenario analysis and contingency planning remain dynamic and that they also keep close to any customers whose circumstances may change as a result of Brexit. Another example which highlights the importance of dynamic scenario analysis is the secondary and tertiary impacts of rating downgrades or falling growth forecasts and asset prices on regulatory capital resources and requirements.

3. **Consider how future strategies might be affected, positively or negatively, by the terms of the UK's exit from the EU.** There may be strategic opportunities for local Banks and Financial institutions for acquisition of businesses or market share as competitors reposition themselves from the UK to Europe. But there may also be threats, e.g. to digital strategies that are intended to take advantage of the EU's Digital Single Market, if the UK does not secure ready access to it.

4. **Begin to work through detailed plans and timelines for any relocation strategies that may need to be invoked.** For Banks and other Financial institutions operating in Cyprus via branches and using the UK as a hub, a Brexit may require establishing a new regulated subsidiary in Cyprus. This needs to take some account of the likelihood that other financial services firms will be considering similar strategies, which could then result in a surge in new applications, putting even a normally responsive regulator's resources and response times under significant strain. And even if a new authorisation is not required, because a local subsidiary already exists, timelines remain important. New IT infrastructure, new regulatory permissions, new internal model approvals and new Board and senior management appointments may all be needed, none of which tend to happen quickly. Although the work required here is detailed, in many cases it will be necessary to enable Boards and senior managements to understand when they might have to activate contingency options to be ready on time.

Contacts

If you would like to discuss risk assessment and mitigation strategies for your firm in light of the Brexit vote, contact Alexis Agathocleous, our FSI Leader and Clea Evagorou our Strategy Consulting expert, whose team could help you plan a response.

Alexis Agathocleous
Financial Services Leader
Email: alagathocleous@deloitte.com
Direct line: +357 25 868710

Clea Evagorou
Senior Manager | Strategy Consulting
Email: clevagorou@deloitte.com
Direct line: +357 22 360600

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Offices: Nicosia, Limassol, Larnaca.