LEADING TREASURY PROFESSIONALS

GIVING DIRECTION

BRIEFING NOTE:

Brexit 2016

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The Association of Corporate Treasurers

The Association of Corporate Treasurers (ACT) sets the benchmark for international treasury excellence. As the Chartered body for treasury, we lead the profession through our internationally recognised suite of treasury qualifications, by defining standards and championing continuing professional development. We are the authentic voice of the treasury profession representing the interests of the real economy and educating, supporting and leading the treasurers of today and tomorrow.

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Table of Contents

Executive Summary

The UK hosts domestic business, multi nationals with worldwide interests, branches and subsidiaries of multi nationals. They import and export goods and services, and these organisations are staffed by UK, other EU, and non-EU employees.

On June 23 2016, a referendum will be held in the United Kingdom (UK) to decide whether the UK will leave or remain in the European Union (EU).

A vote for the UK to remain in the EU will require changes already agreed by the EU's Council of Ministers (the Council) in February 2016 to be implemented. A vote to exit will require that the UK redefines its legal and trading relationships with the EU.

There is a huge degree of uncertainty, both about the outcome of the vote, and the consequences of the decision on both the UK and the EU. Indeed, a vote to remain could end up looking like something similar to the leave vote.

We cannot assume elegant politico/economic arguments will mean anything to many UK voters whose exposure to the rest of the EU is limited to rules about bendy bananas, sports competitions and holidays. Nor can we know the impact of either result on the remainder of the EU where, in some locations, separatist movements are already gaining ground.

Irrespective of the UK's decision there will likely be a two-speed Europe going forward. The EU have committed to further drift of the 19 Eurozone countries from the rest of the EU and in particular ever closer Banking Union amongst the Eurozone member states.

To paraphrase Mr Rumsfeld: we can't know an unknown; and as at least one journalist has already noted, we know so little that the hustings may go quiet after a month because both sides will have run out of anything to say.

The intention of this Briefing Note is to identify those areas where corporate treasurers may wish to start asking questions of their businesses and scenario planning the possible outcomes.

The impact of the referendum will not be the same for any two businesses. More than ever, treasurers need to thoroughly understand and know their business, and to increase communication with the business units to understand how their behaviour may need to change to meet the outcome of the referendum.

This Briefing Note follows on from Blogs already published on www.treasurers.org (https://blogs.treasurers.org/?p=313877 and https://blogs.treasurers.org/?p=313980).

Background

As a quick summary:

- the EU remains by far the UK's biggest trading partner, accounting for 45 per cent of UK goods exported and 53 per cent of imports[1]

- in 2014 the UK imported 27% of its food from the EU; while it exported £18.8bn of foodstuffs[2]

- the UK energy Net Import Dependency in 2014 was 46.2%, that is we imported 46.2% of our energy when converted to "thousand tons of oil equivalent"[3]

- we import 85% of coal used in the UK in 2014[4], which was sufficient to meet all coal used in electricity generation; but little of this energy originates in the EU[5]

- the UK runs net internal and external deficits. Its government debt at "the end of January 2016 was £1,581.6 billion, equivalent to 82.8% of Gross Domestic Product; an increase of £52.7 billion compared with January 2015."[6] Approximately a quarter of this is funded by foreign lenders.

Staying In does not mean "No Change"

The UK Prime Minister's decision to call the referendum was made after agreeing certain changes governing the UK's relationship with the EU. These changes were established at the meeting on 19 February 2016 of the Heads of State of the EU's 28 Member States.

Although the press has tended to concentrate on changes to social welfare rights obtained by Mr Cameron, the changes which affect financial markets are critical for treasurers and, in essence, recognise the ring-fencing of non-Euro states from Euro states going forward and the creation of a two tier EU.

For example: Banking Union and resolution of banking issues only applies to Eurozone states thereby recognising that the European Central Banks's (ECB) remit is limited to Eurozone members. Similarly further economic and monetary union can progress within the Eurozone but must respect the rights of non-Eurozone member states to opt out.

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1 Data for 2014 http://researchbriefings.files.parliament.uk/documents/SN06091/SN06091.pdf

2 DEFRA Food Statistics Pocketbook 2015

3 Dept. of Energy and Climate change: Digest of United Kingdom Energy Statistics 2015, Table 1B

4 Dept. of Energy and Climate change: Digest of United Kingdom Energy Statistics 2015, Table 2.1

5 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/462360/Coal_2014.pdf chart 2

6 http://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/january2016

Essentially, irrespective of the outcome of the UK referendum, the EU will become fragmented, comprising a Eurozone bloc and some other non-Eurozone countries.

But Leaving Does Not Mean Regulatory Freedom

'Leave' campaigners frequently make reference to the wish to be free from Brussels originated regulation. However, it should be noted that with regard to financial regulation:

- The basic terms of CRD, BRRD, EMIR, and MiFID arise from the Pittsburgh commitments by the G20, which as a matter of legal process have been implemented through the EU. As the UK is a member of G20 and is not voting on 23 June on whether to remain in the G20, these regulations will still apply in the UK.
- 'Equivalence': a crucial word[7]. The UK financial community is able to operate across the world's major financial centres, including those of the rest of the EU, because the UK's financial regulation is similar in substance and enforcement to that of other global financial centres. Changing substantially from the current form would lose the UK's equivalence status and those markets would be closed to the UK. Losing equivalence would lose a substantial export market (and potentially the very people who populate much of the City of London as they decamp to other financial centres).

The Vote itself Creates Volatility

The immediate concern for corporate treasurers is the volatility arising in financial markets by the decision to call a referendum.

This volatility makes it more important for businesses to manage their financial exposures to protect profit margins. However, the uncertainty of the result makes it even more problematic to hedge transactions which span the referendum.

The volatility may continue post June, as change to the EU/UK relationship will take place irrespective of the result of the referendum.

[7] http://www.bloomberg.com/news/articles/2016-03-08/carney-follows-bankers-in-warning-brexit-to-cost-finance-jobs

What Does Leaving Mean?

A useful approach when considering what form the UK relationship with the remainder of the EU might take in the event of a 'Leave' decision is to consider the range of arrangements already in place by which non-EU members trade with the EU[8], although, clearly, the UK could negotiate its own agreement and not follow any of these models.

- **The Norway Model: European Free Trade Association (EFTA) with European Economic Area (EEA) membership:**

  - As a member of the EEA, Norway has access to the single market and follows EU legislation in areas such as the free movement of goods, services, people and money.
  - It is not bound by EU laws governing things like agriculture and fisheries or monetary union, but it does have to make a financial contribution to the EU budget and is liable to tariffs on exports of a number of agricultural products to the EU.
  - An independent study commissioned by the Norwegian government has calculated that Norway has had to incorporate approximately 75 per cent of EU laws into domestic legislation in return for access for access to the EU market, but with no vote or veto on the creation of those rules.

- **The Switzerland Model: EFTA membership:**

  - Access to the single market is governed by a series of bi–lateral agreements, which cover some but not all areas of trade. For example, Switzerland has agreements in place for goods but not services
  - It makes a financial contribution to the EU although it has no vote or veto over the creation of EU rules
  - This is model is coming under pressure as Switzerland voted to limit immigration from the EU and does not automatically update its own rules to match those of the EU.

- **The World Trade Organisation (WTO) Model: Free Trade Agreement.**

  - The WTO sets out rules for international trade that apply to all members, so this is what the UK would adopt, after a period of transition, if no bi-lateral agreements were made following an EU exit.
  - It would mean that the UK would not have to accept free movement or contribute to the EU budget, but goods exported to EU countries would have to meet EU standards.
  - WTO trade arrangements mean that the UK would have to apply have a single, universal set of tariff rates, covering imports from the EU and the rest of the world alike. Under WTO rules, the UK would not be allowed to treat any of the WTO's 161 other members differently, unless there was a trade agreement in place.

[8] https://www.gov.uk/government/publications/alternatives-to-membership-possible-models-for-the-united-kingdom-outside-the-european-union

An Exit Will Lead to a Debate about Trade

The UK business world has long been the home of multi-national organisations. The London Stock Exchange's liquidity, and the UK's open and stable regulation has made the UK a natural home for big business. Ease of access to the broader EU real economy and financial markets has made the UK a point of entry to the EU[9].

The longer term uncertainty of leaving is that the continuing trade relationships with the remainder of the EU would have to be renegotiated. The freedom with which UK based businesses import from, and sell to, other EU Member States, and that their staff have to move across EU borders, cannot be assumed to continue. For example, business based in the UK needs to begin to consider how to operate in a world where similar customs duties and business visas are required to trade with and work in Germany as are required in the USA.

In the event of a UK vote to leave the EU, each Member State would wish to maximise its position. For example, M. Macron (France) has already proposed that financial services could move from London to Paris.

How long will a renegotiation take?

The short answer is 'Nobody Knows'. The Treaty of the European Union[10], Article 50 is the much quoted source of the two years to renegotiate but:

a) that period can be extended by mutual agreement; and
b) any renegotiation requires a "qualified majority" of Member states.

[9] Nissan, Honda, and Toyota have the benefits of leveraging off their Japanese reputation for reliability and their UK manufacturing bases to sell on to other EU member states.
[10] http://www.lisbon-treaty.org/wcm/the-lisbon-treaty/treaty-on-European-union-and-comments/title-6-final-provisions/137-article-50.html

Considerations for Treasurers:

Unfortunately, given the high level of uncertainty about what the economic environment looks like post referendum (irrespective of the outcome), there are few straightforward answers but the following areas need to be considered whether a business is headquartered in the UK, has subsidiaries there or even 'just' does business with the UK.

Also, treasurers should consider the impact of 'remain' and 'leave' on all areas.

The following topics for consideration have been extracted from the 'Treasury's role in driving Financial and Business Strategy' Business Briefing as being most applicable when considering the possible impact of the forthcoming referendum.

Governance

1. Treasury Roles and Objectives
   The outcome of the referendum is unlikely to change your Roles and Objectives… unless your business strategy is altered.

2. Treasury Policy
   But it may require changes to your Treasury Policies if:
   - your business requires some re-engineering to meet a post Brexit world
   - access to certain types of financial markets and products is altered post referendum.

3. Qualified Personnel: Will your employees remain qualified?
   Free movement of labour across the EU exists and is based upon a concept of "equivalence". For example EU nationals can currently work within the UK National Health Service without being subject to re-qualification, and vice versa. Whilst the fundamental skills of your team will remain unchanged, in certain regulated businesses, such as banking for example, formalised qualification is required.

   Post referendum:
   - Will this 'equivalence' remain?
   - As a more general point, will EU employees require visas?

Corporate Funding

4. Corporate Structure: Where are your legal entities domiciled and why?
   In a post referendum world, corporate structure may be impacted both at a business wide level and also at a treasury structure level and both may impact the activities of the treasury.

   - Will there be additional costs of doing business as a result of the introduction of new or additional duties on cross border trade?
   - Will legal permits be introduced in order to trade in some jurisdictions?
   - Will new trading companies have to be established?
     - New banking arrangements will be required and KYC requirements met.

5. Funding: Will sources of finance alter?
More distance between Eurozone regulation and that of the UK, whether in the EU or out, may further the trend amongst banks towards domestication of their business with the UK and GBP being seen as external, more exposed, riskier, and therefore attracting higher weighting in credit pricing for Eurozone banks.

- Will your current bank relationships remain appropriate?
  - UK businesses may find their choice of banks alters or shrinks. For example, non- Eurozone banks may find it impracticable to operate within the Eurozone as banking union develops.
- Are you a UK business which borrows from the European Investment Bank (EIB)?
  - There is no clarity yet as to what happens in this case. However, the UK contributes equity to capitalise the EIB which like any bank borrows, generally in the bond markets, to raise the remainder of the capital to fund its loans. Therefore, this should enable the UK investment and loans to be disaggregated if necessary but this is not certain.
- Does your organisation access other EU Governmental loans and grants?
  - Grants may have continuing qualification obligations and you should understand what they are to then understand what the impact if exit is negotiated. Discussion at present concentrates on the loss of grants, but has yet to consider what the UK may choose to do with its saving from contributing to the EU grants process[11].
- Will pricing be impacted as a result of the referendum?
  - Possibly not. The pricing of capital markets, in the form of traded bonds and derivatives is already being adversely affected by MiFID, EMIR, and CRD which the UK would anyway need to observe or re-legislate into UK law to maintain equivalence should it leave the EU.

6. Own Credit Risk: Will this affect pricing?
One of the possible consequences of the referendum will be the review of the sovereign credit rating of the UK. UK companies will need to monitor the effect on their own credit rating of any changes to the UK's credit rating. While few corporates today match the UK's AAA/AA1 rating, it is rare for any corporate to better its nation's own rating.

Cash Management and Liquidity

7. Cash management: How will this change?
Irrespective of the outcome of the referendum in June, cash pooling arrangements should be under review as negative rates drive central banks to stop current accounts being used to park cash, and CRD IV may lead to increased credit costs. Differences in the form of banking

[11] http://www.ft.com/cms/s/0/b023067e-e05d-11e5-9217-6ae3733a2cd1.html#axzz41qhSFA5A

separation within and outside the EU, and further Eurozone banking union may further complicate pooling of funds across entities and banks.

- Will cash management arrangements need to change?
    - Treasurers will need to ensure their relationship managers are aware that they need to be informed promptly of on any planned changes to cash management systems and processes. As precedent, after 2008 some banks were required to withdraw from certain markets and only six weeks' notice was given to some customers to set up new banking arrangements.

- Will your Shared Service Centres (located regionally, e.g. in the Netherlands or Central Europe), still be optimal?
    - They may no longer be as efficient at handling UK business. Irrespective of the outcome of the referendum, this could be an issue if Eurozone financial regulation develops separately from UK regulation.

8. Counterparty Risk:

Many corporates use credit ratings as a means of selecting counterparties from their pool of relationship banks and applying exposure limits to them as part of their investment policy.

- Will your banks continue to meet your investment criteria?
    - The timing of the Brexit referendum and the implementation of bank 'ring-fencing' solutions (Vickers, Volker, Liikanen) are broadly concurrent and we would expect this to create further confusion. Post bank restructuring, your business may be transacted by a bank's different legal entity, or entities, to that currently acting for you, and the rating agencies may apply ratings to these new entities which are outside of your current Treasury Policy.

Treasurers will need to ensure their relationship managers appreciate the need for early advice if any bank is withdrawing from a particular line of business or seek to have it transferred to a different entity in its group.

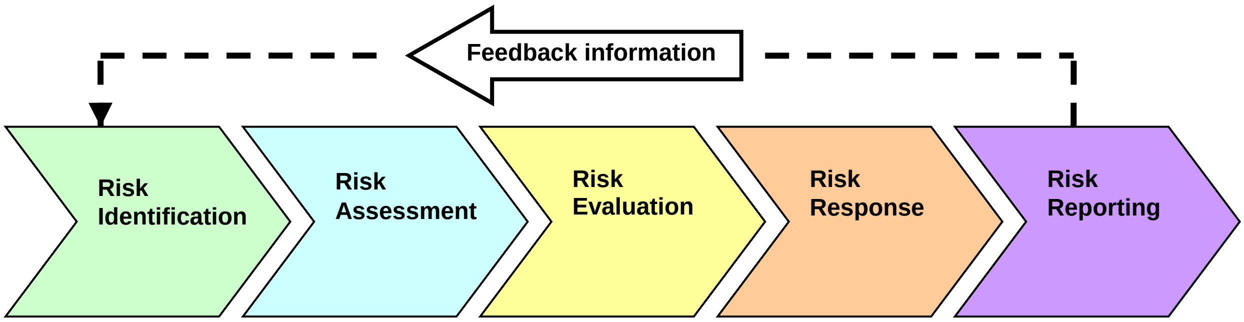
9. Working Capital Management: Will the working capital cycle be extended?
    - How will working capital be impacted?
        - Working capital may be affected by any of the issues above but, in particular, the trade concerns could lead to imposition of duties and border controls when goods and services move across border, so resulting in extending the working capital cycle.

Treasury should liaise with procurement teams to understand if contracts with non-domestic suppliers and customers are capable of amendment to accommodate these changes or could be terminated if these changes rendered them uneconomic.

Risk Management

10. Risk Management Framework
    - How will your organisation risk profile alter?
        - Brexit, the referendum, or the process if the UK leaves the EU, may change your risk profile if your businesses location(s) were specifically chosen to facilitate cross- border trade.

You should use the overall framework to identify, and be aware of potential risk points as the post –referendum world unfolds, and take risk management action as appropriate.



11. Risk Reporting: How will the referendum impact risk reporting?

With immediate effect, your risk reporting should begin to note any potential change to risk arising from the referendum. Initially this may be a list of risks with qualitative rather than quantitative impacts noted but post referendum, the risks most relevant to your specific organisation will become clearer and can be more closely monitored and addressed. Remember that a ‘Leave’ vote will result not only in UK/EU renegotiations but also may impact the remainder of the EU membership. In the event of a ‘Remain’ vote, there will be the risks associated with ever closer banking union to be monitored.

- How will the referendum impact reporting?
    - Consider frequency, level of detail and the circulation of risk reports - they should not be treasury specific.

12. Currency/Commodity Transaction Risk

As the currencies of trade remain the same whether the UK is in or out of the EU, the principal issue will be one of rate levels and volatility as we progress from the current market uncertainty through to potentially greater uncertainty, particularly if the vote is to leave and this will continue until new trade arrangements have been agreed.

It is impossible to say whether GBP will strengthen or weaken as a result of the vote, and treasurers should beware of speculation on the result. Volatility, as a technical measure in itself, has already increased and will impact on option pricing. The final outcome on trade negotiations for a Brexit could lead to a fundamental review of the value of GBP against world currencies, but again, it is impossible to say whether GBP would strengthen or weaken.

- How do you address the increased volatility in financial markets?
    - Treasurers may wish to consider how protective of profit margin they should be where costs and revenues are affected by foreign currency. Is the cost of increased hedging of forecast purchases and sales offset by removing the risk of increased volatility eroding margin?

Commodity pricing is generally USD sensitive but the referendum comes in the lead up to the US presidential election thereby potentially aggravating foreign exchange volatility.

13. Economic Foreign Exchange Risk:

It has been mentioned in the press that the UK had extensive global trading relationships prior to membership of the EU (revolving around the Commonwealth and also South America). In the event of a 'Leave' vote, it is not possible to predict who the UK's key trading partners may be: for example, Australia, Canada and New Zealand now have deep trade relationships with China. But post Brexit trade dynamics could be radically different from those today.

- Will the organisation change its strategic plan?
    - Drivers of economic risk encompass sources of materials, target markets and location of production. Treasurers will need to keep close to their business' strategic planning to understand how their funding, risk management and cash management strategies will need to change, and then to implement those changes in their Treasury Policies and activities.

14. Foreign Exchange Translation Risk:

- How will any changes in the organisation's strategic plan impact the balance sheet risk?
    - Treasurers tend to neutralise translation risk by seeking to match assets to liabilities in a given currency: the net investment hedge. This approach is adopted because translation exposure can affect credit ratios and cash flow measurements that may be relevant to debt covenants. The measures and ratios that can be affected by movements in exchange rates include:

- Net worth or enterprise value
- Gearing
- Net debt / EBITDA
- Interest cover
- Cash flow (and measures involving cash flow).

Treasurers will need to engage in discussion over changes which may be made to business models: for example, a decision to move production from the UK to a remaining EU member state, to change a source of raw material, to shift sales drives from EU to USA or elsewhere. Those changes then need to be tracked through to the balance sheet effect to identify changes in the translation exposure and their potential impact on financial ratios.

15. Interest Rate Risk
    - What will any change in interest rates mean to the organisation?
        - The referendum is taking place at the time when western style economies are conflicted by the realisation that they need eventually to raise interest rates and immediate concerns over deflation which have created short term negative rates.

To date central banks' priorities have been to avert deflation by encouraging holders of funds to spend and invest. What we do not know is the long term effect of low rates which discourage savers, inflate pension costs, and drive investment to "hotspots" such as the UK domestic property market where asset inflation does not assist the macro economic measures of consumer inflation.

The UK's membership of the EU does indeed make it a part of a greater whole with the scale of the USA and China. However, even in the event of a 'Remain' vote remaining in the EU leaves the UK out of the continued development of Eurozone Banking Union.

Treasury Operations and Control

16. Accounting, Tax and Regulation

Remittance and commercial systems may need review in the event of an 'out' vote as trade and financial negotiations proceed. However perhaps the best said is that the potential for change which the Brexit referendum brings highlights the need for treasurers to get their EMIR reporting validated, reconciled, and paired. For UK corporates this is not the time to be fending off an FCA compliance visit.

THE ACT WELCOMES COMMENTS ON THIS REPORT

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