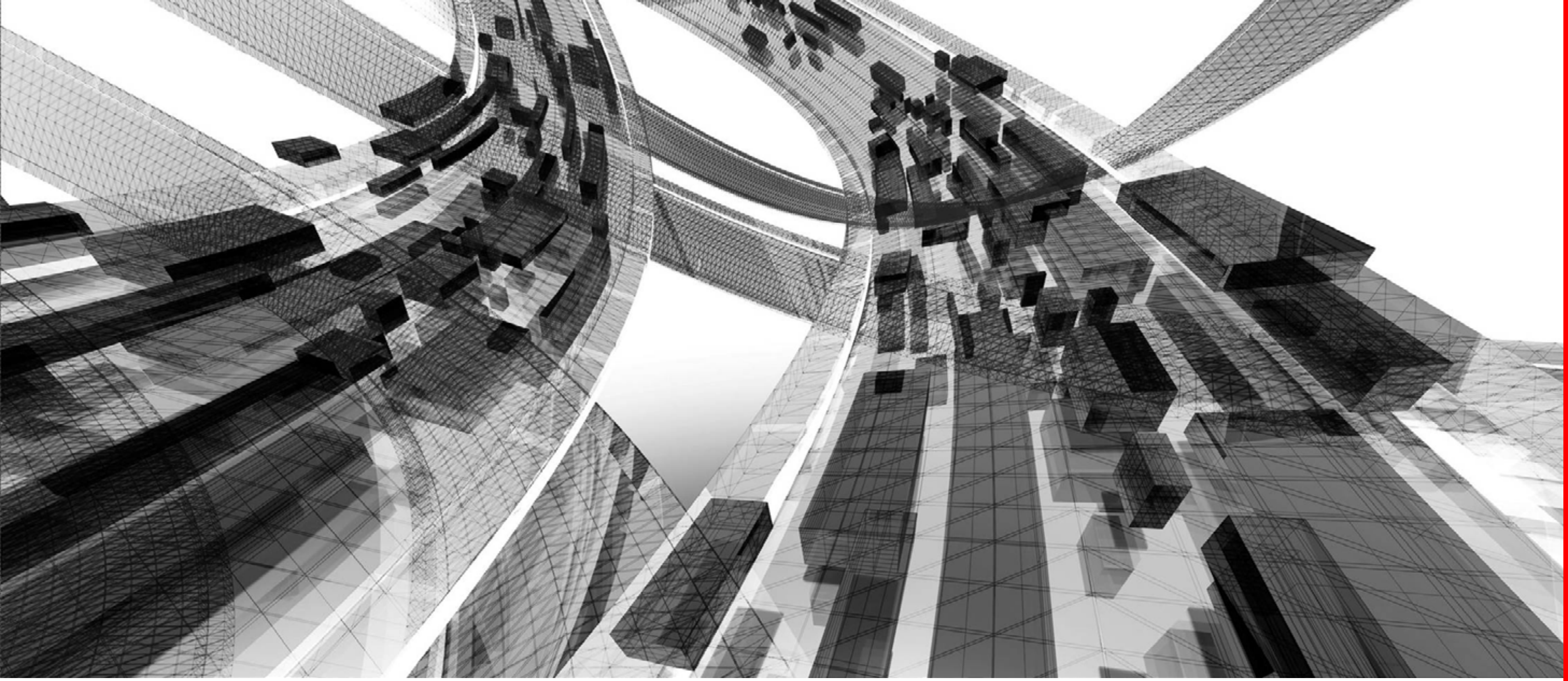

Further aspects from the UK referendum on EU membership

Franck Motte
June 2016

HSBC

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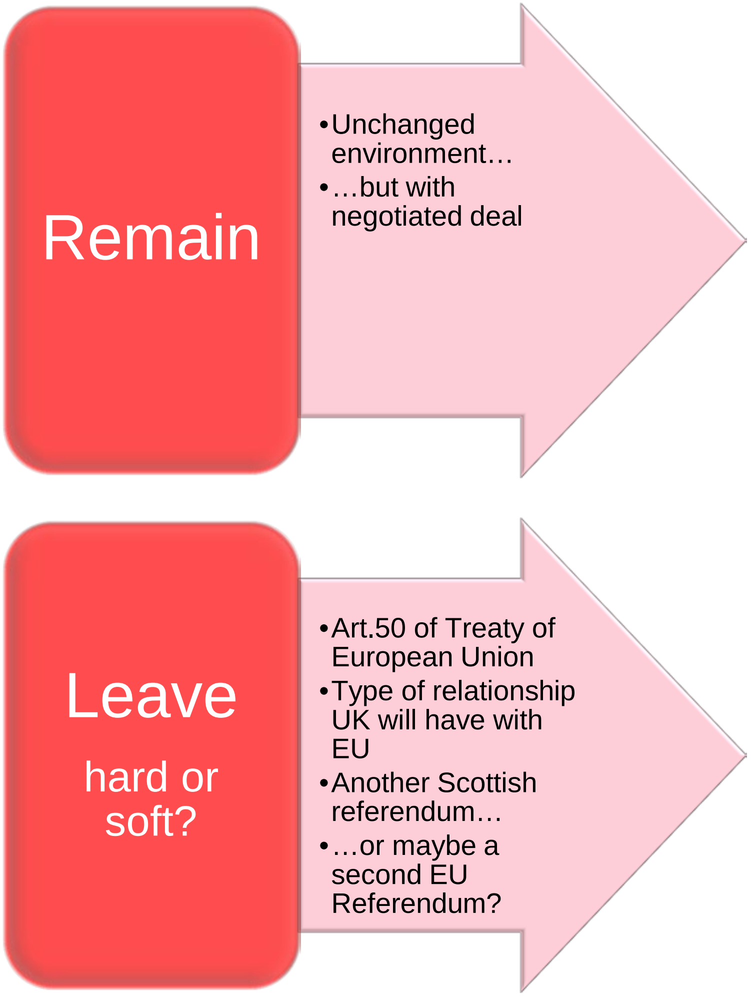
The UK's EU Referendum to be held on 23 June 2016

- **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)

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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[1] an article entitled '*The process for withdrawing from the European Union*'
  - Prime Minister David Cameron has suggested[2] 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

[1] See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/504216/The_process_for_withdrawing_from_the_EU_print_ready.pdf
[2] See Prime Minister's Statement on the European Council, Hansard, 22 February 2016, Column 24. (http://www.publications.parliament.uk/pa/cm201516/cmhansrd/cm160222/debtext/160222-0001.htm#16022210000001)

- **Another EU Referendum?**
  - In principal, the EU Referendum is not binding on government
  - There have been some suggestions[3] 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[4] 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?

[3] For example see The Telegraph (http://www.telegraph.co.uk/news/2016/05/17/leading-eurosceptics-raise-prospect-of-second-eu-referendum-as-p/)
[4] For example see The Guardian (http://www.theguardian.com/politics/2016/may/26/alex-salmond-scottish-independence-vote-likely-brexit)

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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[5] 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
- **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

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

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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