EY DKM

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Brexit watch

Monthly briefing on Brexit developments

In this issue

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The publication of the Withdrawal Agreement brought with it a degree of clarity and a further wave of instability. We are now clearer as to which road the UK can, or may, take in relation to Brexit. There are now three possibilities for the UK: accept the deal, extend the deadline beyond March or exit without a deal. A fresh round of resignations from the Conservative Party followed the publication of the draft Agreement and it is now looking likely the Agreement will not be voted through Parliament. The vote is reported to be on 11 December, following a five day long debate in the House of Commons.

Like all things Brexit, the announcement was welcomed by some, mainly businesses, and not by others. The Agreement finally provides businesses with a degree of clarity, particularly with regard to the transition period. The commitment to work towards a Free Trade Agreement in the longer term was also welcome, though the focus has inevitably been on the controversial 'backstop' which both sides hope would never be required.

However, the final hurdle, and arguably the most difficult, is getting the Agreement passed by the UK Parliament. If the Agreement fails to pass, then the UK is not left with many options, a point which has been reiterated by both Irish and European politicians. The Conservative Party's confidence and supply partners, the DUP, have already outlined they will vote against the agreement. Theresa May is now left with the important task of selling the deal to her colleagues which will see the British Prime Minister travel the UK in order to garner support.

This month's issue of Brexit Watch includes an interview with Cormac Kelly, the international banking advisory lead for EY Financial Services. Cormac discusses the attractiveness of Ireland for international banking firms as well as next steps for the industry in relation to Brexit.

1 Political Developments

Europe

The best Britain will get

Jean-Claude Juncker told reporters that '*Those who think that, by rejecting the deal, they would get a better deal, will be disappointed*'.

United Kingdom

Draft Withdrawal Agreement published

November saw the release of the draft Withdrawal Agreement between the UK and EU. While the release of the Agreement heralded some long-awaited progress, the document itself was not met with universal approval. The almost 600 page document contained a number of divisive topics from finance to governance. The draft Agreement also addressed the Irish border issue, which has been a prominent hurdle since the inception of Brexit negotiations. The content of the document encouraged a number of resignations, including Dominic Raab who has been leading Brexit negotiations with the EU, though early indications that there would be a vote of no confidence in the UK Prime Minster proved wide of the mark.

The draft Withdrawal Agreement outlines that Northern Ireland (NI) would be closely aligned with the Single European Market thus preventing the need for a hard border on the Island of Ireland (IOI). These backstop arrangements could remain in place until an alternative that prevents a hard border is found. The bureaucratic requirements necessitated by these intertwining customs networks remain unclear.

This backstop approach has prompted a number of responses from the Democratic Unionist Party (DUP) in NI. This week Arlene Foster outlined that if the British Prime Minister wanted the DUP's continued support, it would mean removing the backstop from the Withdrawal Agreement. Constitutional concerns remain paramount for the DUP and they maintain any deviation from the rest of the UK is a red line issue for them.

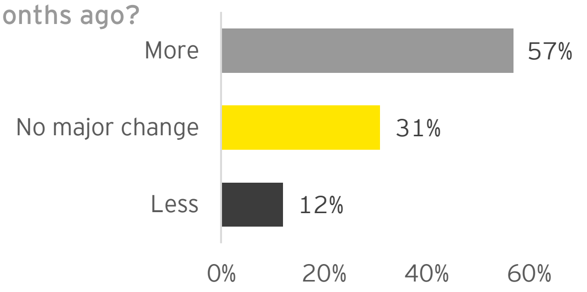
Businesses support deal

Business leaders in the UK realise that it is the current deal or a cliff edge Brexit. Executives from the City of London have urged members of Parliament to accept the deal, otherwise a resulting no-deal would harm the UK economy further.

The political uncertainty which surrounds every step of the Brexit process has not gone unnoticed by businesses.

Despite the progress made in terms of negotiations and of publishing a draft Agreement, only 12% of respondents in our EY webcast held last week felt less nervous about Brexit than they did 6 months ago, when no deal was on the table.

Fig. 1: Are you more or less nervous about Brexit and the impact on your business compared to 6 months ago?



Next steps

As of this week, the draft Agreement has been formally accepted by the heads of the 27 countries of the EU and the UK Prime Minister. The next steps for the Withdrawal Agreement will be put before parliament for a vote, due to take place on 11 December.

If the deal is voted down by parliament, the UK could ask the EU for an extension of the deadline. The existing deadline (29 March) could be pushed out with approval from all 27 member countries. The alternative to an extension is the UK leaving the EU with no deal.

Ireland (NI & ROI)

No plan B

Leo Varadkar has outlined that the draft Agreement is the only agreement on the table, the alternative being a no-deal. This point was reiterated by Simon Coveney. The EU27 has made a conscious decision not to discuss the possibility that the draft Agreement may get voted down in the House of Commons, although this remains a strong possibility.

Mr Coveney outlined that the current deal on the table does not undermine the integrity of NI and the UK, but instead offers the best of both worlds for NI.

Draft Agreement worse than no-deal

In the wake of the publication of the draft Withdrawal Agreement, deputy leader of the DUP, Nigel Dodds, said the current deal on the table is worse than no-deal. These comments appear to be out of touch with businesses in NI, which appear to be cautiously optimistic in relation to the draft Agreement. Angela McGowan, Director of the Confederation of British Industry (CBI) in Ireland outlined that the CBI was broadly supportive of the deal.

2 Economic Developments

Brexit currency fluctuations

As discussed in previous issues of Brexit Watch, the implications of the UK's exit from the EU are diverse and far reaching. The majority of these implications may not be fully realised until the UK leaves the EU in March 2019.

Currency, on the other hand, is affected by each new Brexit story, with markets reacting swiftly to the words and agreements between politicians. Some experts agree that if the UK exits with no deal then Sterling will suffer. Countries with a high level of openness and international trade are particularly at the mercy of currency shifts. Brexit brings with it uncertainty and instability which is reflected in currency markets.

Fig 2: Euro to GBP 2015 - 2018

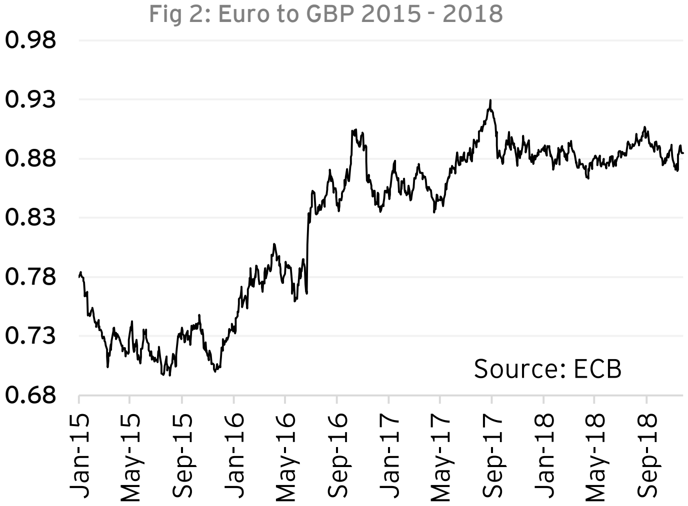
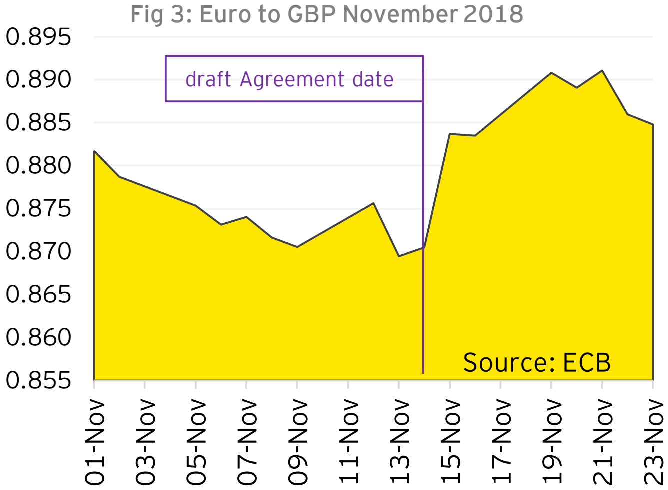


Figure 2 outlines the trend of Euro to GBP currency fluctuations from 2015 to 2018 year-to-date. The result of the Brexit vote in June 2016 is clear. Since the Brexit referendum result, Sterling has failed to return to its pre-Brexit level against the Euro. It remains unclear how directly consumers perceive the Brexit process to be affecting them with the complexities of imported inflation and other economic adjustments often poorly understood. However, it has become more expensive for businesses in the UK importing from Ireland and the EU since the referendum. A high volume of imports for a country creates more exposure to currency fluctuations. This has had the effect of making UK goods cheaper for ROI, boosting consumer spending, but increasing the costs of Irish exports to the UK, negatively impacting the value of exports.

Increased costs may in turn be passed down to retailers and consumers. If the price increases by enough, it may influence the demand for that product. ROI has a high level of trade with the UK and increasing costs of exporting to the UK may encourage UK importers to look elsewhere.

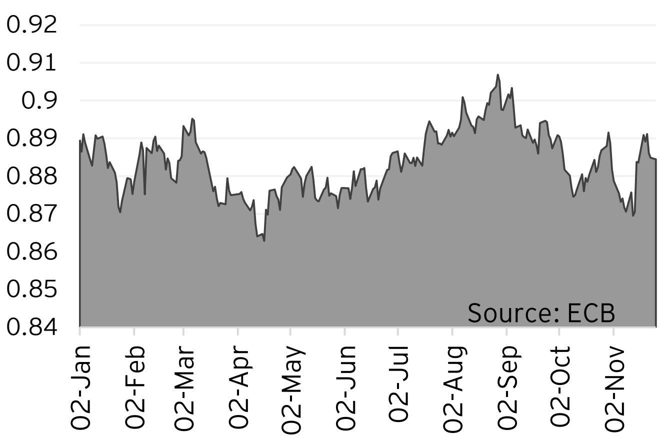
A similar pattern has been observed with the publication of the draft Withdrawal Agreement in November. Purchasing power of the Euro increased. While this would stimulate demand for goods from the UK, it may decrease demand for goods from the EU to the UK.

Fig 3: Euro to GBP November 2018



In the wake of the draft Agreement, the pound fell by 1.8% against the Euro and by 1.9% against the dollar in the 24 hours following its publication. In the subsequent week, the pound fell further against the Euro, down 2.5%, but steadied against the dollar. However, the level of volatility is not uncommon and therefore should not be overstated, though it perhaps gives an indication of what may lie in store if a no-deal exit becomes more likely after 11th Dec.

Fig 4: Euro to GBP 2018 year-to-date



3 Business Developments

Businesses cautiously welcome the draft Withdrawal Agreement

Business groups across the island have welcomed the draft Agreement for providing some long overdue clarity to firms.

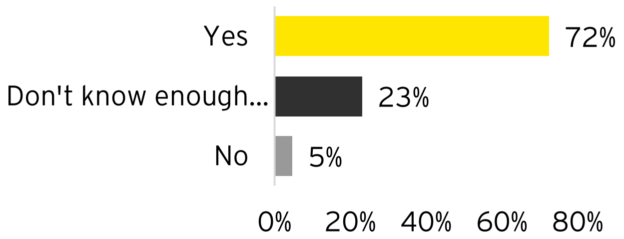
Given the disproportionately high representation of agri-food in NI exports to the Republic, (It has been projected that NI dairy exports to ROI would reduce by 65% in a WTO (no deal) scenario) it is unsurprising that the Ulster Farmer's Union has voiced its support. According to Ivor Ferguson of the Ulster Farmer's Union their support is rooted in its assurance of free trade with the EU, as well as alleviating the concern of a no-deal by offering the backstop insurance. Echoing this was Seamus Leheny of the Freight Transport Association, who says that this ensures frictionless movement of goods across the Irish border.

In-house EY insight

Michael Hall, EY's Head of Markets on the island, has welcomed the degree of certainty afforded by the draft Agreement, but has also stated that the accompanying political dispute means that firms will not stall contingency plans yet. He has called the backstop a positive development for NI firms operating on an all-island basis, but pointed out that businesses can only be assured of this safety net if the Agreement is passed in Parliament.

In our webcast held on 20 November, attendees were asked for their preliminary opinion of the draft Withdrawal Agreement. The majority consensus was that the Agreement was a good foundation upon which to execute Brexit, with 72% endorsing this. Around a quarter of respondents had not yet formed an opinion which, given the dense 585-page document, is unsurprising. Strikingly, only 5% actively opposed the Agreement. However, echoing Michael Hall's comments, businesses are still not confident enough to halt contingency planning (see figure 7).

Fig 5: Thinking about the impact on your business, do you think that the draft Withdrawal Agreement is a good basis to structure the UK exit?



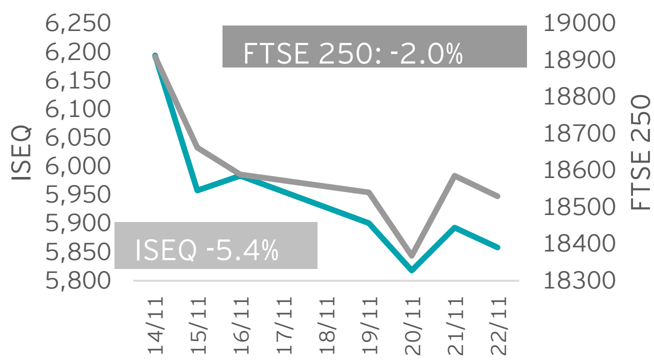
Source: EY Brexit Webcast

Immediate effects

Volatility has been the most marked impact of recent political developments. As events and corresponding public sentiment take a turn for the better or worse, significant shifts materialise in stocks and shares to reflect this. Financial services, travel and tourism and airline sectors were among the most vulnerable following the publication of the Agreement. RBS shares fell by 9% on 14 November, Thomas Cook fell by 4.5% and Easyjet and Ryanair neared a 7% fall. Sustained volatility marred the following week also. Fig 6 shows the effect on financial markets between 14 to 22 November. The Irish stock exchange (ISEQ) was particularly affected, given its close economic ties with the UK. The multinational-focused FTSE 100 was less affected than the FTSE 250, with the former collecting around three quarters of its revenue from outside the UK. The fall in Sterling will also have provided a boost to the FTSE 100.

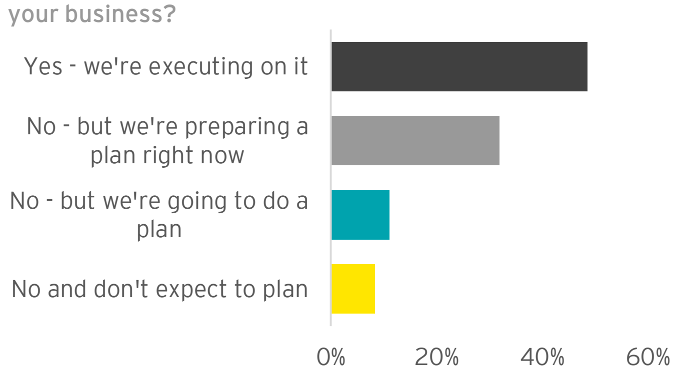
The key message is that we are currently operating in a very sensitive market, with sharp downward or upward shifts to be expected until such times as the tumultuous political environment stabilises.

Fig 6: ISEQ and FTSE 250 movements, 14 – 22 November 2018, adjusted daily close values



Source: Yahoo finance

Fig 7: Do you have a plan to mitigate any Brexit impact to your business?



Source: EY Brexit Webcast

4 Spotlight on: EY Financial Services

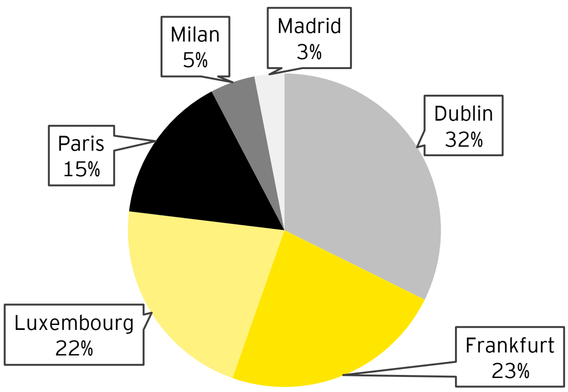
Cormac Kelly
Cormac is international banking advisory lead at EY Financial Services (FS). His focus is on transformation in the banking and capital markets and wealth and asset management sectors. He is also the Brexit leader for EY FS.

EY's Brexit tracker shows Dublin as one of the most popular relocation choices for financial services firms. Why do you think that is?

Apart from being the only remaining English-speaking member state in the EU, what we are hearing is that for a lot of firms, the decision to choose Ireland was made for three main reasons.

Fundamentally, Ireland is an attractive place to do business: we are established, familiar and relatively efficient for inward investment and for founding entities and new businesses. Secondly, a lot of the banks made the decision to go where they already had a presence, and they were able to use and leverage their existing presence here into what is needed post-Brexit. Thirdly, we have a very focused, robust regulatory environment and, while that might pose initial application challenges, that very reputation was also a draw for those organisations that want to operate in Europe.

Fig 8: Moves confirmed and/or executed, EY Financial Services Brexit Tracker, Q3 2018



How are firms finding the authorisation process in Ireland?

What we are seeing very clearly with the application and authorisation process is that it is not a case of first in, first out. Instead, it is a case of best in, and earliest out. The onus has been on the institutions to provide the extensive amount of information that the regulators require – to articulate what they want to do in the new jurisdictions, to decide on their precise entity structures, and to establish governance and business models that satisfy the regulators.

For many it has been a challenging, some may say exhausting process, but for those who have made it through, it has been a strong learning experience. Firms have been adapting to the different style of a new European regulator, and the level and depth of engagement that is required.

The key topics they've had to deal with are their structures for governance and oversight and of course the people and risk frameworks that will get the banks running from day one, post-authorisation. All of this has been occupying the boards and new management teams for the last 12-18 months.

What are firms focusing on now?

From a general perspective, the majority of financial firms have selected their jurisdictions and are moving through the process. The focus is now shifting to operational readiness. Preparing for day one means focusing on their people, processes and technology, along with ensuring they can satisfy the regulator in their new jurisdiction.

However, the continued uncertainty over the precise nature of a deal and its impact on financial services has been challenging. We are still in a situation of trying to establish whether we will have a hard Brexit or a no-deal Brexit, and that has imposed significant strains on the financial institutions. There are also some big ticket items that are yet to be finalised and are causing concern. These include delegation rights, the cross border application of insurance policies and the market infrastructure issues for banking and capital markets around clearing, trading and data infrastructure.

The proposed withdrawal agreement does little to clarify these points, with a notable absence of detail on post-Brexit financial services rules – although the recent agreement to review the equivalence framework is a positive move.

What is next?

For all of its issues and challenges, Brexit is the catalyst for a broadening and deepening of the international financial services sector in Ireland. There is no doubt that Dublin is evolving into a major European financial hub. It is critical that we are prepared for this next wave. We need to make sure we are developing out our infrastructure, and growing our capabilities and our understanding of these new businesses and organisations. So what is next is ultimately about stepping up to support and service to enable the broadening and deepening of the international financial services sector in Ireland.

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