KING&WOOD MALLESONS

The Power of Together

KWM presents

Brexit – Through the eyes of business

Over a four-month period, King & Wood Mallesons met with some of our key clients to discuss their views on Brexit. We sat down with chief executives, managing directors, heads of risk and heads of government affairs within the City of London. The combined annual revenue of the clients we visited – many of whom are in the financial services sector – is more than £120 billion.

We asked whether, amongst all the bluster, there was genuine consensus on the Brexit question from within the business community. All conversations were held on a Chatham House basis, to allow clients to express their views freely, which prompted some fascinating and freewheeling discussions about what is arguably the biggest political and macroeconomic decision in a generation.

Here, we present our findings.

When we began client conversations – in October 2015 – the general consensus was that the UK would stay in Europe. Over the course of four months, and numerous interviews, that certainty has slipped.

Initially, our questions were met with some complacency: "The house view is that we will stay in", said one client. "The status quo isn't bad enough for people to leave–they'll stick with what they know," said another. But as the 'leave' campaign has made headway, companies are being forced to take note:

"The [Brexit] risk assessment section of our annual report is getting larger, and we will soon be forced to formalise our concerns," one client told us more recently.

Meanwhile, the importance of wider cultural and political considerations has been brought into sharp relief. As one banking client put it: "Referendums are never fought on the actual question and there is always another issue more prevalent on the day."

While the Conservative Party leadership contest exerts its own levers on the Brexit debate, the hot button issue of the day is migration, and its exact role in the campaign is still somewhat unclear. Political pressure throughout the Member States is lending credence to the UK's calls for EU reform. And it's not only David Cameron who is feeling that pressure. In Germany, divisions continue to grow over the country's open door refugee policy and for the first time, Angela Merkel's once unassailable position is looking tenuous. In the UK, the most recent YouGov poll gave the 'out' campaign a four-point lead, with respondents citing "greater control of borders and immigration from EU" as their prime concern.

If Cameron's reform package is judged to address those concerns, it will further his case for remaining in a reformed EU, but many voices on both sides of the political spectrum have already questioned whether his reforms offer any meaningful change in this regard.

"Ultimately, the electorate will decide whether the UK is in or out and they do not care about David Cameron's treaty amendments," said one client. "He will say he has achieved something regardless of the outcome in any event."

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Certainly, the situation remains volatile, with Eurosceptics decrying any attempt to reform within existing EU structures.

"Getting traction for EU reform with other EU members, in the midst of terrorist attacks and a refugee crisis, is a difficult task, some might say impossibly so," said one client. The same individual, who was in favour of remaining in, nevertheless claimed that outside the EU, the UK would have the ability to set "more intelligent immigration rules", which target migration specifically of high value, talented individuals.

Yet the free movement of people is a cornerstone for many clients' business strategies, and they query how easy it would be to recruit the right calibre of employee, if their company were to shift from London to another EU city in the event of a Brexit.

"There is doubt about the talent pool available outside London. Would we take people from the UK? Would it be that easy if those people have no right to live in Europe?" asked one client.

"Back office staff will be an issue if we move financial services to European offices," said another. "High flyers will probably be willing to travel to earn their money, but encouraging the rank and file to move will be more difficult. In Switzerland, for example, companies have sometimes struggled to get the right staff in place."

There is also the question of where a new financial centre would be based. France and Germany seem obvious contenders, and indeed, Frankfurt is the most oft-cited city in our client interviews, though Dublin also receives lots of mentions. Doubts exist, however, as to how easily a new financial centre could meet the increased demands placed upon it.

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"In a Brexit scenario, it's fair to assume everything would coalesce around a single place," said one chief risk officer. "But it might not be possible for all demands to be met by this new centre. In Ireland, for example, could regulators cope with all the new work? Traditionally, it was considered an easy place to do business because the regulators were 'light touch', but if lots of entities suddenly shift there, post Brexit, they may be overwhelmed by the sheer volume of work."

There is also the question of whether, in 2016, 'light touch' regulation is really the boon to business that it was once considered.

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>
> FINANCIAL SERVICES CLIENT

The regulation fallacy

Before migration became the cause celebre for the Eurosceptic movement, the rallying cry for Brexit enthusiasts was the fervent desire to tackle perceived Brussels bureaucracy. Red tape was tying companies in knots and robbing individual Member States of their autonomy – or so went the theory. In reality, the view is much more nuanced, and even those tasked with clearing regulatory hurdles accept that regulation is a necessity in the business landscape – particularly in a post-2008 world.

We encountered no strong views that a Brexit would lead to less regulation – or in fact that EU regulation was any worse than domestic regulation. Rather, clients' key concern was the need for consistent regulation across markets, suggesting that even in the event of a Brexit, the UK would need to remain closely aligned with its trading partners in the EU.

"Regulation of financial services is considered fair game," said one client – a large player in the financial services sector. "No one here – or elsewhere – is arguing against that."

"There isn't any disproportionate regulation on financial services from the EU," said another. "The problematic regulation is home grown!"

One managing director, asked whether overregulation or inefficient regulation at the EU level were burdensome for his business, responded: "HMG is at least as intrusive in financial services as at the EU level – and some behaviours in the sector have given justification for this."

He went on to say that for self-certification or self-regulation to be an option, business must first demonstrate good behaviours.

Another financial services client agreed that UK rules are "more stringent" than EU regulation, and stressed the importance of greater harmonisation, rather than deregulation.

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MULTINATIONAL CLIENT

"The PRA [Prudential Regulation Authority] and the FCA [Financial Conduct Authority] should be better aligned. They give mixed messages and it's difficult to keep them both happy. They won't integrate, but they should be better aligned and offer greater regulatory consistency, including with the EBA [European Banking Authority]."

One multinational client, whose European headquarters are in London, went so far as to cite examples of where EU regulation could be helpful.

"For cross-border companies, it's helpful to have a harmonised set of rules," said the client, though they conceded that one EU market doesn't mean one regulatory framework, in practice.

"There are national variants at each level," the same client continued. "But UK business doesn't have an objection to existing regulation. Accessing EU markets has actually been facilitated by regulation."

Acknowledging the historical and perceived flaws of Brussels, the European Commission is now less emphatically Europhile than it was once. It has cleaned up its own legislation and taken a more nuanced approach to promoting its agenda. In the Juncker Commission, there has been an 80 per cent reduction in new regulations. For the time being at least, the business community seems to agree that EU over-regulation is a myth.

A post-Brexit world

"I worry about the City's competitiveness on remuneration. UK regulations on pay are draconian and a disincentive to talented individuals who can make more money in New York or Asia."

CEO

And so, if EU regulation is not the dominating force it was once thought it to be, what are we trying to achieve – or to escape – in leaving the EU?

"I worry about the City's competitiveness on remuneration," says one client. "UK regulations on pay are draconian and a disincentive to talented individuals who can make more money in New York or Asia. The UK believed that with correct accountability and appropriate clawback measures, higher pay could be controlled and managed, but we can't allow for higher pay because of EU compensation rules. Minus the EU, we could remove those provisions and bring new competitiveness back to the UK."

That said, the same client concedes that London will always be an attractive proposition for individuals, given the vibrancy and geography of the city: "I don't doubt that the UK would remain attractive."

The Vote Leave campaign sets out its mission statement in the following terms:

"Technological and economic forces are changing the world fast. EU institutions cannot cope."

VOTE LEAVE

"Technological and economic forces are changing the world fast. EU institutions cannot cope. We have lost control of vital policies. This is damaging. We need a new relationship. What should it be?

We negotiate a new UK-EU deal based on free trade and friendly cooperation. We end the supremacy of EU law. We regain control. We stop sending £350 million every week to Brussels and instead spend it on our priorities, like the NHS and science research.

We regain our seats on international institutions like the World Trade Organisation so we are a more influential force for free trade and international cooperation."

But clients are quick to question how much influence the UK would really exert outside of Europe – and whether the costs of EU membership are not outweighed by the vast benefits of full and unfettered access to the single market.

"The single market gives us access to some 500 million consumers, and a large number of economically rich potential customers," says one major bank, before adding that alone, the UK would have a much smaller voice on the world stage. Indeed, a representative of the Obama administration noted in January that the US has "no interest" in signing free trade agreements with individual countries, instead preferring to concentrate on trading blocs.

Relying on seats on international institutions like the WTO could also prove to be a problematic solution to the Brexit disruption that would be wrought on UK plc. "The WTO is an enforcement arbitrator and WTO rules are thin and do not cover services," said the same banking client. "They could not be used as the basis for trade, post-referendum."

The so-called 'Norway option', in which the UK leaves the EU but becomes part of the EEA, is often cited as the most likely post-Brexit scenario. But membership of the EEA would still require significant financial contributions, as well as upholding the four freedoms – including the

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BANKING CLIENT

free movement of people – thus providing the government with little political coverage on the controversial issue of migration. The EEA would give access to the single market for trade in goods, but not full access for financial services, and perhaps most crucially, it would demand adopting a range of EU legislation without having a seat at the table when that legislation is devised.

Whatever the eventual outcome, it is the uncertainty preceding it that is perhaps most troubling businesses, who report a slowdown in FDI, as investors tread water until after the referendum. One client reports that they have no large projects projected to finish after the first quarter of 2016, in light of the economic uncertainty surrounding Brexit.

The message we hear most often from clients, is that if needed, they can adapt, and they will adapt, but not without great upheaval and great cost.

"The costs of restructuring do not bear thinking about," said one interviewee. "It would be a huge distraction for UK plc."

Another admits that in the event of Brexit, the company will be playing catch-up: "It's my job to manage tail risks, but the costs of Brexit are so prohibitive, we haven't started to put measures in place yet."

Life beyond London

Most major firms have some capacity elsewhere in Europe, and in the event of Brexit, many EU companies are expected simply to go back to their 'home' cities, whilst perhaps maintaining a small base in London. But with the financial sector contributing between eight and nine per cent of the UK's GDP, that would be a significant blow to treasury coffers.

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BANKING CLIENT

For US banks that use London as a base from which to run EU operations, that structure may become untenable if London is no longer the gateway to the EU. Whether this system of 'passporting' would be allowed post-Brexit, is debatable. Some clients are optimistic as to the UK's bargaining power, but one chief executive warns that Britain should expect to feel some retaliatory pain from the EU, if it votes to leave.

"The EU will have to punish the UK for leaving," he says. "If the rhetoric is very negative, the EU will be harder on us."

A corporate client agrees that we "should not underestimate how furious" the EU will be that the UK has walked away, while another says the terms of any future agreement will depend on "how firmly we slam the door behind us". Given that the EU treaty provides that the exit terms of a departing member are discussed and agreed between EU members – without the participation of the departing member – this is of real concern to some.

Whatever the terms, the departure of financial services would deal a serious blow to the sectors that rely on them for support. In the West End, for example, a reduction in financial services will see supply go up and demand driven down for both office space and services.

Financial services are acutely aware, however, that their plight has little resonance – some say none whatsoever – in the mass market. They are keen to see the 'In' campaign articulating arguments that speak to a broader cross section of society.

"Arguments for staying in should be built on a solid base that cannot be eroded," said one client responsible for government affairs. "That means focusing on the economic implications – lost jobs, higher taxes and lack of foreign investment."

Another client urged: "They [the 'In' campaign] should be talking about the impact that Brexit will have on the automotive sector. It's more tangible and the impact would be felt across the country – not just in London."

Indeed, several clients stressed the importance of the EU to rest of the UK.

"London is in a unique position as its own sort of city state. The impact of Brexit may be greater on the rest of the UK," said one managing director.

Another criticised the "myopic and blinkered view" taken in the Brexit debate: "The UK is not just London, but we don't tend to see that. In fact, many of the personalities who are engaged in the debate need to come out, because they're off-putting to people in the middle."

The question of who should be the mouthpiece for the 'In' campaign is a difficult one. Though many clients tell us privately that they wish to remain a member of the EU, they don't feel able to speak out – at least not on behalf of their companies – for fear of being perceived as lobbying for the cause. Some believe it will fall to domestic businesses to make the case.

In fact, the Brexit question may decide more than future relations between Britain and Europe. It could come to define the fate of the United Kingdom itself, with many commentators predicting that if Britain votes to leave, with a majority of Scots wanting to remain a part of the EU, that schism would prompt a second referendum on Scottish independence –and likely the birth of an independent state.

"Cameron's legacy then will be the breaking up of the UK and the EU," one client remarked wryly. "You shouldn't call for a referendum on something you don't want – he has called two."

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>
> MULTINATIONAL CLIENT

A Brexit would also fundamentally shift the dynamics at play within the EU. One chief executive believes that UK influence in the EU, particularly in financial services, is "consistently underestimated".

"If the UK leaves the EU, EU regulation loses a moderate voice and the EU may bring in less attractive rules for banks," he says. "The EU would return to a French/German alliance and the Anglo-Saxon balancing role that we have played would disappear."

The European ideology

Some question whether the referendum could have been avoided entirely with a more active programme of British engagement in Brussels. Several clients lament the UK's "benign disengagement" with Europe, as one put it.

"Ironically, we had higher levels of engagement with the EU under Thatcher than under anyone else, including Blair," said one CEO. "If we decide to stay in Europe, we should be sending our best people to Brussels. You can't influence by complaining from the outside – we need to be part of the working groups; we should have our brightest people there."

Clients are equally frustrated by the UK's complaints about the intrusiveness of the EU; suggesting one simple solution would be a less zealous embrace of EU regulations in all guises.

"We are big enforcers of EU regulation domestically, whereas the Germans are less compliant, despite being everywhere in Brussels. With the UK, it's the opposite," said one interviewee.

Another added: "Many UK laws could be strengthened or changed, within the context of the EU, if politicians were stronger."

Perhaps the quintessential problem, several clients say, is a failure to realise or to embrace the ideology of the European Union, which was created to preserve a lasting peace, on the basis that nations who trade with one another are less likely to go to war with one another.

"In the UK, people feel divorced from Europe; they have no idea who their MEPs are and they don't feel represented by them," said one client. "In Europe, they don't think the EU is perfect either, but they are committed to the project and they feel it is their responsibility to see it through."

Nevertheless, the UK referendum looms and only after the votes are tallied will we truly begin to understand the consequences of the decision. In the event of a Brexit, the UK will only have two years to negotiate the terms of its existence in Europe. If that period elapses and no deal is reached, neither camp wants to consider the ramifications. And despite the two-year deadline, clients estimate that it will take up to 10 years before we see where the chips will land after the biggest of gambles.

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