Implications of a Potential Brexit (06/07/2016)

As the referendum for Britain's exit (or Brexit) from the European Union (EU) nears, debates for and against the move are escalating. Those who are for Britain staying in the EU argue that the economic benefits from Britain's EU membership outweigh its costs; that Brexit will slow Britain's economic growth; that having a single European regulation scheme reduces red tape and benefits business; and that leaving the EU will not result in reduced immigration to Britain. Those that say it is better for Britain to leave the EU say that doing so will allow it to negotiate a better EU relationship; secure its own trade deals with other countries; spend EU membership budget on other priorities; regain full sovereignty; and have greater influence in the world. The decision to stay or leave will be decided via a referendum vote on June 23, 2016.

Withdrawal from the EU is a right of EU member states under the Treaty on European Union, Article 50. The treaty allows any "Member State to decide to withdraw from the Union in accordance with its own constitutional requirements." The impending vote has raised some uncertainty relative to the impact on investments in the United Kingdom (U.K.). While U.S. insurers have some direct exposure to UK-domiciled issues, it is difficult to gage how these investments will be impacted if a Brexit were to occur. With just a few weeks to go until voting, many referendum poll results show that the vote can still go either way. According to the latest BBC News poll (shown below), the percentage of those that want to leave the EU was 48% and those who wanted to remain was 43%. The rest, or 9%, were still undecided.

EU Referendum Poll Tracker

![EU Referendum Poll Tracker](https://www.naic.org/capital_markets_archive/hotspot_20160607.htm)

Source: BBC News.

Concerns over the vote have already led to significant depreciation and volatility in the British pound (GBP). The GBP has whipsawed since the beginning of 2016, with the GBP to U.S. dollar (USD) exchange rate falling from 1.47 on Jan. 1, to a year low of 1.39 on Feb. 26, and partially recovering to around 1.45 on June 6. Since the beginning of the year, the GBP is down 2.19% against the USD. A decision to exit could add further uncertainty and volatility.
According to Standard & Poor's (S&P), the referendum has already started to weigh on Britain's economic activity, with gross domestic product (GDP) growth slowing to 0.4% in the first quarter of 2016 from 0.6% in the fourth quarter of 2015. S&P points out, however, that it is difficult to separate how much of the slowdown comes from weakness in global growth and "cyclical deceleration."

UK government bond yields have not, per S&P, reacted to Brexit fears. Spreads between gilt and bund yields have been fairly steady at about 130 basis points (bps) since November 2015, and spreads between Treasury notes and gilts at around 35 bps.

The potential for Brexit thus far appears to have had a limited impact on equity prices. The following graph illustrates the relative performance of the FTSE 100 Index (UK) to the Dow Jones Industrial Average (U.S.), the CAC 40 (France) and the DAX (Germany) since Dec. 31, 2015. These indices have essentially been moving largely in tandem with one another.

**FTSE 100 Index Return vs. Other Indices (YTD)**
Brexit concerns have led Moody's to caution that a vote to leave the EU could put the UK's sovereign rating (Aa1/Stable) on "negative outlook." A downgrade, it says, is possible if the country's economic growth weakens over the medium term. Moody's believes that an exit would be "credit negative" for insurers operating in the UK, but the negative effect on insurers' credit fundamentals would be "relatively modest." S&P, which has maintained a rating of AAA for the UK since 1978, changed its outlook to negative in June 2015 on worries that an exit would add significant risk to the UK's economy, its financial services sector and its exports. S&P also stated that it "could lower the rating by more than one notch if we reassessed our view of the UK's institutional strength and ability to formulate policy conducive to sustainable growth." Fitch Ratings expects an exit vote will have a moderate credit negative impact on its UK rating (AA+/Stable) due to increased risks to "medium-term growth and investment prospects, its external position, and the future of Scotland within it."

As of year-end 2015, U.S. insurers' exposure to UK-domiciled debt and equity totaled $118 billion, with $105.4 billion in bonds and $12.6 billion in equities. The bulk of the UK-domiciled debt, approximately 81% of the total, was with nonfinancial corporates. UK bonds represented approximately 15% of the U.S. insurance industry's foreign bond exposure (approximately $688 billion) at year-end 2015, second only to Canada (16%). Exposure to UK sovereign debt (gilts) was only 1.5% of the UK-domiciled bond exposure, while UK financial bonds were 17%. Exposure to UK equities was the largest foreign stock exposure for the U.S. insurance industry, at 62% of total foreign stock exposure 3% of which was in UK financial stocks.

The NAIC Capital Markets Bureau will continue to monitor developments relative to the potential Brexit and report as deemed appropriate.

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