Brexit – A UK Perspective

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In March 2017, the UK initiated Article 50 which was the start of the UK`s "divorce" from the European Union following the "leave" referendum in 2016. The issues now facing both sides will determine whether this will be an amicable or very bitter split. Negotiations will be protracted with both sides trying to negotiate an outcome that will be palatable to their electorates.

Article 50 of the Lisbon treaty was deliberately drafted to deter countries from leaving the EU but also to ensure that if any country tried to do so the effect would be to discourage other countries from doing so. Draft guidelines released a few weeks ago stated that the UK will be required to pay "a single financial settlement" (around €60bn) to cover all legal, budgetary, supervisory and enforcement structures. What remains to be seen is if this is enough of a deterrent to other countries with political parties calling for Frexit, Grexit amongst others. (1)

The question is to what extent will the remaining EU27 unite in making the divorce as painful as possible for the UK or will there be countries that will break ranks and try to negotiate favourable terms for themselves and the UK. In 2016, Britain was the third largest contributor to the EU budget accounting for 15% of the EU`s total funding, after Brexit this will leave the EU budget severely depleted. Countries such as Denmark and Sweden have already expressed their unwillingness to increase demands on their taxpayers. Whether Britain follows a "hard" or "soft" Brexit stance in the divorce proceedings will largely be determined by how these negotiations are conducted, and the extent to which the EU tries to "punish" the UK to deter others. This article will attempt to analyse the numbers and try to reflect a view on the possible outcome.

Theresa May's call for a General Election on June the 8th will give her a very strong hand moving into negotiations with a much larger mandate but may also allow her to take a much softer approach in final deliberations if she has a mandate.

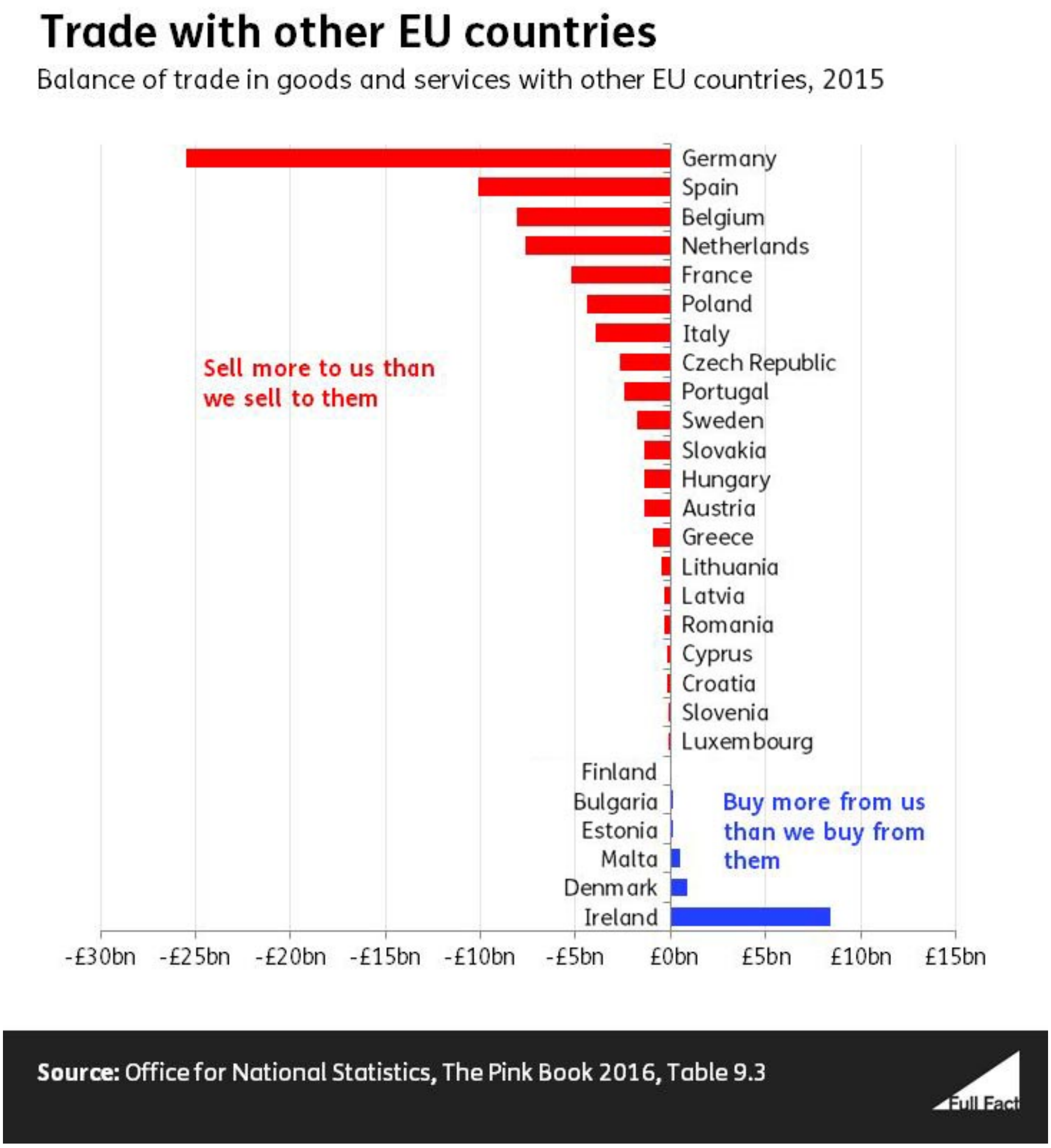
That said, the announcement has come as two polls over the weekend put the Conservatives 21 points ahead of Labour**,** a lead that is likely to greatly increase its existing working Commons majority of 17.
As Bloomberg notes, May will hope that the election will strengthen her hand when it comes to negotiating Britain's withdrawal from the European Union. However, in Brussels and across the EU, it is likely to be merely add to the unpredictability of relations with the U.K. since June's referendum.

An early general election is the only way to resolve the political impasse the U.K. government faces in conducting Brexit negotiations. The 2020 General Election imposed a hard deadline on delivering Brexit on an unrealistic timeline as well as making the Prime Minister reliant on a small Euro-sceptic majority. Both factors would have required political and market pressure to impose the appropriate political shifts that would have allowed a realistic deal to emerge.

It is our opinion that she will win with a substantial majority and this makes the deadline to deliver a "clean" Brexit without a lengthy transitional arrangement by 2019 far less pressing now that no general election will be due the year after. Secondly, it will dilute the influence of MPs pushing for hard Brexit, strengthening the government's domestic political position and allowing earlier compromise over key EU demands for a transitional arrangement and thirdly, it strengthens the PM's overall negotiating stance. (4)

To make sense of any proposed view on an outcome it is important to analyse the trade numbers, the number of nationals living between the UK and the rest of the EU and the change in cash flows across the borders – the following graphs should give some idea of the magnitude of the flows between the different nations and Britain.

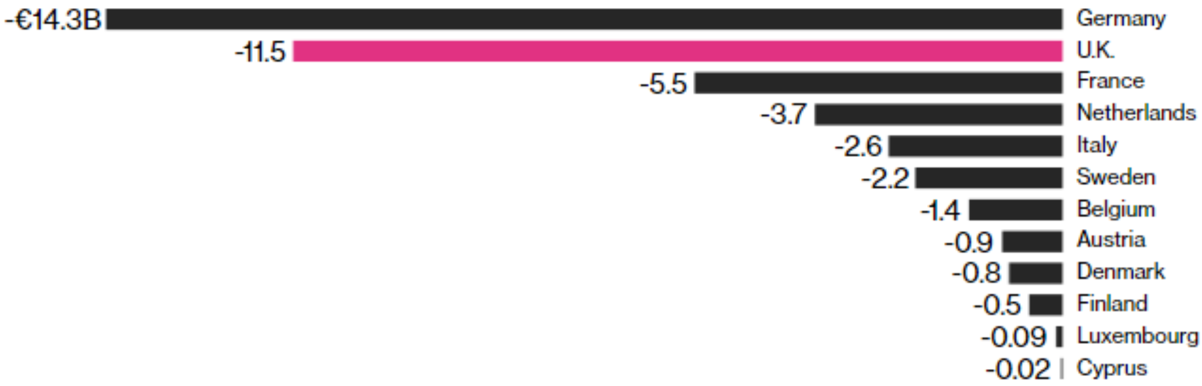
The rest of the EU sells about £60 billion more to the UK in goods and services – so the UK runs a "trade deficit" with the EU. Exports of goods and services to other EU countries were worth £230 billion in 2015, while exports from the rest of the EU to the UK were worth about £290 billion.



The majority of the EU27 sell far more goods and services to the UK than the UK sells to them.

The overall financial position of the EU post Brexit is also interesting to analyse as the table below shows, the €60bn exit bill would mean that the books will be balanced for the next 5 years but after that there would be an extremely large deficit that would impact on the EU bond market and make it far less attractive for foreign investors. The Euro would weaken and inflation could begin to accelerate.

The European Union would be €11.5bn short on their budget after Brexit



Our view is that there are several serious issues that need to be resolved if a complete breakdown in the negotiations is to be avoided. We have highlighted a few we deem to be important to members of IMAP when analysing the effects they may have on cross border transactions. There are clearly many others just as important but which go beyond the scope of this article.

Financial Passporting

This is considered one of the most contentious issues facing the UK service industry. The EU passporting system for banks and financial services companies allow firms that are authorised in any EU or EEA state to trade freely in any other with minimal additional authorisation. These passports are the foundation of the EU single market for financial services.

There are nine different passports that banks and financial services providers rely on to provide core banking services to businesses and customers across the EU. To have the benefit of each passport a Member State signs up to and applies a regulatory regime into national law.

These passports are based on the single EU rulebook for financial services and are therefore not available for firms based in countries outside of the EU and the EEA. Non-EU firms face significant regulatory barriers to providing cross-border banking and investment services to customers and counterparties in many EU Member States.

Banks or financial services businesses from countries outside of the EU and the EEA cannot currently access the passporting regime. To do so they must either establish a regulated business inside the EU or alternatively they may apply for a license under the domestic licencing regime of each individual EU country in which any of them wishes to do business to provide services in that EU country only. Such licenses are not available in all EU countries, provide access only to a limited range of services and generally carry no rights to onward cross-border trade from the country of licensing.

Goldman Sachs expects Britain to lose financial passporting rights after Brexit. The investment bank made the call in its latest "Top of Mind" note sent to clients on Monday, saying:

"Ultimately, we expect the negotiations to result in a UK-EU FTA [free trade agreement] that applies to goods but not services, and a loss of the UK's rights to financial passporting." (3)

The Financial Conduct Authority estimates that around 5,500 companies with a combined turnover of £9 billion rely on passporting in the UK. However, a House of Lords report in to the potential impact of Brexit on financial services, released last week, pointed out that the interconnectedness of financial services in Britain meant that many firms relied on passporting without knowing it.

Losing the passporting rights would force several Banks and Financial Institutions to move their head offices to financial centres in Europe to enable them to carry on their trading operations and sell their financial products into Europe.

Our view is that most International banks and financial institutions are making contingency plans to move should the result prove that they will no longer be able to run European activities from London headquarters. This will benefit cities like Paris, Amsterdam, Frankfurt and other financial centres.

It is our view that access to EU passporting for UK financial services will severely limit the UK Governments `hard Brexit`strategy and will force it to look for a compromise solution.

Cross Border trade and Custom tariffs

A hard Brexit could force the reintroduction of custom duties across borders which would severely impact pricing and lead times for the flow of goods across borders given that custom checks would be required at all entry and exit points in the UK, this would become a logistical nightmare for trading entities.

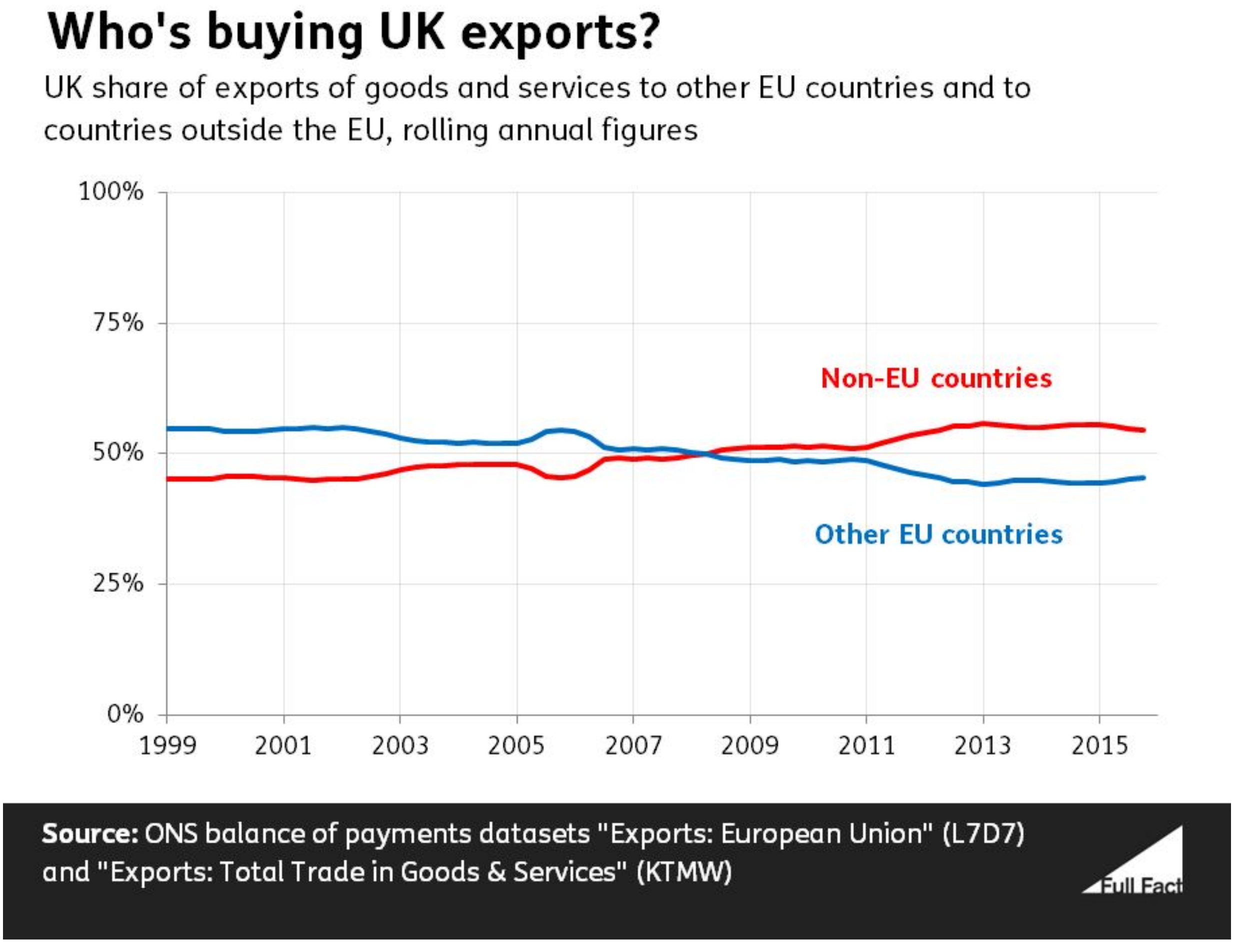
After decades of EU membership UK business regulations are already heavily harmonised with Europe, meaning that the UK could probably strike a very quick deal if it was prepared to go on applying those rules in exchange for access to the EU single market, much as Norway does today.

If the UK intends to push for a broad deal, particularly one covering services, including financial services, it could take some time and involve retreating on other points in the negotiation including EU exporters to the UK. German car makers and French winemakers might well be pushing for access to the UK, but given other tensions in the EU and the need for the deal to be agreed by a qualified majority vote, there would be plenty of scope for other nations to hold the process to ransom.

In the absence of a deal between the UK and the EU, the UK would then be required to follow World Trade Organisation rules on tariffs.

In our view this would be the worst possible outcome and we hope that politicians are able to come up with a common-sense approach and negotiate a deal that will work for enterprises on both sides.

Whilst trade with Europe is extremely important as can be seen in the graph below exports have reversed the trend since 2005 and are now larger to non-EU countries than the EU itself. Whilst this shouldn't impact on negotiations the UK Government will use statistics like these to brink the UK public on side if negotiations begin to falter



Given that the majority of the EU27 exports more to the UK than the UK exports to them we would anticipate that this factor will be a key driver in softening any hard line approach from the EU27.

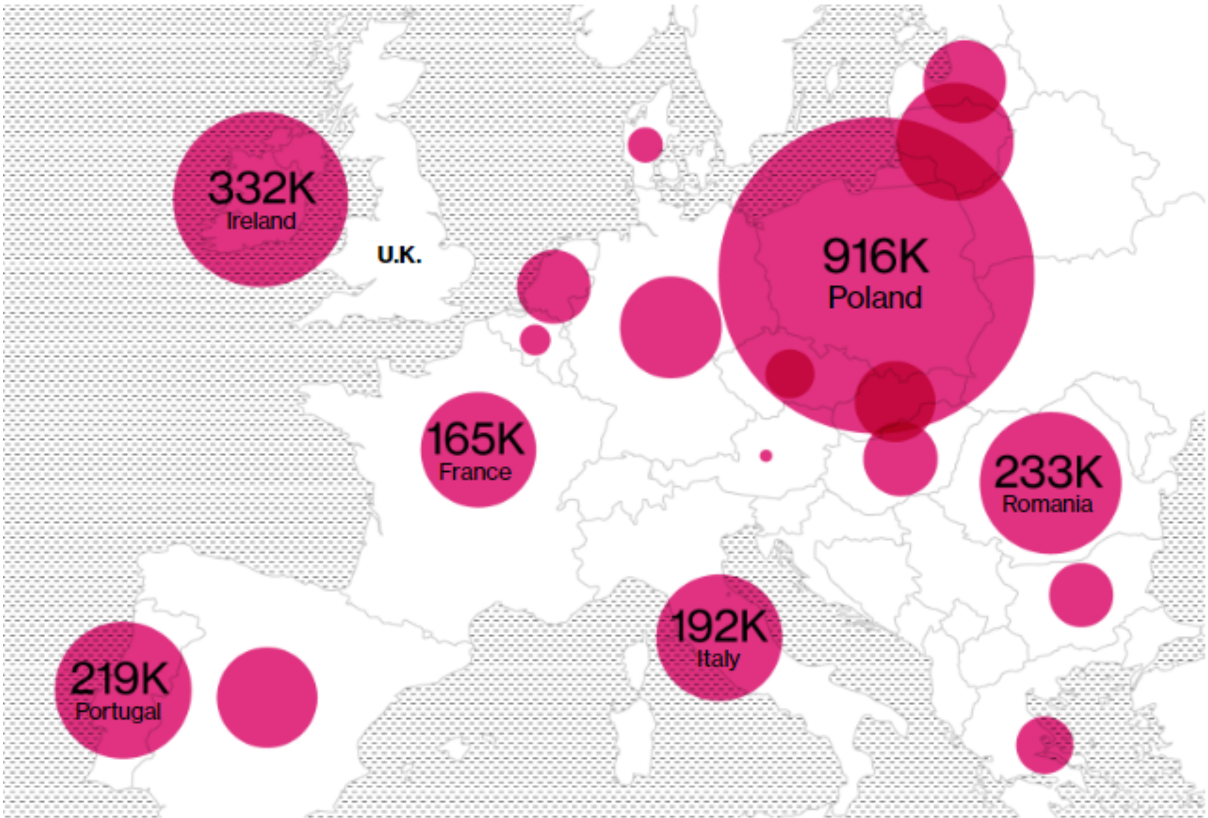
The Freedom of Movement of Citizens

This will be an extremely contentious issue as it will affect the lives of millions of people, the UK Government plans to use the status of EU citizens as a "negotiating card" to make sure that British expats can stay in EU countries, although nothing is certain, the general assumption is that EU citizens living here will be allowed to stay permanently after Brexit.

More than three million EU citizens currently live in the UK and uncertainty remains over whether EU nationals will be still be able to access to healthcare, take out pensions and own property. The UK retail sector employs between 100,000 and 200,000 EU national workers and should stringent rules be put in place it is highly unlikely that these positions could be easily replaced by UK nationals.

Another interesting statistic is that 15% of academic staff at U.K. universities are from the EU27, compared to 5% of the general population. Stricter rules would severely impact the International standing of UK Universities, something that the UK is extremely proud of and which makes a significant impact on the wider UK economy. What is also in question is the amount of academic grants the UK receives from the EU and to what extent that will be affected post Brexit.

The UK is hugely reliant on foreign workers to keep the economy growing and the diagram below shows the origins of EU citizens currently living and working in the UK:



The withdrawal of this labour pool would put a physical break on the UK economy and is one of the reasons the UK Government has made a number of announcements reassuring EU citizens currently in the UK that they will be allowed to remain post Brexit.

Our view on possible outcomes of the Brexit negotiations:

IT is essential that the UK Government find ways to attract foreign talent and investment while ensuring that the homegrown talent is equipped with the right skills for local industry. If the Brexit outcome does not address this the UK population will deem the process to be a failure. The elections in both France and Germany will delay any debate on this topic until the outcomes of those elections are known.

Any extreme swings to the left or right in Europe would strengthen the UK's hand at the table as we would expect such a move to lead to an immediate strengthening of the value of Sterling at the expense of the Euro.

Another crucial point to be considered in these negotiations is the role of the European Court of Justice which has the potential to shoot down any deal (including after it's been ratified by Britain and the EU). The Commission will shape negotiations through doing most of the detailed preparation. Once again, it's important to avoid thinking the larger institutions will view Brexit through the lens of relations with Britain, they will be their manoeuvring to position themselves within the EU that emerges post Brexit. The European Parliament especially will be hostile to a deal reached by some of the larger member states if they have little regard to the positions of others in the EU, because that would point to a Union run by the largest states. This could potentially weaken the Union.

Any Brexit deal will also reshape the EU's relations with states such as Norway, Switzerland, Turkey, Iceland, Lichtenstein, Ukraine and non-EU states in the Balkans. Each of these States has, to varying extents, built relations with the EU that most clearly in the cases of Norway and Switzerland were intended as conveyor belts that would eventually draw them into the EU. Brexit could throw those conveyer belts into reverse. If Britain did want to seek an EEA style deal, akin to that of Norway, then Norway will get a say. If Britain gets a unique deal then some in those states might seek to emulate it. Brexit therefore holds the potential to be one of the pressures that reconfigure the politics and relationships of the whole of Europe. (2)

Considering all these extremely difficult and complex elements our view is that the UK will be prepared to make a payment somewhere close to the €60bn envisaged to ensure that cross-border tariffs will be dropped, passporting will be maintained and provided the UK Government will be given some latitude in limiting the movement of EU Nationals across its borders to satisfy the domestic political agenda. We would expect UK citizens living in the EU and EU citizens living int he UK at the time of Brexit to be allowed to maintain their current residency status.

From an M & A perspective we expect an extremely volatile period for financial markets especially currencies and this will impact on cross border activity in the short term. Some Companies will put potential deals on hold pending the outcome but hopefully others will see tremendous opportunities arising from all this uncertainty.

Whatever the outcome entrepreneurs and business leaders will find ways to conclude trade and transactions to their mutual benefit. As Confucius once said, "May you live in interesting times". Whatever Brexit brings, the next few years will definitely be interesting.

References:

1) Niall Ferguson – Hover Institute Stanford
2) Dr Tim Oliver – Kings College London
3) Goldman Sachs
4) Deutsche Bank - George Saravelos