

The morning after: Brexit uncertainty and what it means for business

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Summary

The 'in-out' nature of the Brexit debate, and the focus on uncertainty about the referendum outcome, obscures another, equally important layer of Brexit uncertainty for business, which is about what a vote to leave the EU would actually mean in practice. There are uncertainties about both the destination - what the future relationship between the UK and the EU would ultimately look like - and the journey to get there. We are unlikely to get clarity about the destination before the referendum as those who want the UK to leave the EU want to avoid this becoming the question. But the alternatives have very different implications for business. There are equally many uncertainties about the journey, in part because the process of leaving the EU is unclear, but also because politics - in the rest of Europe as well as the UK - will trump economics in the negotiation between the UK and the rest of Europe. Most large businesses will want to evaluate the risks created by Brexit uncertainty from a fiduciary, operational, and strategic perspective.

The question of Britain's membership of the EU has become very real for businesses operating in the UK, now that a number of pro- and anti-EU groups have launched their campaigns. The tightness of the opinion polls suggests the outcome is highly uncertain, particularly as we do not yet know what the Prime Minister's efforts to renegotiate the terms of Britain's membership will produce or even the date for the vote.

The 'in-out' nature of the debate, and the focus on uncertainty about the referendum outcome, can obscure another, equally important layer of uncertainty, which is about what a vote to leave the EU would actually mean in practice. This note aims to bridge this gap by assessing 'Brexit uncertainty' and the implications for businesses operating in the UK.

There are many uncertainties about what a vote to leave the EU would actually mean, but these can essentially be divided into two categories. One set is about the Brexit

destination - what the future relationship between the UK and the EU would ultimately look like. The other is about the journey - how we get there - and the unknowns along the route.

An uncertain destination

When the dust settles, what will the relationship between the UK and the EU look like? No country has left the EU before. There are examples of countries breaking up, but none as sophisticated or as developed as the UK and EU economies. There are, however, several possible models the UK could look to, even if none alone is a perfect guide to the eventual outcome.

Quite a bit has been written about these models. In a [recent report](#) we considered five. For the sake of simplification we can reduce this to three main contenders - the Norwegian, Swiss and Canadian models. The Norwegian model is based on the European Economic Area agreement and involves full

participation in the single market and cooperation with the EU in selected other areas. The Swiss model is based on a series of bilateral accords and is aimed primarily at securing access to the single market in specific sectors, but not all. The Canadian model is based on a Free Trade Agreement with the EU. It is looser than the other arrangements. We have labelled it the Canadian model because Canada has recently signed an FTA with the EU that is the deepest and most comprehensive of its kind.

Most of what is written about these models is to compare them with membership of the EU in an effort to address the question of whether the UK is better off in or out. However, in order to understand the uncertainty about the eventual destination following a vote to leave the EU, it is more important to consider how these models differ from each other. They do so along many dimensions. In Table 1 below we highlight five of the most important for business, although this list is far from exhaustive.

Table 1 - Key differences between alternative Brexit models

Access to the single market	Only in a minority of sectors are UK-based companies likely to find they maintain full, uninhibited access to the single market, regardless of the model.
Regulatory divergence	The potential for divergence varies with the model in a way that largely mirrors access to the single market and is therefore lowest under the Norwegian model and highest under the Canadian one. Divergence creates a compliance cost that may be significant in some sectors.
How decisions are taken and by whom	The Norwegians must accept regulations set by the EU. The Swiss and Canadian models involve negotiation, but with imbalances in bargaining power. This matters to companies that want to influence regulation.
Movement of labour	The Norwegians are bound to accept free movement of labour, while the Canadians are not, although there are provisions in this and other FTAs concerning inter-company transfers. The Swiss are currently in dispute with the EU over free movement and this has the potential to jeopardise access to the single market if it is not resolved.
The legal framework	The UK would no longer have to accept decisions by the European Court of Justice, but the Norwegians are bound by rulings of the EFTA Court which often follows ECJ decisions. A criticism of the Swiss model, and by extension the Canadian model, is the lack of a clear legal framework.

The extent of the challenge posed to businesses by uncertainty about the destination depends on the sector. Financial services provides a useful case study as its many sub-sectors are likely to be affected in different ways, depending on the model that is adopted.

Case study: financial services

A critical issue in the case of financial services is whether firms based in the UK would continue to be authorised to provide wholesale and/or retail services to EU-based customers. The key tests for the EU in deciding whether to authorise UK firms would be the ‘equivalence’ of the regulations in the EU and the UK post-Brexit, the willingness of the UK’s own regulators to share information and to co-operate with the European Supervisory Authorities, and independent assessments of the UK’s compliance with international standards. The EU already has a well-established practice of interpreting this test differently depending on the type of service that is offered:

- i. The tightest standards operate for retail services, where consumers are judged to need additional protection. In effect this means UK providers being shut out under any model other than something like the Norwegian one. This can apply to a wide definition of ‘retail’ investors including some mid-sized pension funds.
- ii. A more flexible interpretation operates for wholesale services and especially for ‘alternative investment funds’ such as hedge funds or private equity. In these cases equivalence is largely tested by reference to international standards, such as those set by the Financial Stability Board, and subject to agreeing ‘Multilateral Memoranda of Understanding’ with EU supervisors. This type of approach would be consistent with a looser model, such as the Canadian one based on a Free Trade Agreement with the EU. But even in wholesale banking there are risks, as the UK would find it harder to prevent the ECB from encouraging the migration of euro-denominated services to the Eurozone without the protection of the European Court of Justice which has to uphold the integrity of the single market. Moreover, it is possible that other developments in the EU could threaten the UK position in wholesale banking, particularly if the Capital Markets Union initiative reshapes wholesale capital markets in a way that disadvantages the UK. That seems like a distant prospect now, but Brexit would mean the UK would not be there to shape the future direction of policy in this area.
- iii. Between the retail and wholesale ends of the spectrum there is quite a large grey area of uncertainty where, for example, in sectors like insurance ‘third countries’ are not shut out of the single market, but are subject to a strict ‘line-by-line’ test of equivalence and potentially to additional capital and solvency requirements, which basically entails adopting regulation as set by the EU. This is what is required of the Swiss in insurance and in some other sectors.

The important point to take from this case study is that most UK providers of financial services cannot say with certainty to their shareholders, their staff or their customers what impact Brexit would have on them as they do not know what the Brexit destination will be. A similar problem applies in most other sectors, even though the details are inevitably different in each case.

It is also highly unlikely that there will be any clarity about the Brexit destination before the referendum. This is because there is no consensus among those who want to leave the EU on what the model should be for the UK's future relationship with the EU. This is for a good reason. When the alternative Brexit models are scrutinised it is clear that what is most attractive politically is also most damaging economically. To put it another way, independence from EU regulation - a totemic issue for many who want to leave the EU - comes at a price, which is the ability to trade freely with the EU. Equally, those who want to leave the EU will want to ensure the referendum is focused on the 'in-out' question without clouding this by broadening the debate to include what 'out' actually implies.

An unclear path

We now turn to the second category of uncertainties, which is about the journey. The first point to recognise is that it cannot be smooth. If the Prime Minister loses the referendum he will almost certainly be called upon to resign and would be unlikely to survive. This means a Conservative leadership contest in which the candidates put forward their visions for the future relationship with the EU.

The relationship would not, however, be for the UK alone to determine as it must be negotiated. The negotiation would be much tougher than what the current Prime Minister is attempting now as he seeks to alter the terms of the UK's membership of the EU, tough as that may be.

Article 50 of the EU Treaty sets out the process for leaving the EU. Under this the new UK government, once formed, would have to negotiate a withdrawal agreement. This raises several questions, legal and political, which create multiple sources of uncertainty along the journey to Brexit. Table 2 outlines five such questions, although there are others.

The example of financial services is again illustrative. There would need to be a long and difficult process of disentangling UK regulation from its EU origins and clarifying the relationship between UK regulators and EU institutions, such as the three European Supervisory Authorities. There may need to be transitional arrangements to ensure continuity of both regulation and authorisation during a protracted negotiation and perhaps also in its aftermath. Even then, given the uncertainties affecting that negotiation, financial services providers may need to adjust their operations to protect against the risk that authorisation to sell services from the UK is withdrawn, possibly at short notice. And during the period of negotiation there would be a risk

Table 2 - Questions about the journey

How long will it take?	Article 50 says two years unless there is unanimous agreement to extend the negotiations. But two years would not be enough. It took 12 years for Switzerland and the EU to agree their bilateral accords.
Who has power in the negotiations?	The UK would be negotiating with both the EU the 27 other member states given mixed competencies. The European Parliament would have to endorse the deal. There would be multiple, divergent interests and many de facto vetoes that could be used to block a deal. For example, might Poland threaten to veto an extension of the negotiation if it thought a deal would curtail the rights of Poles in Britain?
What happens if the negotiations fail?	Article 50 says that all treaty obligations would lapse after two years, meaning Britain would be shut out of the single market, damaging trade and investment interests on both sides. That may be unlikely, but it could nevertheless impact on the negotiation as this nuclear option would be worse for the UK.
What would life be like in the interim?	The UK would still be in the EU but without influence. The Commission would have little interest in accommodating the UK in drafting new regulations or directives that would continue to apply in the interim.
Can the system cope?	The process of disentangling UK legislation from its EU underpinnings and filling in the gaps would be fiendishly complicated and time consuming, potentially posing risks to business if it is not handled competently.

that new regulation is unfavourable, particularly as the UK has been an advocate in the past of EU openness to third country firms and would now be without real influence in the EU Institutions. Again, similar questions and issues would apply in sectors other than financial services, albeit with varying degrees of severity and taking forms that are often specific to the individual sector.

Conclusions

One response to this analysis is to argue there is a strong economic incentive for the UK and the EU to get a deal done quickly that is in the interest of all parties. This is undoubtedly true. But it misses a more important point which is that politics are likely to get in the way and will ultimately be decisive in determining both the Brexit destination and the path to the destination. The dominant influence of politics is most evident in the UK

now, but would become equally apparent in other EU countries following a vote to leave the EU. The French and German leaders both face elections in 2017, most likely soon after the referendum. How they respond to the UK following a vote to leave the EU will be in large part determined by domestic public opinion. The same will be true in other EU member states even if they are at different points in their electoral cycles.

This means that if Britain votes to leave the EU in a referendum this will not resolve Britain's 'Europe problem', but rather Britain will face a new kind of 'Europe problem'. The interdependence between Britain and Europe means Britain will not want to or be able to ignore Europe. The UK would in effect be choosing to leave the EU shortly before attempting to negotiate a way back in to some or all of the single market. Many member states will require to be seen to extract concessions in the negotiations to make this politically sellable at home, making the outcome even more unpredictable and adding an additional source of Brexit uncertainty.

Brexit uncertainty is a significant issue for most businesses in most sectors. There is almost no sector where businesses would find that they continue to enjoy unimpeded access to the single market under all possible models for the future relationship with the EU. Businesses will also face uncertainty along what would be a bumpy and lengthy transition. These uncertainties will create risks - and perhaps also opportunities for some firms. Most large businesses will want to evaluate these risks now from a fiduciary, operational, or strategic perspective and possibly all three. The nature of the uncertainties are such that no one silo in an organisation should be examining them alone. It requires a careful reading of the politics in the UK and other major European countries as well as the economic incentives faced by the different parties and the commercial landscape. This means strategy teams, legal advisors, risk committees and executive boards working closely together.

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