Financial & markets regulation

Brexit: How to avoid a cliffhanger

Most parties accept the need for a transitional deal but there is little agreement on the format

The Big Read

The British prime minister, Theresa May, must decide what kind of Brexit is best for Britain - and whether it is obtainable

OCTOBER 11, 2016 by: **Alex Barker** and **Stefan Wagstyl**

Brexit negotiators refer to it as "the cliff edge". Wall Street bankers urged Theresa May (https://www.ft.com/search?q=Theresa+May), Britain's prime minister, to make it "a long runway". To Downing Street it is simply "the problem": can Britain engineer a smooth exit out of the EU?

After Mrs May's promise (http://next.ft.com/content/7b78f276-8940-11e6-8cb7-e7ada1d123b1)to start formal divorce talks by March next year and pursue a clean British departure from the EU, the political clock has started on Brexit Britain (https://www.ft.com/brexitbriefing). Looming ever larger over preparations is the risk of the UK taking a hard fall on exit day. If mishandled the bare necessities for cross-border business (http://next.ft.com/content/080280ae-8cac-11e6-8cb7-e7ada1d123b1) — permissions to operate, contract rights, customs privileges, residence permits for workers — are in danger of evaporating overnight. And there may be little warning over what replaces them.

Whether negligible or not, this is a doomsday risk that is too near and too costly for investors to avert their eyes. François Hollande, the French president, declared last week that there "must be a price" for Brexit. With no certainty over what that will be, it is fear of this worst-case scenario that is driving the dynamics of the world's most complex break-up talks — and forcing business into decisions (http://next.ft.com/content/94667d58-8b5c-11e6-8aa5-f79f5696c731)that may reshape Europe's economy.

A partial remedy would be a transitional deal. Senior Whitehall and EU officials see these arrangements as providing the regulatory foundations for Britain, potentially up to 2025. "Transition, transition, transition," says one senior European official who will be involved in Brexit talks. "It is crucial, in a way it [a transitional deal] is the most important immediate outcome of this divorce. But there is no guarantee of a deal, none at all."

This fear of an accident — and no deal — stems from the structure of formal Brexit talks. Under Article 50 of the EU treaties, the EU and UK must settle old bills and agree principles for future relations before the end of a preliminary two-year deadline. Left unsaid is that they will need to manage disruption before the switch to a full trade deal, which diplomats believe could be three to 10 years away.

How to fill that gap is not just a British preoccupation; it was the top priority raised by Michel Barnier (http://next.ft.com/content/403d2bda-53f5-11e6-9664-e0bdc13c3bef)on his first visit to Berlin as the European Commission's Brexit negotiator.

"There is not going to be some big-bang trade deal at the moment Britain leaves," says Andrew Hood, a former UK government lawyer now at Dechert. "There has to be a transition . . . and the City is saying it wants clarity on that early, ideally by the summer."

That may be impossible. Each part of the divorce is extraordinarily complicated. But what concerns those at the heart of preparations is how the various parts interact. Nothing may be agreed until it is all agreed. This means that at best it may be an eleventh-hour deal, and at worst a full breakdown with no transition arranged.

"A transition is unavoidable. It is a practical necessity," says **Pascal** Lamy, the former EU trade commissioner and World Trade Organisation director-general. "But it is impossible to imagine a transition without knowing where you are heading, the landing zone."

Paying the price for an exit

The negotiating tensions are plain. Britain will push for as much clarity and certainty as possible, while the EU27 — the remaining members — are calculating that their hand in trade talks will only strengthen post-Brexit. "A lot depends on the shared goal," says one senior eurozone official at the centre of the talks. "If the new relationship were to be a very low ambition agreement. I don't think the transition will be elaborate."

The Brexit minister David Davis, the foreign secretary Boris Johnson, and Liam Fox, the international trade secretary

Then there is the squabble over Britain's exit bill. Berlin, Paris and Brussels are planning to tie soft transition terms to the nitty gritty of divorce: the messy business of closing out hundreds of billions of euros in shared UK-EU liabilities and haggling over budget contributions. No exit terms, in other words, without paying the exit bill. While Margaret Thatcher demanded budget funds to stay in Europe, "now the UK wants to leave and pay nothing", Mr Hollande said. "It is not possible."

So while diplomats on both sides admit that the most economically rational course would be for the EU and UK to agree a transition early, politics is pushing hard in a different direction. “It is not possible to have clarity before the end of the [Article 50] process,” says one EU diplomat involved in talks.

For Germany the priority is the unity of the EU27, even at the cost of its economic and political ties with the UK. “If we have to choose, in the negotiations, between the EU27 and the UK, we will choose the EU27,” says a German official. Chancellor Angela Merkel has also hardened her position, telling business to expect no cosy side-deals to give Britain single market rights while ditching conditions, especially the free movement of labour. In Berlin, that goes for the transition as much as for any distant, final trade deal.

Rather than reducing uncertainty, the EU27 may find it hard to resist the temptation to use the two-year deadline in Article 50 to squeeze Britain.

“Life will keep on getting harder for Theresa May,” says another senior EU diplomat. “The EU27 calculate time is on their side, that she has nowhere else to go and will be desperate to avoid the cliff.” That in turn, says the negotiator, may strengthen the hand of hardliners in the UK pushing for a hard break.

For Britain, even securing a transition may be a mixed blessing. Some companies are interested in the arrangements mainly to keep moving costs down, as staff roll off contracts and leases expire. One head of regulation at a top European bank says: “We will not bet our business on political uncertainty. We have to prepare for the hard scenario. So there will be consequences. The longer the transition, the cheaper it will be for us to shift people and activities.”

There is one other peculiarity in the transition debate; it may not end up as a transition at all. The EU’s trading deals with Norway, Switzerland and Turkey are very different apart from one aspect: they were all conceived as temporary measures but have lasted for decades.

Brexit is going to be a slow, drawn-out process,” says Laurence Boone, Axa’s chief economist and a former adviser to Mr Hollande. “It is impossible to make a clean break overnight. They will call it a transition, but I can imagine this provisional agreement lasts a long time. We are good at that in Europe.”

Four transitional models: The accident

Timescale: an almost immediate exit

Leaders such as Francois Hollande, Angela Merkel and Jean-Claude Juncker will not want to damage the EU economy

The most extreme form of Brexit: no deal and an unfriendly parting; few transition arrangements in place; business done at best on World Trade Organisation rules. On the flipside, Britain would answer the demands of its referendum result by regaining full control of law and its borders, saving EU budget dues and being free to agree new trade deals.

To some Brexiters, this outcome is a viable prospect, not just a negotiating threat. At worst, exports of goods would be hit with tariffs and the status of cross-border companies and residents would be uncertain or subject to the whim of individual member states. Senior British politicians such as David Davis and Liam Fox, the ministers for Brexit and trade respectively, remain confident it would never happen and see the risks as overblown. They argue, that faced with a take-it-or-leave-it offer, Europe's leaders would realise that punishing Britain would hurt their own economies.

Legal advice to ministers has made clear that this course may not be in the gift of the EU27. Should Britain fall back on the WTO, the EU27 would have to apply its tariff rates under the WTO's "most favoured nation" rules.

This would also truncate the time both sides have to prepare. Overnight Britain would lose access to more than 30 EU agencies, some of whose functions would need to be replicated at home, including chemicals and medicines supervisors. Customs operations would need to be dramatically scaled up. "To imagine this can be done in two years is to believe in miracles," says one senior EU official.

The stakes are so high that EU27 nations think there is no choice for the UK but to reach a settlement. Yet no one rules out the possibility of an accident. "The UK has shot itself in the foot and all the rationality has disappeared," says a senior EU diplomat. "If we end up in a political dynamic that could provoke an accident, I would not be surprised."

The status quo prolonged

Timescale: one to three years

The financial services industry could find it unpalatable to stick to rules over which it has no control © FT montage

Technically the simplest transition to arrange; a full runway for Brexit Britain. While no longer an EU member, Britain retains most of its economic rights for a limited period, perhaps between one and three years after the exit via Article 50 is completed. Its relative simplicity makes early agreement more feasible, providing certainty to business.

Some Brexiters advocate joining the European Economic Area, which allows non-EU countries such as Norway to be part of the single market as long as it accepts free movement, sets common rules and pays budget dues. But there is little appetite for that arrangement in Brussels, Paris and Berlin. Using the current legal model — or adapting it — is seen as too politically and legally cumbersome for a temporary deal.

“It is not worth the effort,” says one senior French official. Adds a senior Whitehall official: “For political reasons this will never be the antechamber for Brexit.”

More likely is a special extension of the status quo. Business would want a long period; politics may not wait. The EU side, particularly the European Parliament, will want a cut-off date, in part to maintain enough uncertainty so businesses relocate. That deadline would also fit Mr Davis ’s plan for Britain to maintain most of the EU “acquis” of law right up to Brexit day. But the British side will chafe at the constraints the longer the full transition lasts. Could Mrs May explain to voters at the 2020 election that the UK had left the EU but was still covered by its most important laws, paying its bills and following its court rulings?

Mirroring the EU on financial services regulation would be particularly hard. “Running a leading global financial centre and a massive banking system with a set of rules over which you have no influence is not something you would easily choose to do,” Sam Woods, the Bank of England’s top regulator, told a parliamentary committee in July.

The glide path

Timescale: into the mid-2020s

Plans for a 'long runway to Brexit' requested by bankers could be scuppered by the European Parliament © FT montage; Reuters

This would provide a more elaborate, complex transition. Some access rights to the single market are tapered, while other operating rights are prolonged through bespoke agreements. The aim would be a glide path to a trade deal that sees UK-EU relations gradually diverge. This is politically attractive for a British government keen to assert sovereignty.

For complex, regulated services — like banks — this would result in a legal tangle of arrangements. Some EU laws provide for equivalence, including directives and regulations underpinning wholesale markets. But "it is still not wide enough to support a full investment banking model", says Andrew Procter of Herbert Smith Freehills, the law firm. This means bilateral agreements would be necessary too. For instance national permissions are needed for banks to take deposits, guarantee loans or offer trade finance and a full range of retail services.

"The longer the timeframe the better," says Mark Boleat, head of policy at the City of London Corporation. "Moving locations takes a long time, so businesses are having to take decisions [now]. Without a transition, in three years' time they may say we did not need to do it."

The hitch is the complexity. The more intricate the glide path, the closer it comes to a full trade deal, which is agreed under different voting rules than those that covered the divorce.

But member states and the European Parliament would be loath to see their rights to pass judgment on trade deals given up, so.finding a middle ground will be hard, particularly on services.

Even if terms are agreed, businesses would still live with significant uncertainty; any move by Britain to diverge from EU law would jeopardise market access through the transition.

The basics

Timescale: into the mid-2020s

A very basic Brexit transition would include some kind of safety net for exporters © FT montage; PA

A rudimentary safety net for goods exporters and possibly some services. This provides a more minimal transition but gives the UK greater independence.

Negotiators on both sides agree that it is senseless to raise tariffs against one another only to scrap them when a trade deal is later completed. For trade in goods, this could be achieved by a zero-tariff transitionary agreement. Another option is a deal to remain in the customs union for a set period, giving London time to negotiate new trade pacts that would come into force on the day it leaves the EU's trade bloc.

There are two possible problems. The first is at the WTO. Diplomats warn a "quick and dirty" transitional agreement on tariffs may not pass its requirement for trade pacts to cover "substantially" all trade.

If the customs union is extended it is legally more sound, but it may cramp Britain's ability to negotiate new arrangements outside the EU.

For services — in which Britain generates a £21.4bn trade surplus with the EU — the disruption would be greater. These regulatory arrangements are more complex to negotiate and may be impossible to agree. A transition of some sort would probably be inevitable, if only to give regulators more time to handle the additional workload. For major financial services firms, for instance, it can take regulators up to two years to vet an application for operating rights. The European Central Bank is already warning business that it may be overwhelmed; UK regulators would face similar pressures.

A workaround may be needed, but it may be minimal at first. A full free-trade deal could improve access arrangements.
