Brexit Quick Brief #6

Time to adapt - the need for transitional arrangements

Key points

- Brexit will inevitably bring with it changes to the way goods and services are traded between the UK and the continuing Member States of the EU (EU27). If these changes happen suddenly, there is a serious risk of disruption to businesses and their customers.
- Transitional arrangements are key to ensuring an orderly and non-disruptive exit from the EU and will help avoid damaging cliff edge effects at the point of exit when existing rights and obligations may disappear overnight. This BQB provides illustrative examples of how disruptive and damaging this could be for national economies and business stability. Both the UK and the EU27 have an interest in this transition being orderly.
- Transitional arrangements should provide for a transition period with two phases. The first is needed to bridge the gap between the UK exit from the EU and a new partnership between the UK and the EU. The second is needed to create the time required by users, providers and market infrastructure to adapt to the new framework once it is determined.
- The timely agreement of suitable transitional arrangements by the EU and the UK would minimise unnecessary disruption and reduce the risk of businesses making precipitous, costly – and potentially premature – decisions about the structure of their operations and their dealings with customers, suppliers or other cross-border relationships.
- Transitional arrangements should address the requirements of both the UK and the EU. They should not act as a delay on fulfilling the commitment of the UK Government to exit the EU or be seen as a mechanism for 'cherry-picking' by the UK in relation to the EU. Nor should they act as an unnecessary check on moving to a new long term framework. Their purpose is to facilitate orderly change and to provide businesses with the time to adapt to the new partnership. Transitional arrangements should be comprehensive, non-disruptive – and temporary.

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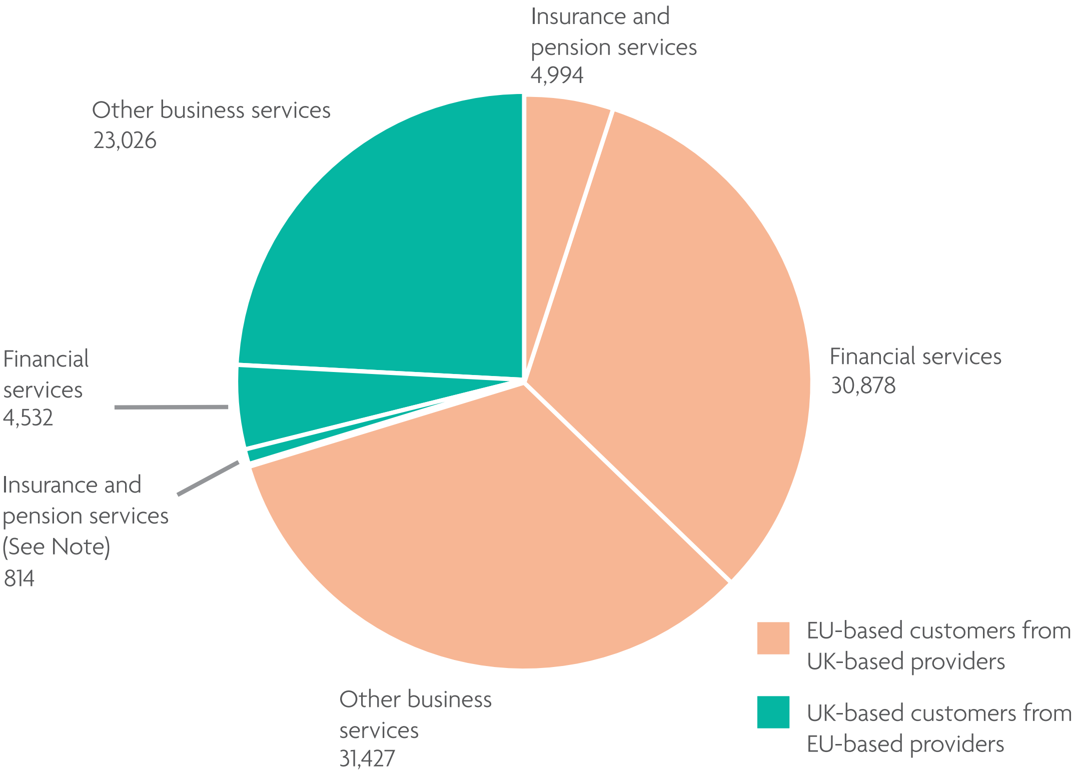
The EU market in financial services today

The UK and the EU27 currently make up a single marketplace for many financial and related services. In 2015 it is estimated around €41 billion of financial and insurance-related services[1] were bought and sold between firms in the two markets. The largest part of this commercial activity represents services sold by British, European, US and other international businesses located in the UK to customers across the rest of the EU. Indeed, for every one euro spent by UK firms with an EU-based financial services company, EU businesses spend more than six euros purchasing financial services from UK-based financial services companies. Each of these transaction represents a business need met by a provider of a service in the other market. These services cover the full range of banking and other financial services and represent by far the largest segment of the current EU market for such services.

The EU27 – UK cross-border marketplace for financial and related services 2015 (€ in millions)



Source: UK ONS, converted to euros at 2015 average spot price of €1.377/£.

Note: 2014 data for sales of EU-based insurance and pension services in the UK.

Why are transitional arrangements needed

The UK's transition from being an EU Member State to a new partnership with the EU27 will inevitably bring with it changes to the way goods and services are traded between the UK and the EU27. While businesses on both sides are beginning to anticipate and plan for change, the scope and nature of these changes are as yet unclear. They could range from a moderate disruption to a significant reduction in current rights and freedoms. This issue goes far beyond banking and impacts any business that sells goods or services between the UK and the EU.

This uncertainty is increased by the fact that the UK is legally required to exit the EU at the end of the two year Article 50 period. The negotiation of a new future relationship is a separate process from the Article 50 negotiation. At present there is no indication that a new long term agreement on trade and services will be in place at the point of exit. The complexities of agreeing, ratifying and declaring unconditional such a long term agreement would in any case make this extremely challenging.

This means that businesses in the UK and the EU face three key unknowns:

1. what a future relationship between the EU and the UK might look like;
2. when that arrangement might be in place; and
3. what might happen in the period between the end of the current EU framework for the UK and a possible future framework.

All of these unknowns make transitional arrangements vital.

[1] Services classified as financial, insurance or pension-related in UK ONS classifications. It should be noted that many services classified as business services in these classifications are closely integrated with the supply of financial, pension and insurance services. Businesses based in the UK and in the rest of the EU traded almost €55bn of such business services in 2015.

How to avoid the cliff edge effect

The most important role that transitional arrangements would play is in avoiding a damaging cliff edge effect at the point of the UK exit from the EU.

Transitional arrangements would allow changes to be managed transparently, soundly and without leading to market disruption and unintended consequences for the real economy.

For businesses and their customers, the most important role that transitional arrangements would play is in avoiding a damaging cliff edge effect at the point of UK exit from the EU in which the legal basis for trade between the UK and the EU27 disappears overnight. The cliff edge effect could result from a sudden re-imposition of tariffs on trade that is currently tariff-free, or the sudden loss of the legal right to provide a service.

In banking and financial services, the cliff edge effect could result in important services to customers being disrupted or left uncertain. Existing contracts / agreements could be subject to legal uncertainty with the potential for contracts to become unenforceable. This disruption goes across different areas including commercial lending, trade finance, sovereign debt, capital markets, derivatives and payment services, where the UK is a substantial provider to the wider EU economy.

The provision of such services cannot necessarily be quickly adapted by either business or their customers without risk of unwanted disruption. If that adaptation ultimately requires revising existing branch structures, seeking new licenses and establishing, capitalising and funding new structures these all take time and careful planning. They may also require changes to supervisory approaches in some EU states.

Transitional arrangements would allow these changes to be managed transparently, soundly and without leading to market disruption and unintended consequences for the real economy. They would allow businesses, their customers and their regulators time to adapt to, and settle into, a new framework. They would also reduce the risk of businesses making precipitous, costly – and potentially premature – decisions about the structures of their operations and their dealings with customers, suppliers or other cross-border relationships.

Box 1: Sudden stops: Financial services - An EU manufacturing company looking to finance a new factory

A rapidly-growing European manufacturing company plans to grow its business in Asia and wishes to build a new factory in the region. The European manufacturing company therefore turns to its relationship bank in the UK as a single and efficient source for its financing needs (see BQB #3: What is 'passporting' and why does it matter?).

Underpinning all these services are the UK-based bank's current rights to serve clients in the EU from the UK – its so-called 'passporting rights'. Although the services appear as an integrated and efficient 'one-stop solution' to the European manufacturing company, the bank draws on at least two different EU financial services 'passports', and a range of other EU frameworks.

For the European manufacturing company the benefit of access via a single relationship bank to services required to meet its financing needs and to the deepest pools of capital in Europe is considerable. The disruption to its financing arrangements and the additional cost and effort required to replace these if lost overnight or with little warning is significant. Such services might be preserved by the UK-based bank relocating the relevant parts of its business into the EU – although this would take time and may not happen.

Status quo

European manufacturing company needs to finance investment in Asia.

UK-based relationship bank provides integrated service including corporate finance advice, lending, capital markets fund-raising, risk management and foreign currency services.

Delivery of banking services to European company relies on passporting under CRD IV and MiFID.

Cliff edge 2019?

Loss of passporting rights means the UK-based relationship bank is severely restricted in providing these services to the EU company without relocation into the EU.

Future framework?

Possible new EU-UK bilateral arrangements for cross-border provision of certain services?

Possible EU recognition of UK market infrastructure?

Possible EU-UK mutual recognition of certain financial products or other standards?

An alternative for the company may be to turn to a more fragmented and costly solution by working with a range of different correspondent and specialist EU based banks, although this would not avoid the risk of disruption and expense around the initial restructuring of its existing financing arrangements at the time of the sudden stop. The solutions available to the European manufacturing company to protect its access to financial products and services are illustrated below.

If access to the financial services provided from the UK is disrupted in circumstances where there are no transitional arrangements or other mechanisms to permit orderly service continuity, then the European manufacturing company is likely to experience administrative and operational consequences. The business may also be subject to restructuring and replacement costs, taxes and other charges that could be significant, and may experience a diminished product and services offering at higher cost.

Steps the European manufacturing company can take to protect its access to financial products and services.

Identify new EU27-based bank relationships.

UK-based bank

Restructure or replace existing products and services to preserve continuity.

Price

Product choice

Liquidity/capacity

Manage the risk of higher costs and more limited service capacity in short to medium term.

Europa SA's to establish their own treasury function in the UK.

Transitional arrangements would ensure that unnecessary disruption to these products services did not take place. They would also mean that where disruption was unavoidable, banks would have time to adapt to continue serving clients, or customers have time to make reliable alternative arrangements.

Box 2: Sudden stops: Industrial services - The EU automotive sector

The EU is not just a large market for cars – it is a single factory floor for automotive production. A car manufacturer will routinely use components sourced in one EU country to build engines in another before moving them to another to be placed in a finished vehicle. That vehicle is then sold across the EU or exported around the world.

The UK automotive industry is tightly embedded in this supply chain. Depending on the UK manufacturer, between 20% and 50% of car components used in the UK are sourced from across the EU. Similarly, an EU manufacturer will frequently source a material percentage of its car components from the UK.[2]

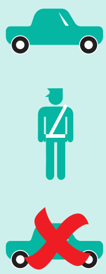
Status quo

EU - made engine imported and placed in UK - made car for re-export to EU - tariff free.

Efficient customs processing as part of the Customs Union.

UK - made vehicle meets EU conformity standards.

Cliff edge 2019?



New tariffs on all components, engine and finished cars?

Additional customs processing?

Loss of EU vehicle conformity status?

Future framework?

EU - UK Free Trade Agreement - elimination of industrial tariffs.

EU - UK trade facilitation agreement - simplified customs procedures.

Mutual recognition of EU / UK vehicle standards.

A UK exit from the EU poses serious risks to this dense network of production and supply.

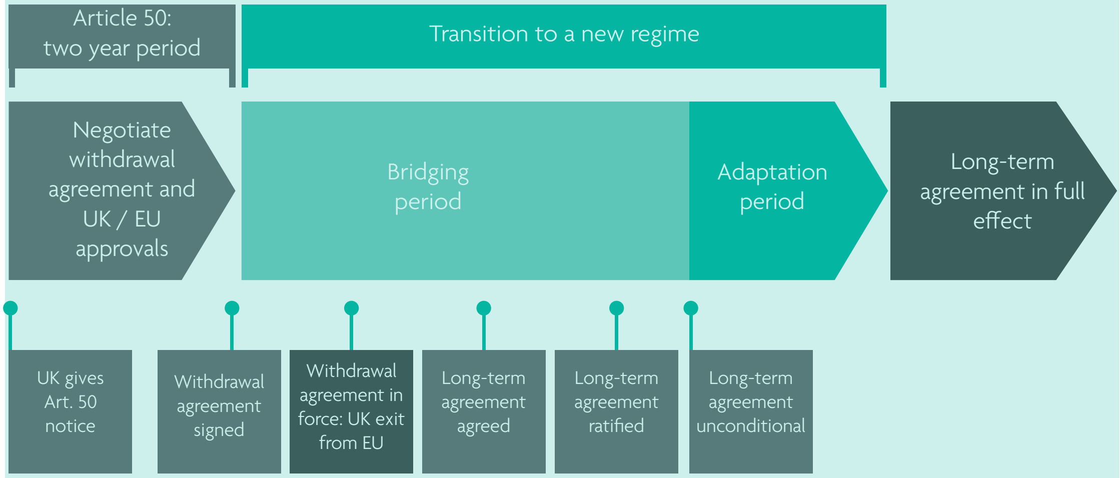
- Every leg of this supply chain that crosses the English channel in either direction is potentially subject to a new tariff – from a few percentage points for components, to almost 5% for engines and a full 10% tariff for finished vehicles.
- All of this EU-UK trade will be subject for the first time in four decades to customs processing at the point of import and export to and from the UK. This means new documentation, new processing and new processing fees, potential physical checks and delays. This presents a huge adaptation problem not just for the automotive sector but for all sectors. Manufacturers dependent on just-in-time processing may find themselves having to stockpile and hold larger inventories – with implications for working capital and other costs.
- The European networks of production are built on a single system of safety conformity standards – so a car authorised for the market in Germany needs no further authorisation in the UK. Unless or until the EU and the UK agree to recognise each others' vehicle conformity standards, carmakers may have to begin duplicating testing and approval systems in both markets from the day of exit.

For all of these reasons, a sudden change for European carmakers has the potential to be highly disruptive to an ecosystem of production that matters a lot for both sides. Transitional arrangements are one way to minimise these impacts – and give companies like this carmaker and their customers time to adapt to change.

[2] Source: ACEA 2016 and SMMT 2014.

How to approach transition

Transitional arrangements should have a transitional period designed to make the transition of the UK out of the EU as orderly as possible. Such arrangements should be comprehensive, non-disruptive – and temporary.



Transitional arrangements should be comprehensive, non-disruptive – and temporary.

Transitional arrangements should act neither as a delay on fulfilling the commitment of the UK Government to exit the EU nor should they be seen as a mechanism for 'cherry-picking' by the UK in relation to the EU. Their purpose is orderly change.

Transitional arrangements should provide for a transitional period comprising two distinctive periods:

A bridging period. This period would cover the period from the date the UK exits the EU after the withdrawal agreement is reached to the agreement of a new partnership framework. This would minimise unnecessary disruption of services during the negotiation of a new partnership between the EU and the UK. Such a period would ideally temporarily preserve existing trading conditions – perhaps subject to specified exceptions – until the point at which a future agreement is agreed.

An adaptation or implementation period. This period would be designed specifically to allow businesses and their customers to adapt and, if required, to restructure to conform with a new framework agreed between the EU and the UK. Alternatively, such a period could also provide a cushion for adjusting to the complete absence of such an agreement. Such a period would be designed mainly to provide time for businesses, their customers and regulators to prepare for a new regime, to anticipate the pressures of restructuring and to react to teething issues.

The scope, substance and basis of transitional arrangements

Transitional arrangements inevitably raise legal, practical and political questions. These will require both the EU and the UK to establish a clear shared interest in making the transition of the UK out of the EU an orderly one. Transitional arrangements should act neither as a delay on fulfilling the commitment of the UK Government to exit the EU nor should they be seen as a mechanism for 'cherry-picking' by the UK in relation to the EU. Their purpose is orderly change.

Negotiating and embedding transitional arrangements in a withdrawal agreement between the UK and the EU would give both sides a greater degree of visibility and certainty for planning for the future.

By making them an integral part of managing the exit of the UK from the EU, the two sides can also put them on a sound footing in a way that is compatible with their international obligations under World Trade Organisation rules.

Box 3: What might transitional arrangements cover?

There are important questions to answer about what a transitional arrangement should cover. To minimise unnecessary disruption and complexity and reduce the scope for unintended consequences, the following elements are preferable:

A transitional arrangement should cover both new and existing businesses and new and existing activity. In addition to avoiding the creation of legal uncertainty, contracts entered into should remain valid and enforceable beyond the transitional period. This will avoid the chilling of valuable economic activity and healthy competition and ensure that businesses can continue to serve customers.

The scope of activity and obligations covered by a transitional period should be based on a 'negative list' – meaning that it would permit the continuation of any activity and obligation that is not explicitly excluded. The Great Repeal Bill, which converts existing EU law into domestic UK law, will work on a similar basis.

An adaptation period should clearly include scope for authorities to assist firms in 'pre-emptive' conformity such as applying for licenses to operate before new operating conditions formally enter into force. They should also make explicit allowance for the need to flexibility in anticipating and adapting to unforeseen issues as a new regime beds down.

Adequate dispute resolution mechanisms will be required during the transition period and under the new partnership to provide protection to users, providers and market infrastructure. This could involve the use of a designated independent forum akin to the EFTA (European Free Trade Association) court.

See also

BQB # 1 Staying in or leaving the EU Single Market.
BQB # 2 An orderly exit from the EU.
BQB # 3 What is 'passporting' and why does it matter?
BQB # 4 What is equivalence and how does it work?
BQB # 5 Data protection and transfer.
BQB # 7 The Repeal Bill explained.
BQB # 8 External trade policy and a UK exit from the EU - clarifying the UK's WTO profile and beyond.