Brexit Quick Brief #2

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An orderly exit from the EU

BBA Brexit Quick Briefs are a series of short papers intended to inform readers about key commercial, regulatory and political considerations around Brexit. While they are focused on banking, many of the issues discussed have wider relevance. Each BQB may be read on its own or in conjunction with other papers in the series. It is intended to expand the series as further topics of significance are identified. Further information is available at www.bba.org.uk.

Key points

- The process for a Member State to exit the European Union is set out in Article 50 of the Treaty on European Union.
- Article 50 directs that a Member State wishing to exit the EU should have two years to negotiate a withdrawal agreement with the other states of the union. However there is no precedent for such a withdrawal negotiation and no authoritative definition of what it should cover.
- A number of key questions about the Article 50 process remain to be resolved between the UK and the EU27. In particular, the question of how and when the future market access framework for the UK and the EU27 can be agreed. Agreeing this as part of the wider Article 50 negotiations will be particularly important for an orderly transition from the position of the UK inside the EU to the new relationship between the UK and the EU following the UK's departure from the EU.

The withdrawal process under Article 50

No state has ever chosen to exit the European Union or its legal predecessors. Although the EU treaties do foresee the possibility of an EU Member State deciding to exit the EU, the process established for this has never been used.

The exit process from the EU is set down in Article 50 of the Treaty on European Union (TEU). This article specifies that a state wishing to exit the EU shall notify the European Council of its intention to withdraw. From this date it will have two years to agree the terms of its withdrawal with the other states of the EU. If such an agreement is not reached after two years, the European treaties shall cease to apply to the exiting state and it shall be deemed formally to have left the EU.

However, there is no precedent for such a withdrawal negotiation, and no authoritative definition of what it should cover. Moreover, the terms of Article 50 provide only limited guidance as to how this process should be conducted.

Article 50 offers some guidance on:

- Timing: It says that the two year process can be *extended by unanimous agreement* of the EU states and the exiting state.
- Agreement: It states that the *withdrawal agreement should be agreed by a qualified majority* of the remaining EU Member States after obtaining the consent of the European Parliament.
- The future: It says that the withdrawal negotiations should be conducted "taking account of the framework for its future relationship" of relations between the EU and the exiting state. However, it also states that this future relationship should be defined and agreed under the terms of Article 218 of the Treaty on the Functioning of the European Union, which deals with the EU's relations with third countries. This is generally taken to imply that the EU and the UK could only agree a Free Trade Agreement (FTA) or similar bilateral agreement on future relations once the UK has become a third country upon formal exit from the EU.

An orderly exit process

What is to be covered by a withdrawal Agreement and how the withdrawal agreement is linked to a future agreement on the long term economic and political relations between the EU and the UK are important questions. Ideally these questions need to be answered early in the exit negotiation, if not before that negotiation has commenced.

A particular risk to an orderly transition is posed by the question of how the EU and the UK might sequence the exit process and the entry into force of any future agreement between the two sides on trade between the two markets. Insisting rigidly that such an agreement can only be negotiated once the UK has left the EU could result in the temporary imposition of tariffs or other restrictions and prohibitions on trade between the EU and the UK (which is currently free of duties or other trade barriers) during any 'gap' period between the departure of the UK from the EU at the end of the Article 50 period, and the coming into effect at a future date of any negotiated new arrangements between the UK and the EU.

Ideally these important questions need to be answered early in the exit negotiation, if not before that negotiation has commenced.

Avoiding such an outcome is in the economic interest of both sides and beneficial to business and customers. The risks from a 'cliff effect', where tariffs and trade barriers are suddenly imposed for a period of time until new arrangements between the UK and the EU can be formalised, and the consequent negative effects on trade, jobs and market stability in both the UK and the EU27 could be very severe.

Box 1: Business and customers and the risk of temporary trade disruption

For any business that trades between the EU and the UK the process implied by Article 50 implies a serious risk of disruption to their operations. If Article 50 is interpreted to require that a state must exit the EU before it can agree a bilateral trade agreement with the remaining EU states, then this raises the important question of what happens to trade between the two markets in the interim period. At present, under the terms of the EU single market this trade is free of tariffs and most other restrictions. In principle, if the EU and the UK revert to treating each other as ordinary members of the World Trade Organisation (WTO), they would be obliged to impose their standard tariffs (where they apply) on this trade until such time as they agree a free trade agreement or other bilateral agreement that covers trade.

This could potentially result in a costly tariff bill on billions of pounds of imports in both directions. This would impact both sides: around a tenth of EU exports are to the UK and around half of the UK's exports are to the states of the EU.

Many UK and EU manufacturers currently import semi-finished goods from the other country, transform them into finished goods and then trade them back in the other direction. For example:

- A UK-based fashion manufacturer imports high-quality leather or textiles from Italy or Spain before re-exporting them as a finished coat, handbag or suit to the EU.
- A UK confectioner imports sugar or milk from France, before re-exporting them to the EU as chocolate or other sweets.
- A UK manufacturer exports precision engineered car parts to the EU, before importing them back into the UK in a finished vehicle.

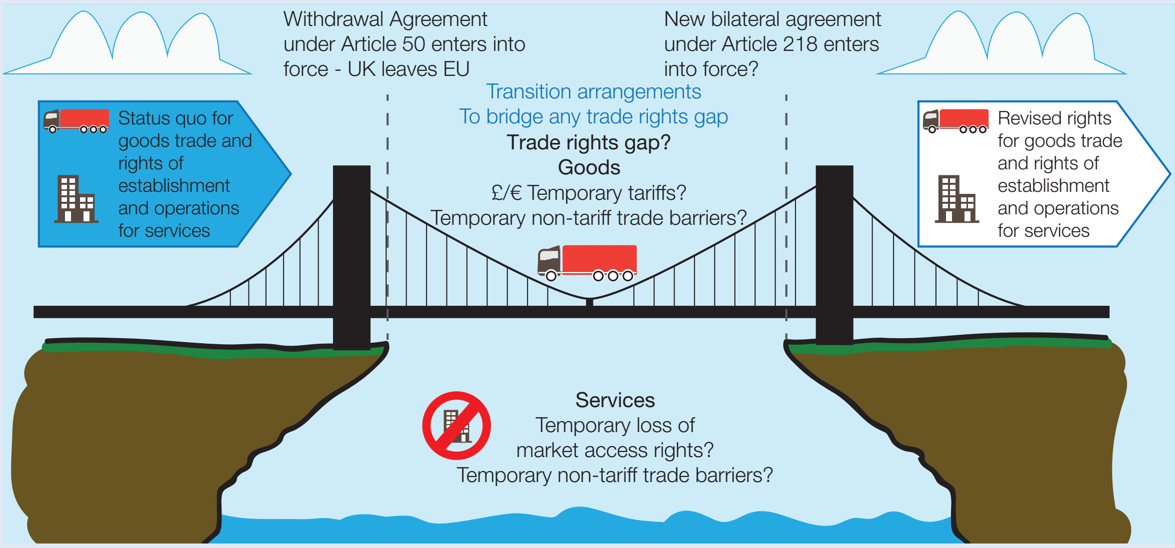
Given the current tariffs of the UK and the EU, all of this trade is potentially exposed to new tariffs if the EU and the UK revert to levying duties on their trade with each other. In addition, the imposition of non-tariff barriers (such as customs documentation, conformance certification and other burdensome administrative procedures), will often have even more significant negative effects upon trade. In all cases it is manufacturers and customers on both sides who face higher costs, and reduced competitiveness.

The risks for trade in services are arguably even greater, if the EU and the UK have not confirmed the rights of businesses on both sides in a new agreement. This is because the rights that the EU and the UK extend to non-EU states in these areas are more restrictive than the rights provided by the single market. This is also true for banking services. And unlike tariff and non-tariff barriers for goods, which result in greater costs and other inefficiencies, services barriers can often result in an outright prohibition on the provision of certain services to a market. Once again, it is service providers and their customers in the UK and the EU who face higher costs, reduced competitiveness, and the reduction in services offerings.

Because of the scale of the impact on trade in goods and services in the UK and EU, the risk of disruption and instability in markets, economies, jobs and growth would be substantial.

The risk of such a disruption can best be avoided by agreeing to negotiate a future trade agreement between the two sides in parallel to a withdrawal agreement, and also ensuring that transitional arrangements are agreed to bridge the period between the point of exit for the UK and the entry into force of a new EU-UK bilateral agreement.

Transition arrangements will help provide service continuity and ensure market stability



Two steps to minimising disruption

To mitigate the impact on trade, the EU and the UK could take two practical steps.

The first is to negotiate a future trade agreement alongside a withdrawal agreement in some way. Even if it is not possible to conclude and ratify a longer term market access framework for the EU and the UK until the UK has formally left the EU, there is no compelling legal or political reason why the informal negotiation of such a bilateral arrangement could not be done in parallel with negotiations on a withdrawal agreement. It is highly welcome that both sides agree to some potential scope for parallel discussions in this respect, provided the necessary terms are met. The aim should be to be in a position to sign, ratify and bring into effect a bilateral treaty cementing future market access and other arrangements between the two sides as soon as possible after the UK has formally left the EU – and ideally simultaneously. Ensuring an overlap in the two processes of this kind would help ensure the shortest possible delay in the establishment of a new stable trading framework for businesses on both sides (see Box 1: Business and customers and the risk of temporary trade disruption).

> The aim should be to be in a position to sign and ratify a bilateral treaty cementing future market access and other arrangements between the two sides as soon as possible after the UK has formally left the EU.

The second is to agree transitional arrangements. Whatever model the UK and the EU ultimately agree for their future relationship there will be a case for transitional arrangements. The case will apply across most sectors and on both sides of the exit negotiation. The two years mandated by Article 50 will almost certainly not provide sufficient time for many businesses or their regulators to adapt to changed terms of trade between the EU and the UK. This will especially be the case for businesses in sectors where changes in practice or service delivery are highly regulated or require complex adaptation – such as banking, the automotive or aerospace industries or other similar sectors. And even more so if the EU and the UK are unable to agree to maintain many of the current freedoms for commerce between the two markets, requiring more material alterations to be put in place.

This change could require the restructuring of supply chains, changes to distribution networks and reauthorisation of operations that have fallen out of the scope of an EU framework such as the passporting regime. These are very substantial adjustments for a business to make, and the time required and complexity involved should not be under-estimated. Even in a 'hard exit' in which the EU and the UK cannot (or choose not to) agree any future preferential terms for trade and market access, there would be substantial value in providing additional time after the point of exit for companies and their customers to adapt. Indeed, because a hard exit is likely to be most disruptive, it will be especially important to provide additional time for adaptation.

In practice, the two-year process mandated by Article 50 provides the UK with vital time to prepare for exit.

In a scenario where the EU and the UK are working on putting in place a bilateral agreement defining a future trading arrangement, a transitional arrangement will be equally important. Because it is very unlikely that such a future framework can be in place at the point of exit – given the two-year framework, the necessary scope of negotiations and the time-consuming requirements of ratification by the UK and each of the EU 27 states -- a bridge will be required between current arrangements and those created by a future bilateral arrangement. In these circumstances a transition period will be a vital way of avoiding a disruptive gap between the old and new frameworks.

It is also welcome that both sides agree in principle that transitional arrangements are important. The form that any transitional arrangements or framework might take will be subject to negotiation between the EU and the UK. A number of different approaches could be used. For example, the transitional period might 'grandfather' current trading rights and tariff-free trade for a defined period of time in some or all areas. It may involve linked obligations for the same period. As a technical matter, albeit an important one, because World Trade Organisation rules restrict the granting of preferential trading terms between WTO members outside of WTO-compatible agreements, it would need to be clearly linked to the UK's transition out of the EU or to a future bilateral agreement - and temporary in application.

Box 2: Transitional arrangements and orderly change

The need for transitional arrangements to manage the practical implications of a UK exit from the EU will apply across many sectors and businesses, irrespective of the outcome of an EU-UK negotiation. The more disruptive the break from current trading rights, the greater the need will be.

For-example, a UK or EEA bank based in the UK and facing the loss of passporting rights into the EU will face important decisions on how – or if – to maintain the services it currently provides to EU customers under that passport. In many cases under current arrangements this is only possible by establishing a licensed operation inside the EU. If it is economic to do so, the bank may opt to do this in order to ensure that it can provide services currently provided from the UK from an authorised entity inside the EU.

However, this is not simple. It can require new licenses or material revisions to existing licences, the hiring and training of staff, the implementation of new IT systems and is likely to mean new capital or other regulatory requirements. It may require contracting and serving customers from a new location. It may require changes to existing businesses inside the EU, or even the creation of new ones.

A smooth transition for this bank and its customers will almost certainly require more than the maximum two years implied by the Article 50 process. The bank's regulators may also need additional time to manage the process of replacing current passporting rights with new licenses and new authorisations. Where the bank is providing sophisticated services the regulatory authorisation will often require the review and approval of financial models and this is typically an especially complex and time consuming element. The bank, its customers and its regulator will all have a clear interest in transitional arrangements to allow for time to restructure operations and not disrupt the supply of funding to the real economy.

Box 3: Migrating financial services involves a complex mix of activities

Activity	Considerations
Location	• Real estate availability and capacity • Lease negotiations
Operational design	• IT design and implementation • Internal processes and support functions
Regulatory application	• Preparation of application / approval period • Legal / tax / accounting considerations
Supervision	• Experience of regulators / relationship with local / central government • Approval of business processes, especially ‘financial model’ approvals
Documentation	• Transferring documentation • Amending existing contracts
Human resources	• Relocating existing staff • Recruitment and training of skilled staff
Business migration	• Testing of systems, processes and procedures • Lift and shift of operations
Client transition	• Educating clients and customers • Re-documentation of existing relationships

Could the UK simply walk out of the EU?

The complexities of the Article 50 process have encouraged some in the UK to suggest that the UK could simply expedite an exit of the EU by unilaterally withdrawing from the EU treaties by way of the repeal of the UK’s European Communities Act. This is the legislation that establishes the place of EU law in that of the UK.

> Ideally these important questions need to be answered early in the exit negotiation, if not before that negotiation has commenced.

While such a course of action is possible in principle, in practice it would represent a major breach of the UK’s long standing commitment to honouring its legal commitments and international law. If it prompted the EU to declare that the UK had left the EU – which is not legally clear - the UK would have left without the protections of a withdrawal agreement and without any action to reduce the costs and systemic and economic risks of disruption for both the UK and the EU that come with exit. It would have no guarantee of a future bilateral treaty on trade arrangements and would risk damaging goodwill on the part of the other states of the EU that will be important for future agreement. Such a course of action is highly inadvisable.

In practice, the two-year process mandated by Article 50 provides the UK with vital time to prepare for exit. The UK has a wide range of practical changes that need to be implemented if an exit from the EU is to be orderly. These include, for example, a range of domestic legislative changes and the development of UK rules and practice in areas currently covered by EU law, such as rearranging EU subsidies for businesses in the UK and frameworks in many areas for recognising the rights of other countries in the UK market. In addition, the UK will need to establish its own tariff and market access profile with the other members of the WTO, which it must do before it can start agreeing trade deals with other countries. Many of these practical changes will benefit from the goodwill of the EU and a clear sense of the UK's commitment to an orderly transition.

In practice, the two-year process mandated by Article 50 provides the UK with vital time to prepare for exit.

The priority for the Article 50 process should be for an orderly transition for the businesses and customers that depend on banking services provided between the UK and the EU, and on the goods and services provided by the many other UK industries and sectors that will be similarly affected. To achieve this, the EU and the UK should agree early on the value of parallel negotiations, transitional arrangements and making maximum use of the flexibilities provided for by Article 50.

See also:

BQB # 1 Staying in or leaving the EU Single Market
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 # 6 Time to adapt – the need for transitional arrangements