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CAPITAL & ECONOMICS

What Does Brexit's Article 50 Mean For Business?

OVERVIEW

Following a nationwide referendum on 23 June, 2016, the United Kingdom is about to begin its formal withdrawal from the EU (known as Brexit) by triggering Article 50 of The Treaty on European Union.

The final terms of the UK's new relationship with the EU following its withdrawal are yet to be decided, although there has been some indication of the UK government's intentions – signaled in recent speeches by Prime Minister Theresa May, and the government's white paper "The United Kingdom's exit from and new partnership with the European Union," was published in February 2017.

With uncertainty continuing, businesses operating in or trading with companies based in the UK and EU are keen to learn how they may be affected. The key issues likely to impact businesses center on the EU's Four Freedoms: the free movement of goods, labor, services and capital within the bloc.

IN DEPTH

Establishing the Four Freedoms across the EU's (current) 28 members has created the world's largest economy and Single Market.

In outlining the UK government's post-Brexit vision, Prime Minister May has made clear she wishes to take the UK out of the EU Single Market, while simultaneously expressing a desire to pursue the "freest possible trade" deal with the EU after Brexit.

"The Four Freedoms have been paramount to the strategic profile of many organizations, and Brexit will represent a major shift in that regard." – David Molony, Risk Finance Consultant, Aon Global Risk Consulting. This means the UK's withdrawal from the EU – now partially defined in the UK government's February 2017 white paper – has potential implications for businesses relating to each of the Four Freedoms.

Free Movement Of Goods

The free movement of goods currently enables tariff-free trade between the UK and the EU.

With the UK exporting goods worth £12.1 billion to the EU in the month of December 2016, this is an important issue for businesses who will closely watch the upcoming negotiations. Equally, as the UK imports goods from the EU worth £19.8 billion in the same month (and the EU enjoys a regular trade surplus with the UK in goods), a mutually beneficial deal will also be desirable for the EU. If no agreement is reached, the UK would likely have to fall back on the rules and tariffs stipulated by the World Trade Organization (WTO) under which other non-European nations already trade into the Single Market.

The nature of the UK's trading relationship with the EU affects all UK businesses exporting to and importing from the Single Market – from car manufacturers to dairy farmers. Manufacturers in particular will see implications around supply chain risk, with the UK importing €6.8 billion of items from German engineering firms in 2014.

The UK government has signaled it is in favor of a new free trade agreement with the EU in some form, although it is not possible to say what shape this will take at this stage. The EU's position is even harder to predict, given the divergent interests of individual Member States remaining in the EU.

Free Movement Of Labor

The principle of free movement of labor allows workers from other EU nations to settle and work in the UK without any restrictions.

In 2016, it was estimated that 6.8 percent of the UK workforce was made up of citizens from other EU countries. This varies considerably from industry to industry, with manufacturing, wholesale and retail, health and social work, and hotels and restaurants among the sectors with the largest proportions of EU workers.

The UK government's Brexit white paper makes clear its desire to control immigration, stating: "We will have control over the number of EU nationals coming to the UK." This is the firmest and clearest position taken by Theresa May's government and would be incompatible with free movement of people in its current form.

With Article 50 starting a two year countdown to Britain leaving the EU, the employment and residency rights of EU workers currently in the UK (and of British workers in other parts of the EU) are a significant concern. All other candidates seeking to win the leadership of the Conservative Party undertook to protect the existing rights of EU workers already present in the UK, but Theresa May did not. Her defenders suggest that it would be wrong to do so whilst the fate of UK nationals in the EU remains unknown.

The movement of labor has implications for the availability and quantity of talent in the British workforce, as well as the ability of British businesses to attract European talent. Even if an arrangement is reached, uncertainty is reportedly already causing labor supply concerns, with 27 percent of UK employers believing they could lose staff who are EU nationals this year. Uncertainty over free movement of labor may also restrict the ability of businesses operating across the EU to make strategic personnel allocation decisions.

Free Movement Of Services

While there is not a complete single market for services, the current EU approach does establish the right to set up a company in another member state and includes important "passporting" rights that allow firms to provide services across borders.

In May 2016, service industries accounted for almost 80 percent of the UK economy – encompassing sub-sectors as diverse as banking, architecture, law, and marketing. The impact of regulatory changes to service industries on the UK economy – the world's sixth largest – could be substantial, and may have knock-on effects on businesses that have services run by UK-based companies.

A crucial element of the EU's free trade in services is the ease of doing business it allows. UK financial services companies, for example, have de-facto regulatory compliance in every other EU member state, enabling them to establish a branch in another EU nation simply with authorization from UK regulators, and without additional compliance or many of the costs associated with establishing a subsidiary – such as separate capitalization. A recent House of Lords' report estimated £40-£50 billion of the UK financial services sector's annual revenues (between 20 and 25 percent) relate to the EU.

UK financial services organizations are keenly aware of the regulatory risk presented by a complex, transitional environment. Strategic decisions to enable quick adaptation to any new regulations are already being developed – particularly around dispute resolution, with the UK due to no longer fall under the jurisdiction of the European Court of Justice.

Several larger financial services firms have already announced decisions to set up or expand operations in other EU member states, relocating operations from the City of London, to prevent any impact on their ability to continue operating throughout the EU. This should mean that the financial sector is able to weather most of the as yet unknown changes – but other industries, less reliant on hard to move intellectual capital, may find it harder to respond.

While difficulties in moving hard-to-hire and hard-to-keep talent might weigh in London's favor, the length of time it takes to obtain new licenses to operate in European markets means that it is possible corporations cautious in preserving continuity of service will have moved some operations to other parts of the EU even if a deal is eventually reached.

Free Movement Of Capital

The EU's commitment to the free movement of capital enables UK-based companies to invest in and own other European companies and more easily raise capital across borders. While the implications of any changes to this for large regional and global organizations are clear, some implications are less so.

A specific issue influencing the access of UK companies to European capital could be access to funding from the European Investment Fund (EIF), which pools billions in funding from European institutional investors and private banks, and committed around 37 percent of all venture funding raised in the UK between 2011 and 2015.

Since the financial crisis, the EU has been working on reforms to the banking sector to encourage increased yet better regulated movement of capital within the union. With London traditionally a dominant location of capital raising for the European Union, Brexit has been seen as a potential threat to the availability of European capital. As a result, some have started calling on the EU to increase efforts towards the European Commission's proposed Capital Markets Union plan to encourage more, and more sustainable, capital movement to drive European growth. This could see a major wave of new reforms in the EU that could have major implications for all European countries and those doing business in and with them. In the short term, Michel Barnier (the EU's chief negotiator) has indicated that the need amongst European institutions and businesses to continue to access finance in London will be considered in crafting the post-Brexit environment, even if that means a 'special' relationship for the City that is not reflected in a wider deal.

How Uncertainty Can Lead To Opportunity

The implications of the UK leaving the EU are wide-ranging and impossible to fully determine at this stage. Businesses will need to develop strategies for responding to Brexit as more information emerges, and the solution for each firm will be bespoke.

A thorough risk assessment should be conducted by any organization operating in Britain or with British companies, considering various potential scenarios for the terms of Brexit, and plans developed to minimize the potential negative impact. Such an assessment may mean that changes to business strategy have to begin to be implemented even before the final terms of any Brexit deal are known.

But this could also be an opportunity to identify more efficient and effective ways of working. Brexit uncertainty could inspire caution and a desire to wait and see what the outcome is, but a full, rational risk assessment may help identify both operational efficiency improvements and ways to tap into new markets and talent pools.

Whatever the outcome of the Brexit negotiations, "organizations now need to consider how to understand this changing profile, and how to navigate the challenges and opportunities of a new post-Brexit world," says Molony. As ever, when facing complex unknown situations, pro-active planning and clearly quantifying the risks involved will ease uncertainty, forge a path forward, and potentially help turn uncertainty into new opportunities.

TALKING POINTS

"Theresa May has signaled a change to the UK business model, away from a collective European rules-based approach, towards a more nationalistic, isolated stance. This is likely to lead to a protracted and unwelcome period of uncertainty and instability for business." – Danny McCoy, Chief Executive, Ibec Irish business trade group

"The simple fact is that businesses all across the UK are carrying on. Directly-affected companies are being pragmatic, and are preparing for a range of possible outcomes." – Adam Marshall, Director General, British Chambers of Commerce

"The possibility of Britain leaving the Single Market makes our work to build deeper capital markets in the rest of the EU more important than ever." – Valdis Dombrovskis, Vice-President, European Commission

FURTHER READING

- Brexicon: Your Guide To The Language Of Leaving The EU – The Financial Times, February 15, 2017
- Brexit: What Will Be The Short-Term Damage When The UK Leaves The EU Single Market? – ABC News, January 17, 2017
- Brexit And The European Financial System: Mapping Markets, Players And Jobs – Bruegel, February 9, 2017
- Brexit And International Contractual Arrangements – Business Day, February 16, 2017
- Brexit: UK-EU Movement Of People – House of Lords European Union Committee, March 6, 2017
- Brexit: The Road Ahead – Aon

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