BREXIT: What if?

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During the last view months, the United Kingdom's (UK) exit from the European Union (EU), the so-called „Brexit", has become a real possibility.

This should not surprise anybody as already the UK's accession in 1973 was by no means undisputed and there had always been euro sceptical positions in British policy. But what is striking today is, on the one hand, that the rejection of the EU is no longer the domain of protest parties such as UKIP, but the ruling party's, the Conservative Party's, mainstream and, on the other hand, that this seems to go hand-in-hand with a growing general xenophobia which one would have never expected from the UK as a (due to the successful decolonisation in the second half of the 20th century) traditional immigration country. Driven by the ever better poll results of UKIP and even more so by his own euro sceptical party members, Prime Minister Daniel Cameron has promised the voters a referendum on leaving the EU. This Referendum should not be later than at the end of 2017. However, now 23 June 2016 has been the date fixed for it.

In order to prevent a referendum result in favour of a Brexit, the Prime Minister had set up a list of demands, negotiated them with the other EU member states and with the EU itself and has really achieved that they agreed to most of it: Full social benefits for EU-migrants moving to the UK only after 4 years; child support payments for children of EU-migrants who stay in their home country only in the relevant amount granted in this home country; no force to an "ever closer union"; additional co-decision and (under certain circumstances) veto rights of national parliaments and a stricter fight against "unnecessary" EU legislation, including the repeal of certain EU rules. However for the British press and for the other Brexit supporters this is all not enough. The result of the referendum is still open, but it is already clear now that the Brexit has become a real possibility.

Advantages? Disadvantages!

More British sovereignty, less influence by continental Europeans on the own country, hopefully less bureaucracy (although the wholly domestic English legislation is partly creating at least as expensive and burdensome restrictions as EU legislation does) and more pragmatism as well as better protection of the own borders, etc. – this is what the Brexit supporters mainly hope for. In terms of economic advantages usually only the EU membership fees to be saved are mentioned. This should be approximately 0.5 per cent of the British gross domestic product or annually round about EUR 10 bn.

In contrast, the economic disadvantages for the UK seem to be much more obvious and dramatic. Only the amount of economic losses caused by the reduction of inner European trade and by new taxes and tariffs in this trade is disputed: Between 1.1 and 9.5 per cent of the British gross domestic product probably – and it is rightfully pointed out that the reduction of the gross domestic product as a result of the financial markets crisis was around 7 per cent, which has triggered the longest and deepest recession in British economic history, from which the country only now slowly recovers.

Particularly harsh will be the disadvantages for the London City as the UK's strongest industry, the financial sector. It already loses ground vis-à-vis Singapore and other financial markets which challenge the City's reputation as the world's leading "off shore" centre. Until now, the City is profiting enormously from the EUR zone as most of this currency is traded in London either as foreign exchange or in the form of EUR-denominated securities. This trade could easily move to the continent, in particular to Frankfurt as the seat of the European Central Bank and, besides the City, Europe's most important financial centre. Already in the last few months there was massive interest by companies of the international financial sector to move to Frankfurt. The attraction to move to Frankfurt rather than London would increase significantly in case of a Brexit. For the UK this could mean less economic growth, *exodus* of capital, loss of jobs in the City, less tax income, and all of this on a large scale.

All this would happen at a time when the political targets of the British government, the other EU member states' governments and the EU institutions should better be aligned, namely should be the same that move most EU citizens: More subsidiarity (in which areas is it really necessary to move or even move more sovereignty to the EU and in which areas would it be better to return sovereignty to national states?), transparency and efficiency, on the one hand, and less bureaucracy and regulatory tsunami, on the other hand!

Brexit supporters seem to think that the other Europeans should themselves look after their targets and the British should simply look at theirs. Historically, this is likely to turn out as short-sighted. It was and is hard for France to accept that, despite its colonial past, it is no longer a "*grande nation*". Equally, it is hard for Germany to accept that, despite its phenomenal economic development after WW2 (the "*Wirtschaftswunder*") and despite its even today very strong economy, it is not a globally important country. Of course, such self-reflection must be hard for the UK too, but it is nevertheless true: Without the EU all European countries have become relatively unimportant.

The EU itself would also significantly suffer from a Brexit. It would become smaller, thereby losing economic and political substance. When it comes to trade and political power, it would be less important. But also internally the difficult project of European integration would be harmed. Logistically, for example the European banking authority EBA would have to be moved from London to the continent. Economically, the EU would lose its fourth biggest net payor and the entire common budget would have to be significantly decreased or the other member states more burdened.

Finally, Germany's gross domestic product would be reduced by a Brexit by presumably 0.3 to 2 per cent, which means approximately EUR 700 per German. Moreover, Germany, already the EU's biggest net payor, would be financially burdened even more. Worse than all of this, the power in the EU's highest decision making organ, the European Council, would be shifted. Rightfully, it has already been pointed out in the press that until now both, the economically liberal countries such as the UK, Germany and The Netherlands, on the one hand, and the more interventionistic countries, on the other hand, have over 35 per cent of the votes in the Council and, thus, a qualified veto right. This equilibrium would be destroyed by a Brexit. Germany, although then even more the highest net payor of the EU, would lose political influence. And this could become very costly when other member states use their stronger voting power to establish a kind of "transfer union" in favour of economically weaker countries.

How could the exit look like?

Advantages and disadvantages back and forth, what if the referendum result will be in favour of a Brexit? Could the UK really leave the EU? Yes, it could!

The UK's exit from the EU would legally indeed be possible. This was not always that clear. Originally, the European treaties neither provided for an expulsion nor for an exit of a member state. Only the Treaty of Lisbon dated 13 December 2007 (which came into force on 1 December 2009) established in article 50 of the Treaty on European Union (TEU) a proceeding for an orderly exit from the EU. Before, it was at least disputed whether under EU law an exit right existed, and for a long time an exit was scarcely conceivable. Irrespective of the by all means not entirely clear legal situation under EU law, the question also arose whether a member state could exit the EU under the general rules of international law, namely under the principle of *clausula rebus sic stantibus* as set forth for example in the Vienna Convention on the Law of Treaties. However, even those who doubted the applicability of this convention conceded that there was no EU law possibility for sanctions against an exiting country.

Today, the legal situation is much less unclear. Article 50 of the TEU sets forth rules on the proceeding for an orderly exit of a member state. This proceeding runs down in four steps:

(i) The member state willing to withdraw shall notify the European Council of its intention to withdraw from the EU; it is not necessary to have or give special reasons for this intention (article 50 para. 2 sentence 1 of the TEU).

(ii) The EU and the member state intending to exit negotiate a treaty on the details of this withdrawal. The procedure for this is set forth in article 218 of the Treaty on the Functioning of the European Union (TFEU), and in this context the European Council will, *inter alia*, provide negotiating directives. The withdrawal treaty shall also include the framework for the future relationships between the withdrawing country and the (remaining) EU (article 50 para. 2 sentences 2, 3 of the TEU).

(iii) The European Council in the name of the EU agrees to the exit treaty with a qualified majority vote and after consent by the European Parliament has been obtained (article 50 para. 2 sentence 4 of the TEU).

(iv) The EU Treaties (TEU and TFEU) shall cease to apply to the withdrawing country in question from the date of entry into force of the said exit agreement, failing that, two years after the above-mentioned notification – unless the European Council, in agreement with the country in question, unanimously decides to extend this period of two years (article 50 para. 3 of the TEU). In other words, the agreement of an exit treaty is not a compulsory requirement for a withdrawal under article 50 of the TEU.

The period for negotiation, two years, is relatively short (particularly taking into account the usual working speed of EU institutions as well as the complexity of the in numerous subjects to be covered by such an exit agreement). The legislative intent behind this short period is that article 50 of the TEU should not make it too easy for member states which are unsatisfied with certain areas of EU law to withdrawal from the EU and at the same time trying to safeguard itself by means of an exit agreement other, more comfortable aspects of EU law (cherry picking).

In the context of the exit agreement, article 50 para. 2 sentence 2 of the TEU speaks of "taking account of the framework for its future relationship with the Union". But in a case of a Brexit, how could such a framework look like? There are at least five possible alternatives conceivable for the future relationships between the UK and the (remaining) EU after a Brexit:

(i) Like the EFTA countries Iceland, Liechtenstein and Norway, the UK could become a non-EU member of the European Economic Area (EEA). However, that would mean that it had to accept the full "*acquis communautaire*", i.e. the entire body of EU legislation. Therefore, it could not achieve the goals of the Brexit.

(ii) Even more difficult would be, like Switzerland, to become – again – a contracting state of the European Free Trade Association (EFTA) but not a member of the EEA. As a result, the UK would not have by itself free access to the "Common Market" of EU/EEA but would need numerous separate agreements with the EU to achieve this. But the example of Switzerland also shows that access to the "Common Market" comes only with a price in the form of acceptance, *inter alia*, the free movement of persons, i.e. of the rules which the Brexit is meant to avoid in the future.

(iii) Another alternative would be a tax union, comparable to the one currently in place between the EU and Turkey. However, the example of Turkey illustrates the problem: Turkey were granted certain concessions by the EU with a view to its possible future membership, and in return Turkey had to accept for itself most EU regulations' and directives' rules (all together not an insignificant part of the "*acquis communautaire*"), for example, also in the financial services area. Therefore, this does not look like an attractive solution for the UK.

(iv) Moreover, the future relationships between the UK and the remaining EU could be simple trade relations on the basis of the rules of the World Trade Organisation (WTO). If so, from an EU perspective, the UK would be a "third country" (this result could also occur by operation of law if no exit agreement pursuant to article 50 para. 2 of the TEU would be agreed and the UK would thus automatically leave the Union pursuant to article 50 para. 3 of the TEU). On the one hand, in such case, the UK would not have to accept the unwanted EU freedoms and rules anymore. On the other hand, such a role as a "third country" would definitely not be in its best interest, as there would be tariff barriers again and no "Common Market" with the EU, i.e. no joint free trade area.

(v) Finally, there might be the possibility of a "special deal", i.e. of the agreement of an individual regulation of the relationships between the UK and the remaining EU (either as part of, or in addition to, the exit agreement) – and this is the solution most of the Brexit supporters favour. These eurosceptics are dreaming of an "EEA light" with unlimited access to the "Common Market" and without unwanted EU rules or budget payments to the EU. Like many other dreams, this one will not become true. The remaining EU cannot afford to agree to such a deal, as this could be interpreted by other EU member states as a signal to negotiate similar exit deals, thereby heralding the end of the Union. And there is also no common sense reason why, in comparison to Switzerland or Norway which had to accept those rules the UK does not want to accept anymore, the UK should be granted a betterment.

Legal consequences for the financial sector

The legal consequences of a Brexit – for both the UK and the EU – largely depend on the exit agreement under the withdrawal procedure pursuant to article 50 of the TEU (if one can be agreed), as a bilateral treaty under international law regulating the future relationships between the UK and the remaining EU. As a result, *inter alia*, after a Brexit the UK's status vis-a-vis other European countries ("third countries"), i.e. non-EU and non-EEA countries, would also be different.

Based on the UK's over 40 years of EU membership and the resulting close interdependencies between the UK and the remaining EU, it is at least possible that there will be a grandfathering with an at least partly retention of "*acquis communautaire*" rules. The extent, the duration and the concrete contract design of such grandfathering would first have to be agreed upon. Whether such agreement can be reached is naturally an open question. However, what is clear is that such grandfathering would be finite, which inevitably raises the question how the relationships between the UK and the remaining EU could look like after the grandfathering period.

Already now, the different and unpredictable future prospects scenarios have led to a situation of great insecurity, and many enterprises have already started to make plans, and more or less concretely prepare, for a Brexit. And those who have not started yet, might do so soon.

In any event, if the referendum's result will be a pro-Brexit votum, there will be tough negotiations between the UK and the remaining EU. Currently, the results of these negotiations are not foreseeable. And what will the results of such negotiations mean for the enterprises and the people on both sides of the Channel? What will happen to the freedoms of the European "Common Market"?

Especially for banks, other financial services providers, insurance companies and investment fund managers on both sides of the Channel the EU's freedom of services has brought great advantages, as, for example, they can offer and perform their services not only domestically but in the entire EU and EEA. By means of EU directives and regulations a "Common Market" for them has been created. In particular, they have via a so-called "EU Passport" the possibility to offer and sell their services and financial products in all EU and EEA countries either by way of cross-border business or by opening a branch office without the need of a respective licence from the relevant host country (countries), provided they are properly licensed for their business in one of the EU/EEA countries. This "EU Passport" system, together with London's mother tongue advantage in regard of international business, has made the London City the natural "hub" to the European markets for many internationally active banks, financial service providers and funds from the US, Asia and other parts of the world.

– **Without exit agreement**

Should there be a Brexit but no enduring regulation of the future relationships between the UK and the remaining EU, including stipulations that rights under the freedom of services, in particular the “EU Passport” rights, should remain applicable, the London-based enterprises of the financial sector could no longer profit from such “EU Passport” system, with the consequence that London would massively lose attractiveness.

The London-based enterprises of the financial sector until now profiting from the “EU Passport” system would probably need national licences in all relevant EU and EEA countries in order to offer and perform their services in these countries. Furthermore, in Europe they would then possibly have to be apply two sets of regulation, the new domestic UK rules and regulations and those under EU law, which could have a significant effect on their costs. This would be particularly true in regard of the large US and Asian banks/investment banks which currently centrally steer their regulatory capital–intensive European business via London-based subsidiaries and their EU/EEA branches on the continent, where they do only business with no or less regulatory capital requirements via subsidiaries in these EU/EEA countries. As the “hub” function of their London subsidiaries would be omitted, since only EU/EEA-based enterprises can use their regulatory capital via the “EU Passport” system on the continent, such “hubs” would have to be relocated to EU/EEA countries. In this context, an especially attractive alternative might be Frankfurt as the seat of the European central bank and European banking supervisory authority ECB.

Brexit supporters might argue that, in contrast, such movement away from the City of London to Frankfurt or other European locations could be counteracted by a new, for these institutions more attractive domestic UK regulatory regime (deviating from the EU law regulatory regime). And this is true too. At least to some degree. However, already since some time there is a trend noticeable in the financial sector to relocate business from London to other places, especially to Singapore, as the regulatory regime of this Asian country is widely regards as particularly attractive and the practice of its supervisory authority (the Monetary Authority of Singapore, MAS) as more reasonable than that of many other countries. Of course, this trend could to some degree be taken wind out of the sails. But only to a certain degree. Neither would a new domestic regulatory regime of the UK change the City’s loss of attraction due to the omission of the “EU Passport” opportunities, nor could the British government at will increase the City’s attractiveness by a new, less demanding regulatory regime for banks and other financial markets players. On the one hand, the British voters would probably be as critical about such plans as the people in the rest of Europe or the US. And on the other hand, also each British government (and whoever is then Prime Minister) will know that in a post- financial markets crisis world high regulatory requirements and administrative standards are important for financial markets stability, and thus also crucial for the attractiveness of a location for business. In this context, sense of proportion is important, not drastic actions!

In summary, a Brexit would effectively damage the attractiveness of the City of London as financial centre if there will be no agreement on counteracting rules in an exit agreement.

In contrast, a Brexit would also have negative impacts on cross-border business into the UK from or via EU branches of banks, other financial services providers, insurance companies and investment fund managers from the EU/EEA. They too could no longer use the “EU

Passport" system and, if there were no stipulations to the contrary in an exit agreement or by domestic UK legislation, would need domestic licences in the UK. Moreover, in addition to the EU rules and regulations, they would thus also need to comply with the new UK rules and regulations, which could significantly increase their costs. In such case, one or the other EU or EEA enterprise might even consider whether the possible UK business or presence is really worth these additional costs.

Only purpose-built rules in an exit agreement (if one could be agreed) could attenuate or even avoid the negative consequences of a Brexit.

– **With exit agreement**

It is not impossible (but by no means certain) that (for example) in an exit agreement a more or less durable grandfathering for UK enterprises in the EU/EEA as well as for EU/EEA enterprises in the UK in regard of their cross-border business and/or branches will be agreed. But until such agreement is really reached, the legal uncertainty is enormous. Provided such an agreement is reached at all (as the remaining EU is likely to have significantly less interest in reaching such an agreement than the UK and thus be tactically in a better position), further questions arise, such as whether such grandfathering is meant to also cover new (i.e. post-Brexit) services and/or products. And in any event, even a long-term grandfathering would have to expire at some point in time.

From an EU perspective, an enduring regulation and/or grandfathering would only make sense within an EU or EEA membership context or in a context comparable with Switzerland's special status (i.e. EFTA but not EEA). But the granting of the advantages of the free movement of goods, services and capital would have, from this perspective, to be connected to the free movement of persons (the rules which seem to currently drive the UK into the Brexit at the first place) and/or the assumptions of costs. Without such a perspective, a grandfathering would have to be clearly finite.

In general, in the case of a Brexit the remaining EU would have little to no incentive to make concessions, as this could turn out to be "seed of evil" for the EU and lead other member states to the idea that it might be possible to continue to have most of the economic advantages of the EU but without the burden of membership. This could lead to a culture of blackmailing and thereby to the entry into the dissolution of the current Union. Moreover, neither Switzerland nor Norway can work as good examples for the UK as they had to pay for their trade advantages with concessions in other areas, namely in regard of the free movement of person – exactly those rules which the UK seems to hate like the devil fears holy water.

Résumé?

For both sides a Brexit would have more disadvantages than advantages. Whether and, if so, with what content an exit agreement can be concluded is a completely open issue. If not, Europe-wide active enterprises of the financial sector will be forced to reorganise their business at short notice in order to continue to be able to use the advantages of the "EU Passport" system, namely more from the EU/EEA, in particular from Frankfurt, than from London. If an exit agreement will be concluded, long-term grandfathering rules in regard of "EU Passports" for EU/EEA banks, other financial services providers, insurance companies and investment fund managers active in the UK as well as for such UK enterprises active in the EU/EEA will be crucial. In the respective negotiations the remaining EU would not be able to accommodate the UK too much, in order not to endanger its own future. What the Brexit supporters want to achieve (namely full participation in the “Common Market” without membership fees and without accepting the free movement of persons), they will not achieve. In any event, the City of London as a financial centre will be damaged, but Frankfurt could significantly profit.

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