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Point of No RETURN

Post Brexit, huge questions remain for treasury and finance

After years of contentious debate, failed votes, and elections, the United Kingdom finally "exited" its arrangement with the European Union on January 31, 2020. While it ultimately happened with little fanfare or drama at the end, the country remains split on Brexit. Stories of celebratory parties occurring within feet of somber events commemorating the end of the UK/EU marriage were common. Despite the fanfare, though, Brexit has not truly come to fruition—the process is far from complete.

Transition period

So, what has happened already and what happens next? Technically, Article 50, the legal mechanism that allows for members to leave the European Union, expired on January 31. Practically, this means that the UK can't change its mind now. If it wants to re-enter the EU, it must apply for membership and have all then-current members accept it.

The UK will now live under the transition agreement negotiated with the EU, requiring it to continue to comply with all EU rules until December 31, 2020. Since the UK is no longer a member of the EU, it has no say on changes in the rules under which it must live through the remainder of this year. More importantly, the two parties have under 11 months to finalize an agreement of how they will access one another's markets and under what terms.

This is an aggressive timeline by anyone's reckoning. The original Withdrawal Agreement negotiated by former Prime Minister Theresa May contemplated a 21-month transition period. Even this was billed as ambitious. Historically, the average time required to negotiate a trade deal between the EU and a third country has been 48 months. Among the quickest of these were negotiations with South Korea and Vietnam, each of which took a little under three years—and the much-touted Canada deal took seven.

In theory, the December 31 deadline could be pushed back. The terms of the Withdrawal Agreement between the UK and the EU allow for an extension to the transition period if this is agreed upon by June 30. However, the current political environment in the UK makes this extremely unlikely. Prime Minister Boris Johnson was elected with a mandate to "get Brexit done" and has since written the December 31 cut-off into UK law. Any delay to this would require new legislation, which has little to no support in the governing Conservative Party. In any case, an extension request after June 30—only four months after trade negotiations are due to start—would require the unanimous agreement of all 27 EU member states.

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Critically linked

Both parties have strong incentives to reach an agreement that gives each access to the other's markets free of tariffs and quotas. The headline figures alone are compelling for both sides: the EU accounts for 45% of UK exports, while the UK accounts for 8% of those from the EU. But more important than trade volumes are the complex links between the two economies, from "just in time" manufacturing supply chains to financial contracts. The knock-on effects of any deal (or lack thereof) that breaks, or even weakens, these critical links would significantly outweigh a simple loss of export revenue—for both sides.

The flip side of this interdependence is the vast scope demanded of any trade deal that can be considered adequate. Negotiations will take place across everything from food standards to banking regulations. Largely obscured by emotive headlines about more tangible (but less economically important) industries like fishing, a battle over the future of financial regulation has been rumbling on ever since the 2016 recognition.

Already, the EU is looking to modify the updated Markets in Financial Instruments Directive (MiFID II) in ways that the UK previously rejected, underlining the challenge ahead for the two parties. Meanwhile, the UK government's current proposal for "outcomes-based equivalence" for financial services rules looks suspiciously similar to Theresa May's suggestion of "mutual recognition," which was rejected out of hand by the EU.

And yet the other alternative on the table—an "equivalence regime" under which UK financial services firms would retain access to the EU market only if the UK kept in place regulations that were equivalent to EU ones—is fraught with difficulties. Not only would it effectively make the UK a rule-taker from a regulatory perspective, it would in fact cover only around a third of financial services activities. Moreover, it could be withdrawn by Brussels with only 30 days' notice, which doesn't provide the security that financial firms are looking for.

Of course, how to implement all these agreements with respect to the border between the Republic of Ireland (an EU member) and Northern Ireland (part of the UK) remains a contentious and emotional issue as well. The soft border dividing the island of Ireland represented a burying of many of the issues that had driven a long and bloody conflict, in the hope that future generations would be better able to resolve them. Now, they are set to be unearthed barely two decades after the Good Friday Agreement brought the conflict to a close.

All in all, a no-deal Brexit (now referred to by the UK government as an "Australia-style deal") is still a distinct possibility.

Impact on treasury

What does this mean for corporate treasury and finance professionals? Despite the seemingly large step taken in late January to exit, the UK remains in a state of transition and uncertainty. This may have a disproportionate impact on capital markets and exchange rates, leading to lower capacity for financing and greater volatility on GBP specifically. The Bank of England stands ready to support the UK economy through the Brexit process, and has neither cut nor raised rates since mid-2018, nor has it expanded its quantitative easing program since 2016.

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Should the Bank of England cut rates or otherwise engage in the markets to drive medium-term rates lower, firms may find it cheaper to issue debt in U.S. dollars and use cross-currency swaps to convert it synthetically to sterling. Right now, firms can utilize these derivatives to save nearly 100 basis points per year relative to USD debt. Should USD rates rise while UK rates fall, these savings could become even larger, and rival savings are seen in the EUR (200 bps).

Secondly, despite the possibility of more drama to come, and the drama that has already happened around Brexit, GBP-USD currency option volatility is at nearly six-year lows, thus reducing the cost of buying options on GBP. For those looking to engage in significant mergers, acquisitions, divestitures, or capital expenditures in the UK, options may provide a tool not commonly utilized across treasury teams to mitigate risk.

While those living through Brexit would like nothing more than certainty and finality on the process, negotiations will take far longer to reach such a point. In the meantime, treasury and finance professionals will need to remain vigilant for opportunities to minimize risks and add value to their organizations.

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