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Brexit Explained: Where, How & What

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The Counselors of Real Estate's European Chapter hosted a Brexit conference in cooperation with the Royal Institution of Chartered Surveyors (RICS) in London on 28 February 2019. This event was subtitled "Requiem for a Deal?" and was well-timed, given the upcoming target Brexit date of 29 March 2019, and the degree of uncertainty that has steadily increased since the vote in the summer of 2016. Both authors were asked to moderate panels, and below you will find our observations from the lively discussions at the conference. These reflect only our personal interpretations of what was discussed, but we do highlight specific views from the speakers and panellists.

WHERE ARE WE IN THE PROCESS?

With less than a month from the targeted Brexit date, we are in a situation where the deal agreed with the EU late last year has not been approved by the UK Parliament. Changes to the agreement are being discussed by the UK parties and various amendments to be voted upon could, even at this late stage, significantly change the UK's approach.

HOW DID WE GET HERE?

Lord Jonathan Hill, Britain's former EU commissioner, told the audience that the UK political debate on Brexit has lacked honesty. It was always unrealistic to expect that the UK would have a better deal outside the EU, given the political red lines that were made clear by the EU from the outset, and which have not changed. The correct question to have asked – especially in the UK, which triggered the divorce – was: How do we build a stable relationship between the UK and EU? The poor process of predominantly UK internally-focused

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negotiations since the vote has damaged the UK's reputation as a pragmatic and stable political partner internationally. Leadership changes might be imminent in both leading political parties after both saw Members of Parliament depart to form a new centrist (and pro-European) grouping. It took 40 years to incorporate the UK into the EU, so it seems a bit unrealistic that it would take just 2 years to reconfigure the relationship. Perhaps 10 years would have been a more realistic period to undo the many different ties that bind the UK to the EU.

According to Lord Hill, assuming Brexit goes ahead, the best chance for a good Brexit outcome is to detoxify the debate and move to the large number of detailed, technical negotiations needed – although he acknowledged that the continuing convulsions in UK politics might make it difficult to take the emotion out of the debate.

John Plender, senior editorial writer and columnist for the Financial Times, noted that EU-UK relations are very fraught at the moment. The UK has always been sceptical about the political aspects of the EU experiment, fearing the creation of a "United States of Europe." As a result, it has stayed on the sidelines for much of the project. The EU is a unique experiment that is in peril, due to internal inconsistencies and the range of disparate countries now involved in it. The EU faces external challenges from China and other emerging markets, Russia, and an unpredictable US. It also faces internal problems as many central and eastern European countries do not share core EU values of representative democracy. Southern European countries do not share the fiscal discipline required to have a strong and economically coherent trade block, and the core is reluctant to share risk with periphery countries. It remains to be seen whether the EU will continue to find ways to muddle through its challenges as it has in the past.

Despite all the challenges and problems with the EU experiment, John Plender thought that it would be better for the UK to stay within the EU to help shape its future as a more agile, open and strong political block, able to stand side-by-side with its US ally and offer a better counterweight against the Russian political and Chinese economic threats.

WHERE DO WE GO FROM HERE?

The general consensus among conference speakers was that a reversal of Brexit, while technically possible, was a very unlikely prospect. The UK could achieve it by unilaterally revoking Article 50 of the Treaty of the European Union, but only if it did so in good faith (not simply to play for time to plot its exit) and only with a suitable legal basis (such as a new referendum or general election might provide).[1]

In the absence of that, or of an agreement to do something different, legislation already on the statute book would result in the UK ending the two-year negotiating period with no deal on 29 March. There would be a purity to this outcome (the UK would simply leave the single market and EU fundamental freedoms would cease to apply). Speakers even recognised that the only pressure for a physical border on the island of Ireland (the risk of which the controversial "Irish backstop" in the existing proposed deal seeks to address) would come from the EU 27 wishing to protect the integrity of its internal market.[2] However, a number of speakers pointed out that leaving without a deal would almost certainly create a very hostile climate for any negotiations the UK might seek with its largest trading partner. The risk of a disorderly Brexit has already led to a number of international agreements to avert cliff-edge problems in particular aspects of financial services and transportation, for example. The EU 27, its member states and the UK have each taken different approaches to helping their businesses and citizens prepare.

Against that backdrop, it was not a surprise to hear the complex question of a possible delay to Brexit beyond 29 March explored in depth in the legal panel by experts from the law firm Herbert Smith Freehills. A 2-3 month delay to allow implementation of an agreement was seen as a likely outcome. A longer delay (which would

run into the next European Parliament) was much less plausible, unless it was linked to a change of approach by the UK, for example, to allow a second referendum to be held.

Of course, if the UK Parliament accepts the deal agreed between Theresa May's government and the EU 27 (or something very close to it), that won't be the end of the story (or even the beginning of the end, as one speaker wryly remarked). The Herbert Smith Freehills team pointed out that the 21-month "implementation" period contemplated by Theresa May's deal for establishing the future relationship is not likely to suffice. The negotiation is far too complex, as is the legal and administrative framework that the UK would have to put in place by the end of the implementation period. In this respect, it should be noted that it took nearly 12 years for Canada to negotiate its recent trade deal with the EU. This means that even four years does not seem overly generous, especially as relations have been damaged since the vote and Article 50 invocation, mostly due to the UK government not having a clear position in its negotiations with the EU. An extension would almost certainly be required, in all likelihood also extending the uncertainty.

WHAT ARE THE EXPECTED OUTCOMES?

Economist Vicky Pryce pointed out that the Brexit timing is not great now economically, as there is a global economic slowdown emerging and trade war in the making. In fact, Italy is in recession already and Germany is getting close. Despite low unemployment, the UK has already missed out on an estimated 2.3% of additional GDP growth since the vote. Depending on the likely outcome of the process, a further 3-9% negative impact in cumulative GDP growth can be expected over the next 15 years. Corporate investment has declined since the vote and explains the persistence of UK productivity stagnation. Hiring more staff while not investing in new factories, equipment or innovation has caused UK productivity growth to lag that of other countries. Consumer confidence has come down as many consumers have maxed out on credit and appreciation of home values has slowed, reducing the wealth effect on the economy.

Property was generally thought to be in a relatively resilient position, with modest leverage in the sector and no imminent supply-demand imbalance. Stephanie McMahon of BNP Paribas Real Estate highlighted heightened uncertainty especially in the increased range of yield forecasts across Investment Property Forum consensus participants, particularly in retail. Paul Tebbit of Blackrock said that Brexit has certainly amplified and accelerated the impact of secular/structural trends like e-commerce on traditional retail and logistics. Serviced office operators like WeWork are perhaps finding acceptance more quickly where there is a higher degree of uncertainty, whether Brexit-related or otherwise. In that context, there was some discussion on the erosion of the security offered by UK lease contracts. The point was made that leases to special purpose companies, without a parent company guarantee, can be defaulted on very easily. Serviced office companies can default on unattractive existing leases and move their sub-letting occupants to a new building across the street at attractive new lease terms.

Reduced need for both retail and office space in the future will offer opportunities for conversion of existing office buildings to residential use. Conversion from retail to residential was seen as more problematic, as it might require larger write downs from current values. Jon Neale of JLL sees Amsterdam as the biggest European beneficiary of international bank movements after Brexit, although New York might benefit even more, as it becomes more clearly ***the*** global financial centre as compared to London.

With economic and financial market sensitivities at elevated levels, central banks have realised that there is limited room for rate normalisation. Real estate continues to look like good relative value compared to other assets. Brexit is distracting the UK government from focusing on other needed policy areas in property and elsewhere, while poisoning its long-term relationship with its closest trading and political partner. The

property panel confirmed that in their view an even bigger risk than Brexit is actually a UK government led by Jeremy Corbyn, left wing leader of the opposition Labour Party.

WHAT HAVE BEEN THE UNEXPECTED OUTCOMES SO FAR?

John Plender highlighted that one unexpected consequence of Brexit has been that support for the EU across Europe has increased due to the UK showing how leaving is not only difficult but harmful. Also, Brexit might speed up the much needed treaty and structural reforms to improve the EU's credibility, accountability and legitimacy. The UK will find it difficult to negotiate new trade agreements when the EU, US and China are each re-balancing their own trade relationships to avoid a possible trade war. Plender also reminded us of George Soros's comment that it seems perverse that the UK should choose to give up a situation where it had the best of both worlds: full common market access as well as its own currency and monetary policy.

On the economic front, since the Brexit vote UK government borrowing has been higher than planned, and more spending cuts will be needed to absorb the impact of Brexit on the UK economy, despite widespread dissatisfaction after nearly a decade of austerity.

Impact of the Brexit vote on immigration has been a mixed bag, with net immigration from the EU coming down significantly only to be offset by an increase in non-EU net immigration (despite the central importance politicians and media routinely ascribe to voter concern about immigration as a factor in the Brexit decision). From the EU fiscal perspective, it was mentioned that there are only five contributors to the EU budget, who tender more than they get back in distributions. The loss of the UK's net contribution will leave a 25% hole in the EU budget. This €4 billion shortfall will have to be rectified somehow.

Phil Clark of Kames Capital found that an unexpectedly positive impact for property as a result of Brexit was that the 2016 vote called an early halt to the typical late-cycle exuberance in using leverage to pump up new supply, which has led to more pronounced cycles in rents and capital values in the UK in the past. Apart from the uncertainties related to Brexit, the post-crisis introduction of more restrictive bank capital rules might have also played a role in controlling such pro-cyclical behaviour in the UK.

Two unexpected real estate related legal issues arising from Brexit are worth mentioning. One is the future of UK loan collateral in Pfandbrief cover pools, which will depend on changes to German law (and is almost certain to be restricted post-Brexit compared to now).[3] Another is explored in litigation on whether Brexit represents "frustration" of the European Medicines Agency's long lease at Canary Wharf, or whether it remains liable to pay rent for the full term of the lease regardless.[4] Adjusting existing contract definitions and contract disputes related to Brexit will keep legal firms and counterparties busy for some time to come, as will securing access to EU 27 markets for fund managers based in London. Tariffs might also impact construction costs with much machinery and equipment (as well as many construction workers) being imported. •

ENDNOTES

1. Article 50 of the Treaty of the European Union recognises the right of a member state to withdraw from the European Union and establishes a procedure and two-year negotiating period for doing so. In late 2018, the European Court of Justice ruled that the UK could, in certain circumstances, unilaterally revoke Article 50 and cancel Brexit.

2. Within the EU, the UK and Ireland are currently part of a single market and customs union, meaning goods that travel between countries do not need to be inspected for customs and standards. The proposed regulatory and customs "Irish backstop" is a plan to avoid creating a hard border between Northern Ireland and the Republic of Ireland. The UK and EU have agreed that an Irish backstop is needed, but agreeing to terms has been a major sticking point in Brexit negotiations.

3. Pfandbriefe are a type of covered bonds issued by German mortgage banks that are collateralized by long-term assets. They provide very low cost funding for relevant lenders, which have become dominant in parts of the UK commercial real estate financing market.

4. Frustration is a contract law doctrine by which a party can escape its obligations in the event of unforeseen circumstances.

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