Brexit: "They think it's all over…" But is it now?

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Hayfin's Chief Risk Officer discusses how UK-EU regulatory divergence will ensure that Brexit remains an important consideration for investors

Thank the Lord! On Christmas Eve, against the run of play, a Brexit deal was struck. The heavens did not fall on New Year's Day. U2's eponymous song was right (almost). Cue sighs of relief all round.

We can now forget about the awkward portmanteau word that entered the lexicon in 2015 and, after five tortuous years, we can consign it to the dustbin of history, along with the endless, repeated analyses of the impact of Brexit across new investments and the portfolio.

If only!

Unfortunately, the deal marks the start of Brexit, not its end.

While each of the EU and the UK may now view the other in terms of Grillparzer's image of walking alive in the funeral procession behind one's own corpse, the reality is that the two entities are unavoidably entangled forever, whatever condition either one finds itself in, dead or alive or somewhere in between.

The deal is a modest starting point to a future economic and political relationship – offering tariff- and quota-free trade in goods but subject to complicated rules of origin and patchy mutual recognition of safety and quality standards. Large areas of trade in services (including financial services) were parked and there is only a bridging agreement on cross-border data flow.

The two main reasons to keep our analyses fresh lie in the so-called level playing field (LPF) provisions of the agreement and in non-tariff barriers (which can be a greater obstacle to cross-border trade than tariffs as they cause border disruption and certification problems affecting the ability to sell products or services in each other's jurisdiction, for example in foods, medicines or chemicals).

The key point is that the UK cannot just take its "mark" from exiting the EU - the initial friction costs of a more costly trading relationship - and then do nothing. Boris Johnson's government needs to deliver some of the prospective benefits of Brexit now that Britain is able to set its own rules, is free from EU regulation and has left the jurisdiction of the European Court of Justice. Change has started in agriculture, replacing the EU's Common Agricultural Policy as the mechanism to support farmers, and it is coming in taxation (the removal of the so-called tampon tax is a small beginning, as VAT is an EU-mandated tax). In time, it will come in new regional support policies (partly supplanting the EU's structural funds), as a component of the government's "levelling up" strategy for the North of England; in deregulation or better regulation across a number of industries including financial services, healthcare and bio-sciences; planning reform; infrastructure investment; subsidies for new growth industries; labour and environmental reform; and the lowering of trade barriers with the rest of the world (including reduction of the UK's WTO tariff schedule).

Such change will create the divergence which is intended to be managed via the LPF mechanics of the new deal. It would permit countermeasures (most importantly new tariffs or quotas) to be imposed in sectors where there emerges unfair competition between the UK and EU because of differences in regulation – in particular as a result of labour, social or environmental policies - or state subsidies. And the regime applies both ways - to the EU and UK - as well as where one party decides to increase its domestic costs by tightening regulation (e.g. in raising workers' rights or environmental standards).

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So we will need to watch both how divergence plays out and how the LPF provisions are applied in practice. Britain will want to push divergence to the limit of unfair advantage and the risk is of escalating disputes followed by tit-for-tat retaliation. Any prospect of a material change in regulation or subsidies in a sector in which we at Hayfin are invested, or in which we intend to invest, will mean we have to run the kind of sensitivity analysis in our credit models to which we have become so accustomed these last five years: assessing the impact of a margin squeeze from additional tariffs on cost inputs or on sales, a loss of sales from higher tariffs that cannot be absorbed by the producer or an inability to sell due to non-tariff barriers.

We have already learnt elsewhere in our investment history that regulatory risk is easy to underestimate. But this, the potential impact of EU/UK regulatory divergence on trade, is quantifiable at the level of an individual credit. We know how to analyse it and the risk is already on the radar. Regrettably, however, its likelihood means we shan't be throwing away the Brexit sensitivities that have clogged our files for so long. Their relevance has only just begun.

Worse, if the agreement ends up as complicated to operate as it is to read and either side threatens to exercise its right to terminate with twelve months' notice, it will be Groundhog Day for everyone.

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