

# Uncertainties around Brexit challenge UK credit outlook



**The uncertainties around the United Kingdom (UK)'s future economic relations with Europe continue to present significant challenges to the country's economic outlook. Given the significant costs associated with a 'hard Brexit', Scope's view is that some form of 'soft Brexit' remains the most likely outcome. This should come with an extended negotiation horizon and/or multi-year transitional arrangement beyond 2019. However, alternative 'no Brexit' and hard Brexit scenarios remain on the table. Scope examines the potential rating effects of the three core scenarios.**

Brexit negotiations are under way, as the 29 March 2019 deadline for an exit from the European Union (EU) approaches. Scope's view is that the most likely scenario remains some form of eventual soft Brexit arrangement, maintaining full or partial access to the single market. However, to reach such an arrangement, the UK may need to compromise on important issues, including the free movement of people. Negotiations surrounding a soft Brexit scenario could last significantly past the two-year window given under Article 50, potentially requiring an extension of Article 50 negotiations and/or post-Brexit transitional arrangements.

Scope considers a no Brexit (or reversal) scenario to be the second most probable scenario. With the multi-year horizons relevant to Brexit in mind, Scope believes that there is the potential for shifts in public opinion. This was shown in recent opinion surveys that found more respondents for 'Remain' if another referendum were held than for Brexit. While the EU would likely welcome such a 'Breversal', Scope however believes there is reason for caution in that a scenario in which the UK eventually remains in the EU could revive momentum towards a multi-speed Europe.

Given the limited foresight shown in current negotiations, the stated intention of the current government to seek a hard Brexit, and the low likelihood that any transitional arrangement will be concluded in the near term, concerns of the third scenario – a hard Brexit – are however likely to remain central to the discourse, in Scope's view, and grow if no deal prevails as the 2019 deadline approaches.

The rating implications under each of the three core scenarios – soft, no and hard Brexit – depend on the path of Brexit negotiations, how much uncertainty is generated prior to any end-state, and how much policy regression occurs meanwhile. Soft and no Brexit scenarios might be the most conducive to a stabilisation of the UK's rating outlook. However, Scope notes that under each of the three scenarios, there remains the possibility for a rating downgrade if the terms of an exit or deterioration in macroeconomic conditions or public finances materially weaken the UK's sovereign credit profile.

**Table 1: Rating implications of Brexit scenarios**

Scenario	Favourable rating drivers	Negative rating drivers
Soft Brexit	<ol style="list-style-type: none"> <li>Norway model</li> <li>Reduced uncertainty</li> <li>Solid policy framework</li> </ol>	<ol style="list-style-type: none"> <li>Swiss or Turkish models</li> <li>High uncertainty</li> <li>Policy regression</li> </ol>
No Brexit	<ol style="list-style-type: none"> <li>Breversal</li> <li>Reduced uncertainty</li> <li>Resilient policy framework</li> </ol>	<ol style="list-style-type: none"> <li>Weakened policy framework</li> <li>Continued uncertainty</li> </ol>
Hard Brexit	<ol style="list-style-type: none"> <li>Policies that soften shock, including transitional arrangements</li> </ol>	<ol style="list-style-type: none"> <li>Cliff-edge hard Brexit</li> <li>Exit from single market and customs union</li> </ol>

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[Scope confirms and publishes United Kingdom's credit rating at AA and changes Outlook to Negative](#)  
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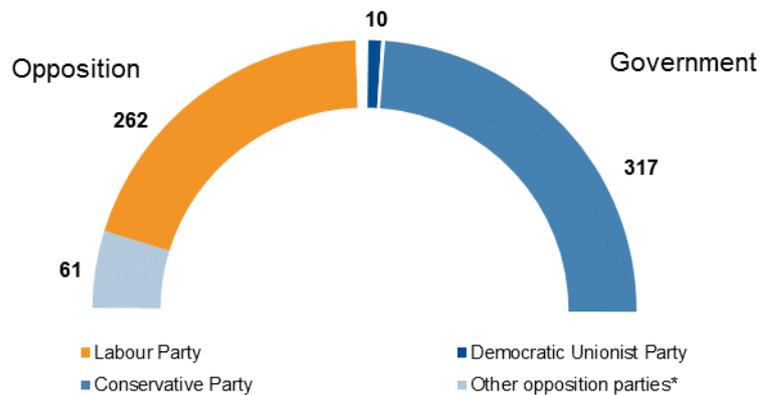
Bloomberg: SCOP

## Brexit is now in motion

### Weakened minority government

Prime Minister Theresa May activated Article 50 of the Treaty of Lisbon in March 2017, officially launching the UK's exit proceedings from the EU. But, after June parliamentary elections – in which the Conservative Party lost its majority in the House of Commons – the weakened position of the May government may reduce the likelihood of a successful resolution to Brexit negotiations by 29 March 2019.

**Figure 1: Composition of the House of Commons, June 2017 election**



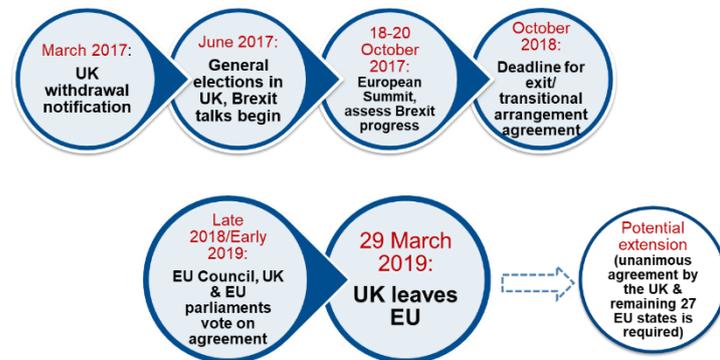
Source: House of Commons

\*Other opposition parties: Scottish National Party, Liberal Democrats, Sinn Féin, Plaid Cymru, Green Party, Independent Unionists

### Early areas of contention could delay talks

In June, the UK and EU launched formal talks on the form Brexit will take. These continued in July, with little ground given by the EU team led by Michel Barnier. The EU's sequential approach to negotiations has meant that talks are restricted until 'sufficient progress' has been made on several opening areas of contention, delaying deliberation on the most critical issues for the UK including a new free-trade agreement with the EU and immigration. The earliest consideration on whether such minimum progress has been made will come at a European summit in mid-October. The opening topics that must be resolved include the rights of European nationals in the UK, the jurisdiction of the European Court of Justice after Brexit, a 'soft' border between Northern Ireland and the Republic of Ireland, and the size of the so-called 'Brexit Bill' – the UK's payment of dues to the EU budget. The resolution of these thorny issues may well prove problematic. The possibility of delays in the early months of Brexit negotiations would restrict the government's room to manoeuvre.

Figure 2: Timeline to Brexit



Source: Scope Ratings AG

### A weaker negotiating hand

In Scope's view, the UK's dilemma in negotiations is that it has the weaker hand. While the trading relationship is mutual, the UK directs 44% of its exports to the EU whereas the EU-27 direct *just* 8% of exports to the UK. The potential economic and financial costs of any form of hard Brexit (in which the UK leaves the EU single market and customs union without a deal) would be much more harmful to the UK than to the EU as a whole – undermining Mrs May's threat that 'no deal is better than a bad deal'. Furthermore, the political repercussions of dilatory action are uneven: while EU policymakers may gain domestic support through intransigence and political grandstanding on Brexit, the UK government would have to contend with potential instability, electoral costs and any change in public opinion if the fulfilment of Brexit commitments is delayed or prevented.

### Baseline for a soft Brexit

#### Soft Brexit is the baseline scenario

Due to the UK's constraints and the potentially significant costs of a hard Brexit, Scope's view is that some form of eventual soft Brexit remains the most likely scenario. Negotiations surrounding a soft Brexit scenario could last significantly past the two-year window given under Article 50, potentially requiring an extension of Article 50 negotiations (possible only via an EU 28 unanimous decision) and/or post-Brexit transitional arrangements. The June 2017 election pushed the next scheduled parliamentary election from 2020 to 2022, allowing the government more time to extend negotiations past 2019 if needed. Recently, there have been some signs of movement in this direction, with the Chancellor indicating greater willingness within the Cabinet for such a transition (of two to three years, ending before a 2022 election). The government, in August, issued a position paper suggesting a transitional association with the EU customs union after departure.<sup>1</sup>

Considering the difficulty of talks and the low likelihood of material near-term concessions from the EU, Scope believes such a 'phasing in' of negotiations considering a transition relationship would be supportive in order to avoid any 'cliff edge' changes in trading conditions. This could at least temporarily include the arrangement that Norway has with the EU, in which the UK would exit the EU but remain within the single market. The continued free movement of people and jurisdiction of European courts would be required in some form during the transition period, a probable controversial proposition in the UK.

<sup>1</sup> HM Government. (2017) 'Future customs arrangements: a future partnership paper'. 15 August 2017.

Due to the complicated interconnections at play, government research has indicated that the process for a full Brexit could last a decade<sup>2</sup>, lending weight to the expediency of such a phased process.

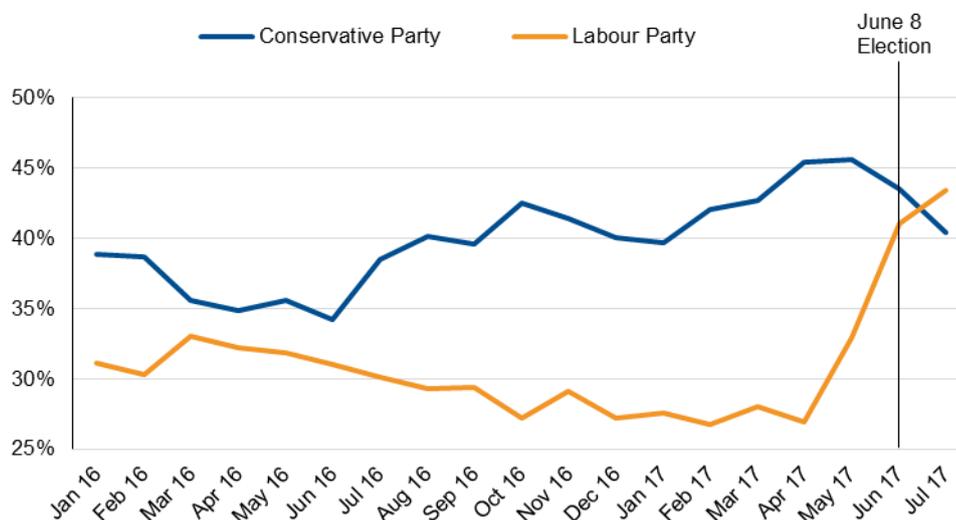
Pro-Brexit groups have argued that a soft Brexit risks the ‘worst of all worlds’ – a condition in which the UK is subject to the rules and regulations of the EU but with no voice in the setting of those laws. Scope recognises this aspect in its baseline for a long run soft Brexit but acknowledges that, in isolation, this factor raises the probability of alternative no Brexit (in which the UK revokes Article 50, and opts to remain in the EU) and hard Brexit scenarios.

### A no Brexit scenario is not off the table

With the multi-year horizons relevant to Brexit in mind, Scope notes that there is potential for shifts in public opinion. In April, a YouGov/Times survey found that 45% of respondents considered Brexit in hindsight to be the wrong decision, while 43% considered it right for the country.<sup>3</sup> This was the first survey to show more against Brexit than for it since last June’s referendum. In July, a Survation survey also found 54% of respondents in favour of Remain, while 46% are in favour of Brexit.<sup>4</sup> While polling data vacillates, the relatively even split during the 2016 referendum and opinion surveys since then underscore the tenuous state of the public majority that initially propelled Brexit. In addition, concerns on the nation’s direction (over 70% considered the government to be on the wrong track in a recent Ipsos MORI study), alongside the lead that Labour has recently taken in polls, place further pressure on Mrs May to soften the Brexit approach, and may cause instability within the Conservative leadership.

### No Brexit scenario depends on shifts in public sentiment

**Figure 3: Labour versus Conservative Party voting intentions, poll of polls**



Source: Various polling companies, Scope Ratings AG calculations

In view of the above, Scope does not consider an eventual no Brexit scenario to be off the table. Obviously, any such scenario would require a confluence of factors: difficulty in extended negotiations, increasing headwinds in the economy due to resulting uncertainty, and/or a material and sustained change in public opinion in favour of Remain. Such a Reversal is likely to involve fresh elections and/or a second referendum. Scope expects

<sup>2</sup> HM Government. (2016) ‘The process for withdrawing from the European Union’. Cm 9216, February 2016.

<sup>3</sup> Bloomberg, 27 April 2017

<sup>4</sup> <http://www.telegraph.co.uk/news/2017/07/02/remain-would-win-brexit-referendum-held-now/>

any such scenario would be welcomed by the EU – effectively illustrating the hardship of leaving the union and dissuading others from considering such a move – and any ambiguity regarding the legality of such a reversal per Article 50 to be resolvable. Scope acknowledges, however, that such a reversal would be a bitter pill to swallow and a non-starter at the minimum in the near term; such a move holds the potential to further divide the nation and escalate Euroscepticism.

### A European perspective...

Of recent, European leaders – from German Finance Minister Wolfgang Schäuble to EU President Donald Tusk – have expressed hope the UK's decision to leave the European Union may be reversed, while admitting that this is 'unlikely'.

On the one hand, any desire for Brexit to be reversed could partially inform an unwillingness to compromise on major and minor issues on the EU-27 end of negotiations, advanced by intentions to ensure conditions outside the union must be worse than those within. However, European leaders should be cautious on any wish that Brexit be overturned. In the aftermath of last June's referendum, the EU has looked more united and stronger, with the common dilemma that Brexit represents (alongside that from other international events, including the 2016 election result in the United States) uniting a more clear and purposeful message from the bloc's remaining 27 member states. It could be argued that a no Brexit scenario – in which the UK remains after failed negotiations – could revive momentum towards a multi-speed Europe, led by the UK and supported by non-euro area member states.

In that, the good that could derive from a soft Brexit, if both sides were committed to its success, should not be so easily overlooked. If the UK concludes an arrangement akin to the Norwegian or Swiss model (in which the UK exits the European Union and enters instead the European Free Trade Association), the UK and Europe's relationship would be mostly preserved, but the UK would be outside the EU and, as such, cease to be the countervailing force it's been inside the EU.<sup>5</sup> While it's unlikely EU leaders will necessarily come to this view, with concentration instead on the risk that a successful exit of the UK could undermine the irreversibility of Europeanisation and damage Europe's role in the world, a deeper consideration of the balance of pros and cons is requisite.

The scenario under which the UK revokes Article 50 humbled and willing to make concessions – to remain in the EU, but, for example, maybe with cessation of the rebate on contributions to the EU budget (worth about GBP 5bn per annum<sup>6</sup>) – would probably be welcomed by the EU. However, should terms to Breversal be worse than those Britain currently enjoys in the EU (including the many opt-outs), this reduces the likelihood that the no Brexit scenario becomes acceptable to the British political establishment, particularly in the near to medium term. Instead, in any scenario that the UK and EU ultimately opt for a shared future, the EU ought to show flexibility to ensure the UK is re-strengthened, recognising the irrevocable bonds shared.

### Concerns surrounding a hard Brexit will remain

Scope considers a no Brexit scenario to be the second most probable scenario after soft Brexit, and more feasible than a hard Brexit. However, given the limited foresight shown in current negotiations, the present government's stated intention of achieving a hard Brexit, and the unlikelihood of any conclusion for a transitional arrangement in the near term, concerns surrounding a hard Brexit are likely to remain central to the Brexit

A no Brexit scenario may increase fragmentation in the EU

Any reversal may hinge on the terms demanded

But concerns surrounding a hard Brexit will remain

<sup>5</sup> Bloomberg, 1 August 2017

<sup>6</sup> Keep, Matthew. (2017) 'The UK's contribution to the EU budget'. House of Commons Library, Briefing Paper, Number CBP 7886, 31 July 2017. Rebate from the EU/EC budget, 2019-2021 forecasts.

## The devolved parliaments complicate plans for hard Brexit

discourse and could grow in scale if no deal prevails as 2019 approaches. This constellation of outcomes is reflected in Scope's recent decision to confirm the UK's AA long-term issuer rating with a Negative Outlook.

### Complications from devolved legislatures

The vote for Remain in Scotland, Northern Ireland and Gibraltar in last year's referendum, in addition, creates complications. Prime Minister May, who emphasised her commitment to the union between the nations of the United Kingdom, faces possible challenges from any future second independence referendum in Scotland – even if this has been momentarily shelved<sup>7</sup>. Since July 2016, opinion surveys have shown a lead for remaining in the UK were a second Scottish independence referendum held.

The potential for the equivalent of a constitutional crisis exists, moreover, if devolved legislatures veto UK parliament acts. This was illustrated in warnings from the national legislatures of Scotland and Wales that they may reject the proposed Great Repeal Bill to transfer EU legislation into British law after Brexit.<sup>8</sup>

## Rating path depends on Brexit and surrounding conditions

### Rating implications of Brexit scenarios

The rating implications under each of the three core scenarios – soft, no and hard Brexit – depend on the path of Brexit negotiations, how much uncertainty is generated prior to any end-state, and how much policy regression occurs meanwhile. Soft and no Brexit scenarios might be the most conducive to a stabilisation of the UK's rating outlook. However, Scope notes that under each of the three scenarios, there remains the possibility for a rating downgrade if the terms of an exit or deterioration in macroeconomic conditions or public finances materially weaken the UK's sovereign credit profile.

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Source: Scope Ratings AG

Under the soft Brexit scenario, an agreement on a transitional arrangement post-2019 would be viewed positively by Scope, particularly if this ensures continuation of current trading conditions with the single market. A Norwegian model – in which the UK maintains full access to the single market after exiting the European Union – would be the most supportive of the UK's sovereign ratings. Alternative frameworks, including those that resemble the Swiss (of partial access to the single market, without full access for the banking sector) or Turkish (customs union with the EU, without frictionless trade on agricultural goods or services) models would be viewed more negatively. However, any action by Scope on the UK's ratings, even in the scenario of a transitional or permanent arrangement resembling the Norway model, would depend on the path to securing the

<sup>7</sup> CNN  
<sup>8</sup> Bloomberg

arrangement – with emphasis on the importance of reducing economic uncertainty – and on the quality of policy in other economic and fiscal areas. If a harder form of soft Brexit becomes more likely, and/or if economic resilience weakens materially or policy drifts adversely, Scope could envision a one-notch downgrade of the UK's ratings to 'AA-'. Conversely, if a soft Brexit is secured ensuring full access to the single market and reducing economic uncertainty significantly, the rating outlook could be stabilised.

Under a Breversal scenario, Scope expects this could be credit positive. However, any stabilisation of the rating outlook or, longer term, rating upgrades, under this scenario remain contingent on a solid policy framework and swift reduction in political and economic uncertainty, driving an improvement in business conditions. If in the scenario, for example, new elections were to lead to a Labour government that reverses the Brexit decision but implements anti-market policies, weakening the economic climate and/or damaging long run fiscal sustainability, this could be credit negative.

The hard Brexit scenario involving a cliff-edge change in trading arrangements after March 2019 would likely result in a downgrade of the UK's sovereign ratings. Scope also expects alternative softer forms of a hard Brexit, including the government's desired route for a transitional association with the EU customs union after exiting the EU, to be credit negative, due to such arrangements probably excluding the UK's services and agricultural sectors. Forms of hard Brexit that involve transitional arrangements to cushion the shock with an eventual endpoint of a full exit from the single market and customs union could be less credit negative, however such scenarios also hurt due to preserving macroeconomic uncertainty. Any scenario in which Scottish independence becomes a possible scenario could also be an additional negative rating trigger.

### **Brexit weakens the economic outlook**

While the decision to exit the EU presents obvious challenges, Scope considers the UK's institutional strength to be high. This includes the UK's large and diversified economy, strong rule of law under the nation's parliamentary democracy, monetary and exchange rate flexibility, a highly credible central bank, deep capital markets bolstered by London's role as one of the world's premier financial centres, and sterling's reserve currency status.

Nevertheless, the deep divisions that the debate on Europe opened up within both the major parties and society at large may prove difficult to heal, and may impede government stability and weaken the quality of economic policy in the coming period. The collective macroeconomic challenges surrounding Brexit inform Scope's Negative Outlook on the UK's long-term sovereign ratings, explained in more detail in "Scope confirms and publishes United Kingdom's credit rating at AA and changes Outlook to Negative", published on 18 August 2017.

**Institutional strength, but  
weakened policy framework**



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