GENERALI INVESTMENTS

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Brexit Deal reached but strong resistance in the UK increases crash Brexit risk

- Yesterday, the UK and the EU agreed on the terms of a withdrawal agreement, which UK Prime Minister (PM) May presented to her Cabinet, gaining only a majority approval.
- The agreement was possible due to a compromise on the Ireland border issue, which now foresees the whole UK to temporarily stay in the EU Customs Union.
- That said, May faces stiff resistance. The Northern Ireland DUP stated that it would vote against the deal and according to media reports May could soon face a no confidence vote triggered by members of her own conservative party.
- In our view, the risk of a crash Brexit has increased. Financial markets reacted with safe haven flows.

EU-UK reached draft Brexit agreement: Following the noise around the Brexit negotiations over the past weeks, the UK and the EU agreed on a draft Brexit deal, which the UK Cabinet has approved yesterday late. While almost everything had already been negotiated until summer, the trickiest and most controversial issue was how to avoid a hard border between Ireland and Northern Ireland ("backstop" issue). The agreement foresees the whole UK to stay in the EU Customs Union, thereby avoiding customs controls within Ireland or between Northern Ireland and England in the Irish Sea. There will be a 'review mechanism', which in principle could be a way for the UK to withdraw from backstop arrangements. But the UK cannot unilaterally exit the backstop arrangement. If by the end of the transition period – which should result in a new UK-EU trade agreement – no solution will be found, it can request an extension of the transition period at any time up until July 2020. Within the transition period, the UK relationship with the EU will be essentially unchanged. On the EU side, the draft agreement paved the way for an extraordinary EU summit likely on November 25, at which the EU-27 Head of States have to approve the deal. If approved, the EU Parliament would immediately start discussions and would likely formally approve it in February. As it stands now, the risk that the EU does not approve the Brexit deal is small.

May faces tough resistance: On the UK side, the UK Cabinet approved the deal by majority only. This morning, Brexit Minister Raab, Junior Northern Ireland Minister Vara as well as Labour Minister McVey stepped down. Members of the Northern Ireland DUP Party – that is needed to secure the government majority in parliament - already announced to "certainly" vote against the deal. Moreover, there is also ongoing significant resistance in May's own party. The British press reported that PM May could face a leadership challenge within her party. A challenge is triggered if 15 percent of the Conservative MPs (i.e 48 MPs) write letters demanding a confidence vote to the chairman of the party's so-called "1922 Committee". This would result in a vote among the party's 316 MPs. A simple majority would decide whether or not PM May stays on as leader. If May wins, she remains in office and cannot be challenged again for 12 months. If she loses, she must resign and is barred from standing in the leadership election that follows. There will be a leadership contest to decide her replacement. Her replacement will become prime minister, but a general election will not automatically be triggered.

This procedure has to be distinguished from a no-confidence vote in Parliament. Under the Fixed-term Parliaments Act 2011, a parliamentary no confidence vote is one of only two ways in which an early election can occur. If such a motion is successful, Parliament must dissolve, unless the motion is overturned within 14 days by the passing of an explicit motion of confidence.

Vote in Parliament: The European Council is likely to convene to an extra summit on 25 November, where the heads of the other 27 EU member states are expected to confirm the deal. The date is not set in stone, especially if a leadership challenge to May will occur. After the summit, PM May could put the deal before the UK Parliament in a timely manner before the Christmas break (Parliament will break for recess on 20 December). By law, the PM needs to present a deal to Parliament by 21 January at the latest. There is no guarantee, that the Brexit agreement will pass the UK Parliament: The Northers Irish DUP (10 seats) announced to vote against, Labour Party leader Corbyn made clear that the deal does not fulfill the six criteria set out by the party and according to press reports about one third of the conservative faction also objects the agreement. In the end it all depends on the ability of PM May to gather votes from other parties in order to compensate for the lacking support within her coalition. Generally, the hurdle for Labour to support May is high, and such a support would likely also come at a price.

No vote would increase probability of extreme scenarios: If the deal finds no majority in the UK Parliament, this opens up for a range of further developments.

- Principally PM May could go back to Brussels to try to amend the deal, but time constraints render this very hard.
- PM May, having invested her political capital into the deal, could step down. This would at least trigger a leadership contest within the Conservative Party or new elections. In fact, the party choice for a new leadership would put the party the party at the crossroads whether to leave the EU with or without a deal (crash Brexit). The latter would imply no transition period and the UK to become a third country to the EU. The Ireland border issue would be unresolved and the no-deal provisions on both sides would come into force.
- Given no majority, the government or the Parliament could also decide to return to the electorate for a second referendum.

All in all, the latest developments have increased the risk of a crash Brexit in our view.

Financial markets react with safe haven flows: The markets responded negatively to the current turmoil surrounding the Brexit deal. The pound lost the US-dollar 1.6% at the time of writing, 1.5% against the euro, and the 10-year UK Gilts lost 10 bps compared to the close yesterday's closing. The FTSE broadly moved sideways.

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