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Brexit and the financial services industry

The story so far

By Mark Boleat

CENTRE FOR EUROPEAN REFORM

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London is the world's leading international financial centre. While it is important not to overstate the impact of the UK's membership of the EU, the single market has benefitted the City. As such, it is no surprise the financial sector was broadly in favour of remaining in the EU.

The industry has accepted the referendum result and is preparing for Brexit. However, it remains in its interest for the UK and EU to come to an arrangement that maintains mutual, cross-border, market access for UK and EU-based institutions and for continued easy access to EU talent. The industry is also in favour of a long transition period, agreed as quickly as possible.

Yet financial institutions have been put in a position whereby they have no choice but to prepare for a worst-case, no-deal scenario. Ensuring a stable transition and a deep and comprehensive future UK-EU partnership is not in any one party's gift. There is much that could still go wrong, and the industry needs to guard against the potential fallout.

Some firms have already triggered contingency plans. Others are holding off on making a decision until late 2018. While political agreement on transition has provided some comfort, the longer it takes for the EU and UK to make it legally binding, the less useful it becomes.

In the long run the UK's priority market remains the EU. Financial services do not lend themselves to being included in trade deals largely because of the specific regulatory requirements to which the industry has to be subject. While the single market includes almost all financial services, no trade agreement has anything other than minor provisions relating to them.

Brexit will not destroy the UK's financial services sector – the industry will adapt as it always has done – but it will probably lead to a smaller proportion of the total European market being based in London and the UK. In order to mitigate the damage the government could:

1. Seek to remain in the single market, with (some) influence over the rules. The first part – single market membership – could be achieved through EEA membership, although politically this would require the UK going against its stated policy and existing red lines. The second part – a say in the rules – seems natural given the size of the UK financial services sector, but it is not in line with EU structures and thinking.

2. Press for the EU to agree to mutual recognition of regulation and supervision, as well as a mechanism to settle differences. If remaining in the single market proves politically unpalatable, mutual recognition would be a good solution for corporates and governments in respect of efficiency of financial markets. Early indications from the EU are that this will be difficult to achieve. It would mark a major change from the way the EU deals with third countries, and does not fit into the EU's

institutional arrangements. In addition, some EU countries are keen on attracting financial services business from London. From the UK perspective, as with any other international agreement, mutual recognition would mean sacrificing some 'control'.

For the moment, the first option appears to be off the table and the second will be very difficult to achieve. Regardless, there are a number of prerequisites to keep Britain competitive in the financial services market. They include:

★ A clear vision of the sort of economy and financial services industry that the government wants to emerge.

★ Tax and regulation policies that enhance the UK's competitiveness.

★ An immigration policy that maintains the UK's attractiveness to talent from the whole of the world.

★ Massively increased activity in international financial diplomacy: in the international agencies, with the EU and with the other countries that have major financial centres – the US, China and Singapore in particular.

In addition, the finance industry, and industry more generally, need to be more vocal. The British people voted to leave the European Union in 2016. They did so in the absence of any reliable information on what 'out' looked like; they did not vote specifically to leave the customs union or the single market. Industry needs to be vigorous in pointing to the consequences of alternative courses of action and advocating policies that help to promote prosperity in Britain.

The government has been publicly supportive of a deal that protects the UK's financial services industry, but to achieve this it needs to modify other negotiating aims, and at the same time further ease the regulatory constraints on EU-based institutions operating in the UK. The jurisdiction of the European Court of Justice (ECJ) may be a red line for the British government in some areas, but it should not be a red line in the financial services sector. For the financial services industry there is no problem with joint supervision by the UK and the EU of activity in the EU by UK-based institutions. The principle of paying into the budget for preferential single market access seems reasonable. The government will have to concede some of these points if there is to be any hope of a reasonable deal for financial services.

Much of the financial services industry in the UK is international in nature, providing services to governments, corporates and individuals throughout the world. It has achieved this status for a variety of reasons, including the English legal system, the UK's time zone, a relatively benign regulatory and tax environment, good connectivity and a welcoming environment for global talent. London was an international financial centre before Britain joined the EU, but membership of the EU has undoubtedly helped its status. As a result, financial services make a very significant contribution to employment and tax revenue in the UK, substantially more so than in any other large country.

Free trade agreements generally do not cover services to any significant extent. The one exception is the European Union's single market. The single market covers almost all financial services. So, for example, a bank or an insurance company based in one member-state can provide its services throughout the European Economic Area (EEA – the EU countries plus Iceland, Norway and Liechtenstein) without the need to establish separate businesses with appropriate capital, liquidity and management in each member-state. This gives scope for significant economies of scale. Many international financial service businesses have taken advantage of this to centralise operations in a single state. The UK has been the principal beneficiary, although Dublin and Luxembourg have also benefited to some extent. The UK now accounts for three-quarters of EU hedging and foreign exchange activity and half of wholesale lending and securities business. The critical mass of business that has resulted from Britain's place in the single market has been vital to attracting business from outside the EU.

The size of financial services to the UK economy

★ The UK has a financial services trade surplus of £61 billion, higher than any other country. £18.5 billion of this surplus is with the EU-27.

★ The UK accounts for 37 per cent of global foreign exchange trading, 39 per cent of over the counter interest-rate derivatives trading and 16 per cent of cross border bank lending.

★ The UK insurance industry accounts for 21 per cent of European insurance premiums.

★ The UK financial services industry paid £71.4 billion in tax in 2016, 11.5 per cent of the UK's total tax revenue.

★ The financial services industry employs over 2 million people in the UK.

The most comprehensive economic analysis of the implications of a possible Brexit on the UK financial services industry was a report for TheCityUK by the consultancy PricewaterhouseCoopers (PwC), based on some earlier work it had done for the Confederation of British Industry.[1] The main conclusions of this report were that in the event of Brexit:

★ In the short term, the gross value added (GVA) of the financial services sector would, under alternative Brexit scenarios, be between 5.7 per cent and 9.5 per cent lower than it otherwise would have been in 2020 – in money terms, a reduction of around £7-12 billion. The impact would moderate over time so that GVA in 2030 would be between 1.8 per cent and 4 per cent lower.

★ This would translate into a reduction in employment of 70,000 – 100,000 by 2020, but again the effect would moderate over time, so the long term reductions would be 10,000 – 30,000 job losses by 2030.

★ The impact of Brexit would be greater in the financial services sector than in the economy generally.

★ There could be potential 'knock on' effects as a result of a combination of factors making London less attractive as a financial centre. This could result in a further reduction in financial services GVA of around 2 per cent in 2020. This would magnify over time, rising to 3.3 per cent in 2030, and resulting in costs to the wider economy of about 0.4 per cent of GDP in 2030.

It should be noted that this analysis was based on the assumption that the UK would serve the Article 50 notice soon after the referendum, rather than nine months later. The delay in serving the Article 50 notice and probable agreement on a transition period will push back the timing of these effects but will probably have little effect on the overall impact.

What the industry has said since the referendum

The immediate aftermath of the referendum was a difficult period for businesses – having to begin preparations for Brexit and having to recognise that the vote was in part against business and the establishment generally. Some Brexiteers argued that the losers should depart the debate and that their views were not relevant. Attention focused on the debate within the Conservative government rather than on what was good for the country.

The financial services industry has accepted the referendum result. But equally it has every right to participate in the 'what sort of Brexit' debate, and has gradually done so. The ideal outcome for the industry would be:

★ Continued access to and influence over the single market – as near as possible to the current situation.

★ A lengthy transition period, finalised as soon as possible, and early clarity on the end position.

★ Continued access to talent from throughout the EU, with the ability to move people between countries quickly and without bureaucracy.

TheCityUK, the overall representative body for the financial services industry, set out its key 'ask' for the Brexit negotiations in January 2017. This was a bespoke agreement delivering mutual market access, transitional arrangements to allow for enough time to implement the new relationship and access to talent.

The mutual recognition of regulatory regimes point was explained in detail in a report by the International Regulatory Strategy Group (IRSG) with the support of the law firm Hogan Lovells. The report outlined the mechanisms for maintaining regulatory alignment, and how possible disputes between the UK and EU in relation to access could be resolved.[2]

The City's proposals would preserve the benefits of efficient wholesale financial markets, serving corporates

1: PwC, 'Leaving the EU: Implications for the UK financial services sector', April 2016.

2: IRSG, 'A new basis for access to EU/UK financial services post-Brexit', September 2017.

and governments throughout the EU. But they run into political realities. They would to a large extent result in the UK having the benefit of being in the single market, and would mark a significant departure from the principles on which the EU operates. The reaction from the EU-27 has not been favourable.

"A very small proportion of financial services covered by the EU passporting regime are subject to equivalence arrangements."

Like other sectors the financial services industry is seeking a lengthy transition period, agreed at the earliest possible stage. The 'cliff edge' would be particularly acute for financial services because of the long-term nature of many contracts. The industry is seeking a two-stage transition. The first is a bridging stage between the date of leaving and the date a new arrangement with the EU comes into effect, when in practice the status quo would be maintained. The second stage would allow the industry to adapt to the new arrangements.

Financial institutions have identified a number of specific problem areas. The issue of existing contracts is critical in several industries, particularly insurance. The Association of British Insurers (ABI) has raised the issue of cross-border contracts written pre-Brexit that will still be in operation post-Brexit, for example liability contracts which can run for ten years and pension contracts which can run for 30 years. The ABI has pointed out that "these contracts cannot be transferred safely and quickly to a new EU location. Special arrangements would be needed to transfer the contracts, covering both legal form and regulatory responsibility". The ABI went on: "If nothing is fixed, insurers will be left in an impossible position and face an unacceptable choice: break their promise to customers or risk breaking the law." The ABI noted that it was not possible to vary the contracts and that transitional arrangements would not be sufficiently long. Transferring contracts to another EU jurisdiction does not work because this is a judicial process and requires at least two years. The ABI concluded that certainty on this was needed by the end of 2017.[3]

This point was also covered in the Bank of England's Financial Stability Report. The report noted that about £20 billion of insurance liabilities and six million UK policyholders could be affected because their policies are with a non-British EEA insurer, and the figures are even higher for EEA policyholders with contracts with UK insurers. Transferring business to an EEA or UK insurer in the required timescale is not possible. The report said that over-the-counter derivative contracts would also be affected.[4] The gross amount of affected contracts is around £26 trillion with £12 trillion maturing after the first quarter of 2019. Banks are looking at options including seeking local permissions and transferring contracts to a legal entity in the EEA – something that is virtually impossible in the timescale.

The issue of contracts that run over the Brexit date has been recognised by the government. On December 20th 2017 the Chancellor announced that the government will, if necessary, bring forward legislation to cover contractual obligations and also allow EEA firms to continue to operate in the UK for a limited period after the UK leaves the EU without being authorised in the usual way. This is a valuable mitigation for EU businesses operating in Britain, although it does not solve the problem for firms based in the UK operating in the EEA.

'Equivalence' is seen by some as the solution to the issues faced by the financial services industry, and it will feature strongly in the phase 2 negotiations on the UK's long-term future relationship with the EU. Under equivalence rules, regulators in one country accept that regulations in another, while being different in some respects, have a sufficiently similar outcome such that cross border activity can be permitted. There are a number of bilateral equivalence regimes around the world, and the EU has operated an equivalence regime (known as a third country regime or TCR) for some years. For example, it has recognised as equivalent a number of central counterparties (CCPs) for derivative contracts. However, this was a tortuous process taking four years, as initially CCPs were in a position in which complying with either US or EU rules meant breaching the rules of the other party.

This issue was exhaustively analysed by the International Regulatory Strategy Group. This noted that "only a very small proportion of financial services which are currently covered by the passporting regime" are subject to equivalence arrangements. And "there is no TCR giving cross-border access for a number of key financial services, including deposit taking, lending, payment services, mortgage lending, and activities relating to UCITS funds [EU-based mutual funds]. There is only a very limited TCR for insurance."[5] Also, equivalence is at the discretion of the European Commission, albeit on the advice of the appropriate EU regulatory body, and can be withdrawn at 30 days' notice.

In practice, the process of granting or withholding equivalence is political, as Switzerland has discovered to its cost: in December 2017 the EU granted Swiss stock exchanges access to EU markets under the equivalency procedure. However, this was granted for one year only and its renewal will depend on the outcome of

3: Association of British Insurers, 'Brexit and insurance contracts', 2017.
4: Bank of England, 'Financial stability report', December 2017.
5: IRSG, 'A new basis for access to EU/UK financial services post-Brexit', September 2017.

negotiations between Switzerland and the EU over an institutional agreement on their long-term relations. Switzerland and the EU currently have 120 bilateral agreements; attempts to rationalise these have been frustrated by the Swiss referendum decision in 2014 to limit immigration from the EU. One year is not a reasonable period of time for a stock exchange to be licensed to operate in the EU, and the issue illustrates that equivalence is as much political as technical and it can be linked to developments in unrelated areas. The current equivalence regime operated by the EU is therefore not an option as a basis for businesses based in the UK conducting cross-border activities into the EU.

In the draft of the 27's negotiating guidelines leaked to the *Financial Times* on March 20th, the EU said that Britain should be given "appropriate access" – while not being allowed to pose any threat to financial stability in the Union – through equivalence rulings. Given the scale of financial flows between the UK and the 27, equivalence might require tougher assessments of the UK's regulatory and supervisory standard, by the European Commission.[6]

It may be argued that such a system of equivalence could be modified to make it more appropriate, for example by the Commission's discretion being replaced by an EU-UK agreement and by the scope being widened to include all mainstream financial services. However, in practice this would not be equivalence, but mutual recognition, which is covered earlier in this section. As will be shown subsequently, there is little appetite in the EU for such a reform.

What the industry has been doing in anticipation of Brexit

Every financial services business that operates in other countries in the EEA – and even some that do not – has had to plan for Brexit. Financial services businesses are heavily regulated and have demanding customers, and many engage in long-term transactions. They are expected to manage risks intensively.

"In the short term, businesses are doing the minimum to provide continuity of service to their customers."

There is clearly a risk that from March 29th 2019 Britain will no longer be in the European Union or the single market, and that there will be controls of labour movement between the other EEA countries and the UK. This risk has to be mitigated. Following the agreement at the European Council in March 2018 it now seems probable that in practice the UK will remain in the single market until the end of 2020. But this is not bankable. There can be no certainty that a transitional period will be granted until the UK's withdrawal agreement has been ratified, which is unlikely to be the case until early 2019. More generally, the value of transitional arrangements diminishes by the day. If they are finally agreed in March 2019 that will be too late for most institutions, although some might be able to slow down restructuring of their business.

So, prudently, all financial services businesses must assume a worst-case scenario. Moreover, their customers are rightly asking questions about what will happen to certain lines of business – existing and new – after March 2019. Regulators are requiring financial institutions to prepare for a worst-case scenario. This is not unpatriotic or scaremongering; it is sound business practice and implies nothing about the merits or otherwise of Brexit.

The Prudential Regulation Authority (PRA) was explicit in a letter to authorised institutions in April 2017.[7] It required firms to plan for a variety of potential scenarios. The letter asked firms to give full information about their plans to the PRA by July 14th. EU regulators have been adopting a similar approach. BAFIN (the German financial services regulator) has written to UK-based insurers operating in Germany asking "what emergency plans have you developed to take into account all conceivable exit scenarios".

Two side-effects of this work have become apparent, although to what extent is uncertain:

★ Business now sees the costs, as well as the benefits, of concentrating activity in one location. Sir Howard Davies, the chairman of RBS and the former chairman of the UK's Financial Services Authority, has commented: "Brexit will alter the picture, whatever the outcome of the negotiations. Foreign-owned firms have concluded that keeping all their eggs in a British basket being shaken vigorously by changeable political winds is risky."

★ Some of the work on location should have been done anyway, and even with a favourable Brexit outcome some businesses will see merit in moving part of their business from the UK for economic reasons – for all of its attractions, Britain, and London particularly, is a high-cost place to do business.

6: 'Brussels to offer City market access – but on the EU's terms', *Financial Times*, March 20th 2018.

7: Prudential Regulation Authority, 'Dear CEO letter – Contingency planning for the UK's withdrawal from the European Union', April 7th 2017.

The two factors reinforce each other.

For the most part businesses are, in the short term, doing the minimum to provide continuity of service to their customers; what this is depends on the nature of the business and the method of operation of the individual company. It also depends on the attitude of regulators in the EU-27 and in the UK. Regulators in the EU-27 will not accept firms establishing 'letter box companies', with all business continuing to be done from the UK. This type of arrangement is not acceptable to any regulator – including the PRA in the UK. Regulators require capital, liquidity and management to be in the jurisdiction in which the business is authorised. They recognise the exceptional circumstances that Brexit presents – with many institutions trying to do the same thing at the same time, which itself poses resource problems for the regulators. Accordingly, they are taking a pragmatic approach that will accept a limited transfer of functions initially, but with the stipulation that over a period of three to five years all the required functions will be transferred. So this might mean, for example, 50 staff initially but 500 after three years.

"There is not one button that all financial institutions will press at the same time to shift some operations to other centres."

It is not the case that there is one button that all financial institutions will press at roughly the same time to shift some of their operations to other centres in the EEA. Financial services businesses are affected by Brexit in very different ways, even if they are doing similar business. For example:

★ Some investment banks, such as Goldman Sachs and JP Morgan, run almost all their EU business from the UK. Others have separately authorised and regulated businesses in other member-states (Deutsche Bank in Frankfurt, Citigroup in Dublin and HSBC in Paris, for example). Moving business for the latter is much easier than for the former and can be done more quickly.

★ Some fund managers sell investment products from London, others from Dublin or Luxembourg, in both cases with the fund management being delegated back to London. The former have much more work to do to mitigate the Brexit risk than the latter.

★ Some businesses have flexible IT architecture that enables business to be transferred relatively smoothly from one jurisdiction to another; others have more rigid systems that will require a new system to be built together with short-term manual workarounds.

Different approaches to contingency planning do not mean that firms have different interpretations of what might happen with Brexit, but rather different circumstances. Most financial services businesses have been going through a series of steps to make their plans:

1. Evaluate all areas of business and identify what could no longer be done lawfully from the UK post-Brexit. The 'broad brush' bit of this exercise is fairly easy. But only the detailed analysis that must then be done will provide the exact picture. It may well be the case that some activities that it was thought could no longer be conducted from London will in fact be able to continue to be run from London – and vice versa.

2. Analyse mitigation options – both short and long term. There are devices that can be used such as 'back to back loans', whereby instead of a loan being made from the UK, it is made by a subsidiary in the EU-27 and then immediately passed on to the UK parent. Another touted device is 'reverse solicitation' by which clients approach banks rather than banks being allowed to approach clients. Such devices are at best not straightforward and at worst – like reverse solicitation – simply do not work: the wholesale financial markets do not operate on the business of clients working out for themselves what financial services they need, then deciding on the best provider and approaching it. Rather, financial service firms energetically market their services through regular direct contact with potential clients. New procedures to mitigate the impact of Brexit would also need to be tested with lawyers, regulators and customers. And what might be acceptable in the short term (recognising the tight time frame in which things have to be done) may not be acceptable in the long term.

3. Analyse longer-term options. These include:

a. Ceasing to do some business – likely to be the case where business is smallscale and not very profitable.

b. Selling business lines that can no longer be done from the UK.

c. Moving business out of the UK.

4. If option c is considered necessary then prepare a short list of alternative locations in the EEA. In most cases this will be a relatively easy task. The list will include any city where the business already has significant relevant operations (hence Paris being the preferred location for HSBC, Amsterdam for RBS and Dublin for Citigroup and Barclays) and the other major financial centres – Frankfurt for banks and Dublin and Luxembourg for insurance and fund management.

5. Conduct detailed analyses of the short-listed locations. This will cover business environment (labour laws, tax and so on), cost and availability of accommodation, availability of talent, attractiveness to employees moving from the UK and the attitude of the local government and the regulators. The last factor is crucial. The point has already been made that regulators are being pragmatic, recognising the short timescale in which all this is being done.

> *"Some companies will make public announcements; others will undertake any necessary restructuring with little publicity."*

6. Select the preferred location.

7. Prepare to operate. This stage involves applying for the necessary licence or licences (a process that can easily take a year or more), identifying premises and beginning to recruit staff.

8. 'Press the button' – taking firm steps to make the new facility operational. This will involve transferring some staff from the UK, recruiting staff locally and arranging all the necessary services that a financial institution needs. This stage also involves the beginning of the expensive process of transferring functions from the UK to the new location. Crucially, it also means that capital has to be provided.

9. 'Going live', that is the business is operating from the new location and not from the UK.

Each of these processes has a number of variations and is set against the background of changes in the environment, for example different interpretations of what will be required as a result of Brexit, changes in business plans unrelated to Brexit, changes in the business environment in potential new locations and so on.

It is impossible to give a precise estimate of the extent of relocation activity so far as a result of Brexit. Businesses simply do not issue press releases, saying:

★ "XYZ is building up its staff in Warsaw in anticipation of a possible vote by the British public to leave the EU. Two hundred people are being recruited who would otherwise have been employed in London".

★ "XYZ investment bank has announced today that it plans to recruit 1,000 staff in a new regional office in Frankfurt. Over the next few years the headcount in London will be reduced by a similar amount."

However, variations on these scenarios have happened, although most of the companies concerned did not issue press releases to draw attention to them. As Brexit day approaches more such activity will take place. The announcement in December 2017 of an in-principle transition agreement, and an accord on the wording the following March, have perhaps caused activity to slow down a little. If this does not quickly translate into a legally binding agreement, and if the phase 2 negotiations seem to be going badly, activity will accelerate. Some companies will make public announcements while others will prefer to undertake any necessary restructuring with as little publicity as possible.

The impact so far

Brexit has already had a significant impact on the financial services industry, although most of this impact is not easy to see. Even though Britain will be outside the EU it will be affected by EU policies. In particular, those financial institutions that wish to operate within the EEA post-Brexit will have to comply with EU rules. It follows that being able to influence those rules is important, particularly as Britain dominates the European wholesale financial markets. The UK has been very successful at influencing EU regulation over the last 20 years through a combination of expertise that goes with the size and importance of the industry, excellent work by officials in the Treasury and regulatory bodies, good input from the industry by individual companies and trade associations, and excellent work by a small number of MEPs.

Immediately after the referendum this influence diminished:

★ Officials were transferred to work on Brexit from other important policy areas.

★ The British commissioner, Lord Hill, who had been responsible for financial services, resigned immediately. His successor, Sir Julian King, has the security portfolio.

★ UK influence was inevitably diminished in the eyes of the Commission and the representatives of other member-states.

★ Some MEPs, seeing a limited life expectancy ahead of them, have resigned their seats or reduced activity.

Even those MEPs and officials still involved in policy work and trying to secure favourable outcomes for Britain find that they have less leverage than before. This is not to say that Britain no longer has any influence on new EU initiatives; some MEPs have continued to work very hard and their own stature has enabled them to have influence. But it is probably no exaggeration to say that British influence on future policy has halved at least.

A second factor has been the diversion of resources away from strategy and product development to dealing with Brexit. Large project teams have been put in place in major companies, aided by consultancy and legal support. So staff who were previously working on expanding the business are now working on protecting existing business. This will not show through in aggregate figures, but will be apparent in profit and loss accounts. A leading consultancy firm in the financial sector says privately that major banks have individually spent over £150 million on Brexit plans and the cumulative costs will run into billions. Similar figures are reported in the other sectors most affected by Brexit – chemicals, pharmaceuticals and the motor industry. None of this is productive in the longer term.

"The loss of the EBA is significant for London's pre-eminent role; and equally significant for the development of Paris."

It is very likely that new investment has been reduced, though it is almost impossible to give precise examples. This is, of course, not to say that no businesses have moved to or expanded in London since the referendum. In some cases access to the single market has not been a crucial factor, while in others a location decision might be so far down the road that the risk was acceptable.

But as soon as the referendum result was known the impact on investment decisions increased. Decisions that might have been to expand or to set up in Britain may have been deferred or even cancelled. Equally, businesses have been building up their operations in other EEA centres in anticipation of Brexit. All these decisions have been at the margin, perhaps affecting anything between a few jobs and 100 jobs at a time, but cumulatively they are significant.

Accordingly, the effect on employment has been comparatively small, and largely reflects new jobs not being created. For the most part the new offices in the EU-27 are employing additional staff rather than taking staff from London and other parts of the UK. TheCityUK has estimated that the total effect so far is a net loss of around 10,000 jobs.

The EY Brexit tracker monitors public statements of 222 of the UK's financial services companies. Thirty-one per cent have said publicly that they are considering moving or have confirmed that they are moving some operations or staff. EY estimates that financial services firms have so far committed to move 1,500 jobs to the EU-27, and on the basis of public announcements by six of the major investment banks they estimate that around another 10,000 jobs could be at risk of moving out of the EU in the event that Britain leaves the single market. Fourteen companies have named Dublin as their location, 12 (all banks) Frankfurt, eight Luxembourg and six Paris. Significant decisions include RBS building on its existing business in Amsterdam, Lloyds Banking Group similarly in Berlin, Barclays and Bank of America Merrill Lynch in Dublin, and Lloyds of London establishing a European operation in Brussels. In addition, as an inevitable consequence of Brexit, the EU's bank regulator, the European Banking Authority (EBA), currently based in London, will be moving to Paris. Although the number of jobs involved is fairly small, under 200, the loss of the EBA is significant for London's role as 'the financial capital of Europe' and equally significant for Paris in its attempts to develop as a financial services centre.

The long-term impact

The longer-term impact of Brexit on the financial services industry in the UK depends on decisions that have yet to be taken in five related areas:

★ The final exit agreement between Britain and the EU.

★ Trade deals.

★ The business environment in the UK.

★ How the EU develops after Brexit.

★ Policies in other financial centres, particularly in the US, Singapore and China.

The final deal between Britain and the EU
The financial services industry wants in effect a continuation of the status quo, but through agreement between the UK and the EU rather than agreement within the EU. What is the likelihood of this being achieved? It is possible, if there is the political will, and if regulators are given a firm steer that this should be done. However, there are both financial stability and political issues that mean that this would not be an easy task. Since the financial crisis the regulation of financial institutions has been greatly strengthened through higher liquidity and capital requirements and much stronger supervision. National governments and regulators are well aware that financial problems in one jurisdiction can easily spread to others through cross-border activity. Such activity is therefore subject to very strict oversight. In the EU's banking union, supervision is now largely conducted at the EU level through the Single Supervisory Mechanism. Informal co-operation between supervisors generally

works well, but is not regarded as adequate. So there are genuine regulatory concerns about loosening the current arrangements between the EU and the UK. The political issues are equally challenging. Such a deal would be complex to arrange – there is no precedent for it. More importantly, at present it seems unlikely that there will be political agreement for it among the EU-27.

"While CETA has a small financial services component, its provisions do not come close to passporting."

They need to weigh the benefits of such an arrangement against the cost to the 'EU project' and business that would move to the EU-27 in the event of higher barriers across the Channel. The wide and deep financial markets in London are an asset for the whole of the EU, providing corporates and governments with the financial services they need at a competitive price. But is this benefit sufficient to outweigh the costs? The prevailing view in the EU-27 at present is that the fragmenting of the wholesale financial markets in the EU will result in a modest additional cost for financial products, but this is acceptable given the wider issues. The preliminary discussions between the EU-27 confirmed this analysis. On January 31st 2018, the *Financial Times* reported:

> "EU Brexit negotiators have set out a tough line on financial services, ruling out an ambitious trade deal for the lucrative sector and arguing that Europe would benefit from a smaller City of London, according to confidential discussions among the other 27 EU member-states.
>
> In a rebuff to the UK, which is seeking to put financial services at the heart of a trade deal with the bloc, an internal EU-27 meeting this week concluded that future arrangements should be based on 'equivalence' – the limited and revocable access given to third-country institutions – rather than a wide-ranging new pact."

Although these are merely media reports of a preliminary negotiating position they chime with other comments consistently made by EU and member-state representatives. The EU's chief negotiator, Michel Barnier, was explicit in a speech to the Centre for European Reform on November 20th 2017:

> "The legal consequence of Brexit is that UK financial service providers lose their EU passport….but the EU will have the possibility to judge some UK rules as equivalent, based on a proportional and risk-based approach. And in those areas where EU legislation foresees equivalence."

The speeches in early March 2018 by Prime Minister Theresa May and Chancellor Philip Hammond, in which both put forward the mutual recognition option, received a similar reaction from the EU and French Finance Minister Bruno Lemaire.

So the most likely outcome is that there will be no comprehensive long-term deal on financial services, only a transitional deal, although Britain should continue to press for the type of arrangement put forward by the IRSG and now adopted by the government. More generally, it seems likely that Britain will be unable to secure much beyond a trade deal covering mainly goods. The most optimistic scenario is something akin to, but preferably wider than, the Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada, which took seven years to negotiate and which is not yet in force. This agreement is largely confined to goods and while it has a small financial services component it does not provide for anything like the current passporting arrangements within the EU. There is no reason in principle why free trade agreements cannot cover services, including financial services, and for Britain this is important, given the huge size of the country's service exports. However, much work will be needed to make any progress, given the lack of precedents.

The alternative scenarios were analysed in a report by the Oliver Wyman consultancy. It concluded that if the UK retained market access on near to current terms, the impact would be only modest, with 3,000-4,000 jobs at risk and tax revenue falling by less than £500 million a year. At the other end of the spectrum, if the UK had no financial services deal whatsoever with the EU, the industry would lose £18-20 billion a year in revenue, which would put 31,000-35,000 jobs at risk along with £3-5 billion a year of tax revenue. There would also be a knock-on impact on the ecosystem that could result in the loss from the UK of activities that operate alongside those parts of the business that leave, the shifting of entire business units, or the closure of lines of business due to increased costs. An estimated further £14-18 billion of revenue, 34,000-40,000 jobs and £5 billion in tax revenue per annum might be at risk.[8]

The British government hopes that trade deals with countries outside the EU can make up for lost trade with Europe. That is unlikely, not least because the UK has a comparative advantage in trade in services (which make up almost half the country's total exports), and the best evidence we have shows that the EU's single market has boosted services trade between its member-states, while free trade agreements have had no discernible effect.[9]

8: Oliver Wyman, 'The impact of the UK's exit from the EU on the UK-based financial services sector', 2017.

9: Monique Ebell, 'Assessing the impact of trade agreements on trade', National Institute Economic Review, November 2016.

Trade deals typically do not cover services to any great extent and cover financial services hardly at all. Until there is some firm evidence to the contrary, it is safe to assume Brexit will not provide any notable opening for Britain to strike financial services trade deals or enable UK financial services to avoid being subject to EU rules. This does not mean that there are no opportunities to expand financial services business outside the EU. There are, but Brexit does not make it easier to exploit these opportunities.

The business environment in the UK

It has been suggested that once it is outside the EU Britain will be able to follow a path of radical deregulation to gain a competitive advantage over continental Europe – a model which has come to be called 'Singapore on steroids'. Singapore is a highly regulated financial centre, so the comparison is not apt; but more importantly, there is no appetite in the UK, either in the finance industry, government or regulators, for significant deregulation. Rather, there is a wish to stay within international norms and as far as possible to mirror EU regulation, at least in the short to medium term, simply because many institutions based in the UK will still be operating in the EU, albeit through subsidiaries rather than passporting. However, there is an argument for modifying the regulatory regime to give more emphasis to competitiveness rather than trying to prevent every conceivable problem. For example:

★ The UK has implemented the EU's Solvency 2 directive, governing capital requirements for insurance companies, in a more onerous way than is required by the directive.

★ The UK's regime for senior staff remuneration and competence is the toughest in the world. While the PRA already indicated that outside the EU Britain might wish to remove the cap on bankers' bonuses, this still leave other onerous requirements in place.

"There is no appetite in the UK, either in the finance industry, government or regulators, for significant deregulation."

★ The UK has very strict capital requirements for foreign banks wishing to operate in the UK.

★ The cost of regulation in the UK, both fees paid to regulators and compliance costs, are at the higher end of the spectrum.

★ Even the simple task of opening a business bank account in the UK has become complicated.

A thorough review of the whole of financial services regulation from the perspective of competitiveness could, at the margin, help to retain and attract business to London. Ideally, this needs to be done now. However, there is very little bandwidth in government, regulators or the industry to look at these issues, because Brexit is rightly absorbing all the available resources.

In this respect it was encouraging that in December 2017 the PRA announced measures that would make it easier for EEA banks to continue operating in the UK post Brexit, and the Treasury announced that if necessary it would bring forward legislation for a time-limited 'grandfathering' regime. Currently, these banks can operate without PRA authorisation. After Brexit they will need to seek PRA authorisation to operate as a subsidiary if they conduct retail business or a branch if they do wholesale business only. Normally the PRA would assess the adequacy of home state supervision. The PRA statement said that for EEA banks this could in effect be taken for granted. This is as far as the PRA could be expected to go, but it is still the case that the 77 EU banks currently operating in the UK under the passporting regime will have to go to the considerable expense of applying for a licence to operate in the UK, a process that the PRA has said may take up to 12 months. A few may decide that it is not worth doing so but most will accept the cost, albeit a further addition to the heavy cost of doing business in London.

There are related issues that are not specific to financial services:

★ Physical connectivity – no flights equals no business. London still scores quite well in this respect, but the current handling of airport capacity is not encouraging. And London requires a better transport network and better management of the network it has.

★ Britain is nowhere near the top of the league table in respect of electronic connectivity. We must aspire to be like the Baltic states – Latvia, Lithuania and Estonia – which have shown the way.

★ Tax is important – both personal and corporate. Britain already scores fairly highly in this regard, certainly compared with the major industrial countries. But it is important that public policy is made on the basis that higher taxes tend to curb activity. The British government has arguably already gone too far in a small number of areas – the bank levy, stamp duty on expensive houses and taxation of non-doms – such that higher tax rates may not bring in much revenue to the exchequer, and may even lower it. Tax changes need to be carefully thought through, with the assumption that they will affect activity.

★ Talent is a particularly difficult issue. Britain has benefitted hugely from its relative openness to talent from around the world, and from the EU in particular. Financial services, construction, hospitality, social care and food packing and processing are among the sectors that are heavily reliant on labour from other EEA countries. But concerns about immigration were one of the factors driving the referendum result and the government is committed to bringing net immigration down to the "tens of thousands". There has been some hope that stricter controls on EU nationals could be balanced by easier access from Commonwealth countries in particular. But the government has given no indication that this is likely; indeed, given that net immigration from outside the EU is already over 100,000 a year it is difficult to see how this could be done. The university sector has already been adversely affected by the clampdown on non-EU immigration and is making warning noises about the impact of Brexit. Similarly, the technology sector is heavily reliant on being open to the best talent from throughout the EU, and already there are signs that London's relative attractiveness is diminishing, as a result of high cost as well as Brexit-related concerns.

"Brexit will mean that European corporates will pay more for financial products – but not to a substantial extent."

How will the EU develop after Brexit?

It remains to be seen how the EU will develop post-Brexit, and what impact that might have on the UK. Immediately after the referendum, Britain's economic growth was among the highest of developed countries, while several EU countries were growing more slowly, and as long as Marine Le Pen had a chance of winning the French presidency, the risk that the eurozone would return to crisis remained. Eighteen months later, the tables have turned. Britain's growth rate has fallen to around 1.5 per cent while other EU countries are growing at in excess of 2 per cent, and the eurozone, while fragile, is still intact.

The UK has contributed greatly to the EU being a relatively liberal open-market economic area. There is a justified fear that without the UK's influence the EU will become more protectionist, although those fears are just as justified about the UK and the US. In this respect it is wrong to think of the EU as a single political entity. The UK has generally had much more liberal employment and business friendly laws and tax regimes than France and Germany in particular, which has contributed to EU business being run from London, although it has not resulted in labour productivity in Britain being higher. So currently there is nothing preventing France, Germany and other EU member-states from adopting more business-friendly laws and as they are inside the huge single market of the EU, with its network of trade agreements, there is scope for them to become more competitive. France has already taken significant steps in this respect.

The EU may become more closed to the rest of the world as a result of Brexit, but it remains to be seen if this will have a significant impact on economic performance. But it would be unrealistic to bank on the failings of the EU in the future bringing substantial competitive benefits to the UK.

There are some sectors of the financial services industry where the EU without Britain might take steps that would be significantly damaging to the industry in the UK, and which Britain would have little ability to prevent.

One sector has already been the subject of much speculation. Currently, London is the European centre for clearing of euro-denominated derivatives. The European Central Bank (ECB) has already made one attempt to shift this business to the eurozone. The UK managed to combat this, with the help of a favourable judgment from the European Court of Justice. With Britain no longer having a seat at the table, another attempt would be more successful. However, the business is so large and complicated that EU countries recognise that it simply cannot be lifted out of London and put somewhere in the EU. In the short term the most likely outcome is that the ECB will want more say in regulating the activity in London, but longer term there may be the gradual movement of business to other exchanges.

The more worrying sector is fund management. Currently, regardless of where investment funds are legally established, the management of the fund can be delegated to anywhere in the world. Dublin and Luxembourg have regulatory and tax regimes that are favourable to funds being established in those locations, but London has unrivalled expertise in fund management. DExEU's sector report on asset management notes that the sector had assets under management of £8.1 trillion, £1.3 trillion of which was managed for clients in the EU-27. Asset management is a very important part of the UK economy, accounting for 1 per cent of GDP, a £6.2 billion trade surplus and £5-7 billion a year of tax revenue.[10]

As with derivatives, after Brexit there would be nothing to stop the EU attempting to require funds authorised in the EU to manage those funds from within the EU. This would meet with strong resistance from the industry, from the UK and also from other jurisdictions including the US, which have significant fund management industries.

For both these sectors, and potentially for others, Brexit will lead to years of uncertainty during which London would lose some of its attractiveness and therefore some of its business. How big 'some' will be remains to be seen.

What about the impact of Brexit on the financial services market in the EU? It is already clear that Brexit will not

10: DexEU, 'Asset management sector report', 2017.

lead to the emergence of a new financial centre in the EU, replacing London. Rather, London will remain the largest European financial centre, but smaller than it would otherwise have been. Frankfurt will emerge as the major alternative banking centre. Luxembourg and Dublin will be the other main beneficiaries. Brussels, Berlin, Amsterdam and Paris are among other cities that will pick up some business. So will New York and Singapore for business that need not be located in the EU.

This will not be a disaster for European corporates. They will have less efficient financial markets and will pay more for loans, insurance, hedging and other financial products – but not to a substantial extent.

> *"Britain should seek alliances with other countries with big financial centres, to influence policy at the global and EU level."*

Policies in other centres

London has become an international financial centre, serving not just the EU but wider financial markets. Some business is done from London that equally could be done from New York, Singapore or other financial centres. Brexit diminishes London's attractiveness by reducing the amount of EU business that can be done from the UK. This will be taken into account in location decisions being made by the major financial institutions. It is not the case that business that leaves London will automatically go somewhere else in the EEA. Some business will cease and some business will go to the other major financial centres. So for example, business that could been done from New York or London might in future be more concentrated in New York, particularly given the tax cuts and other business-friendly initiatives by the current US administration.

One of the points made by advocates of Brexit was that the growth markets are in Asia, not Europe. This is correct and as financial services business is dependent on other economic activity it follows that more financial services business will be Asia-related. Some of this can be done from London, but Singapore and Hong Kong are more natural centres for that activity. Singapore in particular will be identifying and seeking to attract any business that might move from London. Hong Kong remains an important centre for China-related business and, in the longer term, Shanghai could become an international centre, but only when the Chinese authorities accept that 'international' means precisely that.

In seeking to preserve London's attractiveness as an international financial centre, the UK government will need to carefully monitor and be responsive to policies not just in the EU but also in New York, Singapore, Hong Kong and other financial centres. This will be all the more needed, since each of these centres is likely to be a beneficiary of Britain's lost business as a result of Brexit.

Financial diplomacy

There is no doubt that Britain will need to continue to influence work at the international level on financial regulation and supervision. Indeed, some supporters of Brexit correctly made the point that much financial regulation has originated at the global level, with the EU merely being an implementation mechanism. Britain will also need to seek to influence EU activity, given that the European market will remain important for many British-based financial institutions. At present much of this influencing is done through the EU. Post-Brexit it will need to be done outside the EU through several different channels:

★ In Brussels itself, where Britain will need to lobby the EU from outside rather than being part of the decision-taking process. Britain will need to build up a more significant government presence in Brussels. The Norwegian mission to the EU will be a good model on which to build – but Britain will need a much larger operation than Norway.

★ Business similarly will need to beef up its presence in Brussels. It is significant that the American Chamber of Commerce to the European Union has a vision which includes "the most effective advocacy force in the EU". Individual American corporates also have a substantial presence in Brussels.

★ Financial regulation is now done through global, regional and national organisations. Three international committees – the Basel Committee of Banking Supervisors, the International Organisation of Securities Commissioners and the International Association of Insurance Supervisors – are increasingly responsible for setting the framework within which the EU has made rules. Post-Brexit Britain will need to increase its involvement in the international bodies, and also remain influential in the Financial Stability Board which has general oversight of financial stability issues.

★ Britain will need to seek alliances with other major countries with significant finance industries, to seek to influence developments at the global and EU level. The US, Japan, Singapore, Switzerland and China are the most important such countries.

Britain has been excellent at financial diplomacy within the EU, largely through Treasury officials, supported by regulators and also by MEPs. Much of this expertise is now engaged in trying to secure the best possible Brexit outcome. When this is done, and even while it is being done, more resources will be needed, and ultimately diverted to the international financial diplomacy arena. Much of the work will need to be done by finance specialists, working with the Foreign Office. This will be a real challenge, but will be vital if Britain is to continue to have the influence it needs in setting the rules for the global financial system.

Conclusions and recommendations

The best outcome for the UK financial services industry would be for Britain to stay in the single market and continue to have influence over the rules that govern the sector. However, the government's Brexit red lines suggest Britain is destined to become a 'third country' with no special access to the single market. Consequently, to maintain the largest possible financial services industry in the UK requires the following:

★ A clear vision of the sort of economy Britain wants to be – ideally, open and liberal.

★ A liberal policy on migration – from within and outside the EU. This will be difficult to achieve given the government's objective to reduce net immigration to under 100,000.

★ A tax regime that attracts business to the UK. This does not mean a low-tax environment, but rather one that recognises that businesses and people are mobile.

★ A review of regulation to ensure that international competition issues have due weight, while continuing to operate within agreed international norms.

★ A massive strengthening of financial diplomacy, aimed at securing as much market access as possible.

★ In addition to the longer-term issues noted above, in the short term regulatory requirements on EU financial services businesses passporting into the UK need to be further eased, beyond the announcement by the Treasury and regulators in December 2017.

Time is of the essence. The faster the post-Brexit trading conditions for financial services are laid out the better. The longer it takes to get political and legal agreement, the more business will be lost, hitting tax revenue and employment.

The government's stated position is that Britain will leave the single market. However, the agreement on Ireland in the December 2017 'joint report' complicates its stance and may perhaps influence the debate about remaining in the single market. And the more that businesses analyse the implications of leaving the single market and begin to incur huge costs in preparation for operating outside it, and the more the practicalities are understood generally, the stronger the arguments in favour of a change of policy. The Labour Party remains divided between those who believe that continued single market membership is essential to the economic well-being of the UK, and those who believe that it would contradict the result of the Brexit referendum. Business, including the financial services industry, should add its weight to the debate on the side of remaining in the single market.

The UK should continue to seek an agreement with the EU on mutual acceptance of each other's regulation and supervision, as well as a mechanism to settle differences along the lines put forward by the International Regulatory Strategy Group. This would be a good solution to ensure the efficiency of financial markets for corporates and governments. While this option has not so far found favour in the EU, it should continue to be the negotiating position of the sector and the government.

The government has been publicly supportive of a deal that protects the UK's financial services industry, but to achieve this it needs to modify other negotiating priorities. The ECJ may be a red line in some respects but should not be for financial services. The principle of paying into the budget for preferred single market access seems reasonable. The government will have to concede some of these points if there is to be any hope of a reasonable deal for financial services.

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