

The City and the EU after Brexit; some (mainly pessimistic) thoughts

David Miles
Imperial College
London

January 2020

Some simple points

- London has been the place where a high proportion of financial services central to the operation of European stock and bond markets, derivatives trading, forex and many banking operations are provided from.
- At the time of referendum about 50% of EU equity was raised in London. About 75% of the EU foreign exchange and interest rates derivatives trading takes place in the UK. Around a third of the wholesale financial activities of the EU take place in London
- The economic factors that lie behind this can be reproduced elsewhere within the EU over time but not perfectly generating some long run loss in efficiency. On top of that are transitional costs.
- That is not in the interests of users of financial services throughout Europe and not in the interests of the UK.
- Unfortunately the way Brexit negotiations have proceeded so far gives little reason to be optimistic about how this plays out.

Figure 1: Largest global net exporters of financial services, \$bn, 2018

Source: TheCityUK calculations based on UNCTAD data

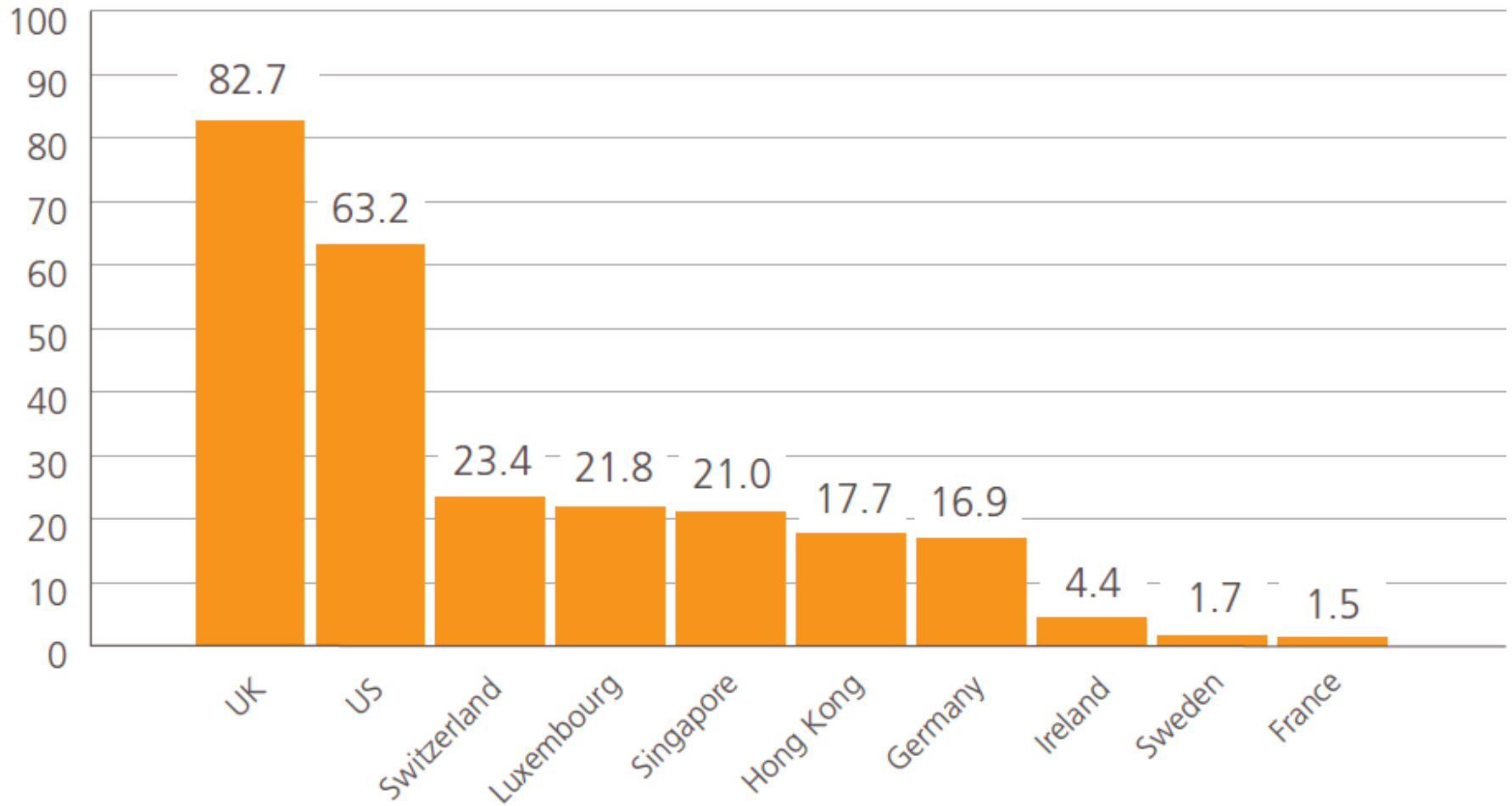


Figure 7: International bank lending and borrowing, % share Q2 2019

Source: Bank for International Settlements

| Country | Lending | Borrowing |
|----------------|---------|-----------|
| UK | 16 | 18 |
| Japan | 12 | 5 |
| France | 10 | 12 |
| US | 10 | 12 |
| Germany | 7 | 7 |
| Hong Kong | 5 | 4 |
| China | 4 | 5 |
| Netherlands | 4 | 3 |
| Switzerland | 3 | 3 |
| Singapore | 3 | 3 |
| Canada | 3 | 2 |
| Cayman Islands | 2 | 2 |
| Luxembourg | 2 | 2 |
| Spain | 2 | 2 |
| Italy | 2 | 2 |
| Others | 16 | 18 |

Figure 8: Foreign exchange trading, % share, April 2019

Source: Bank for International Settlements

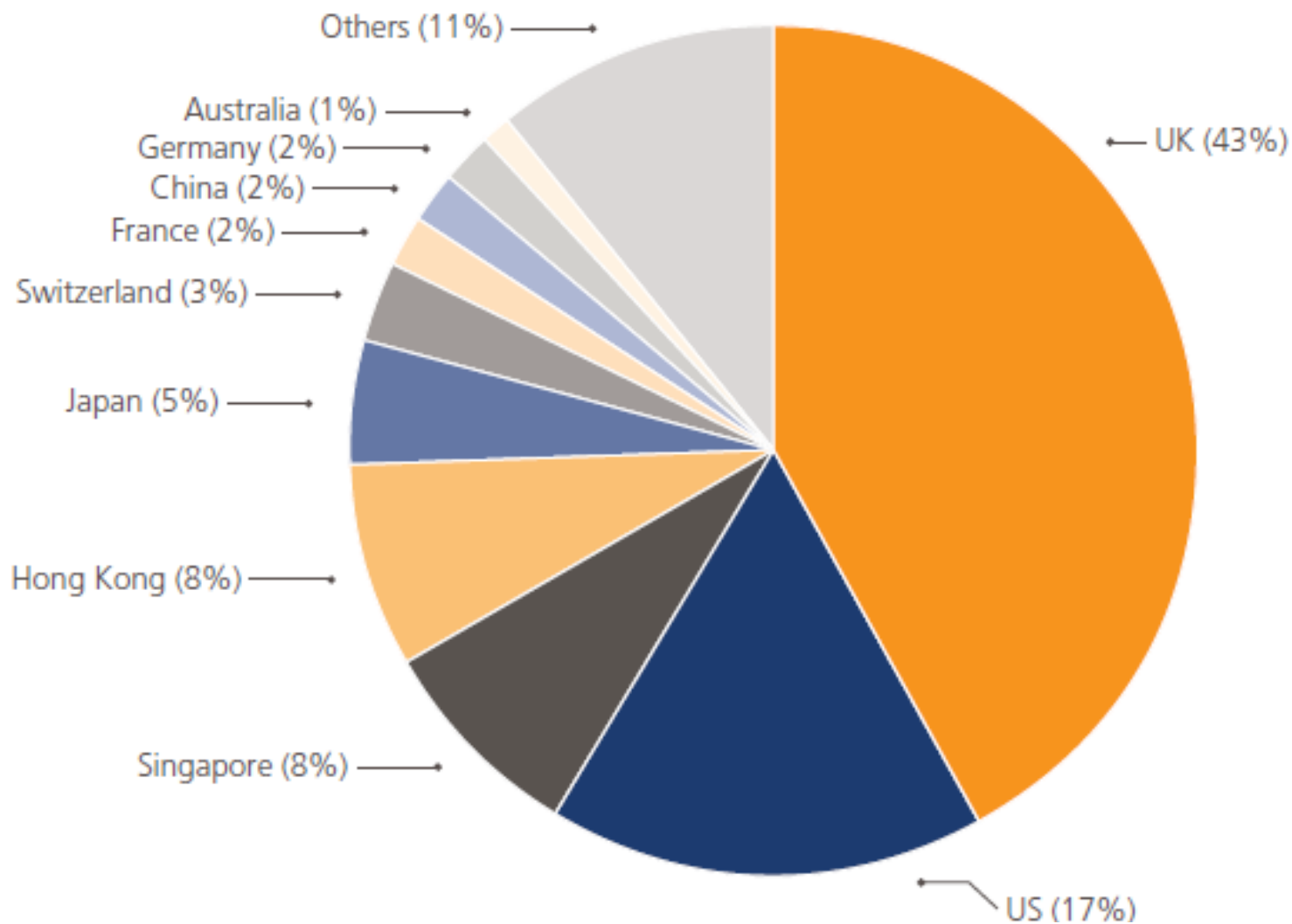
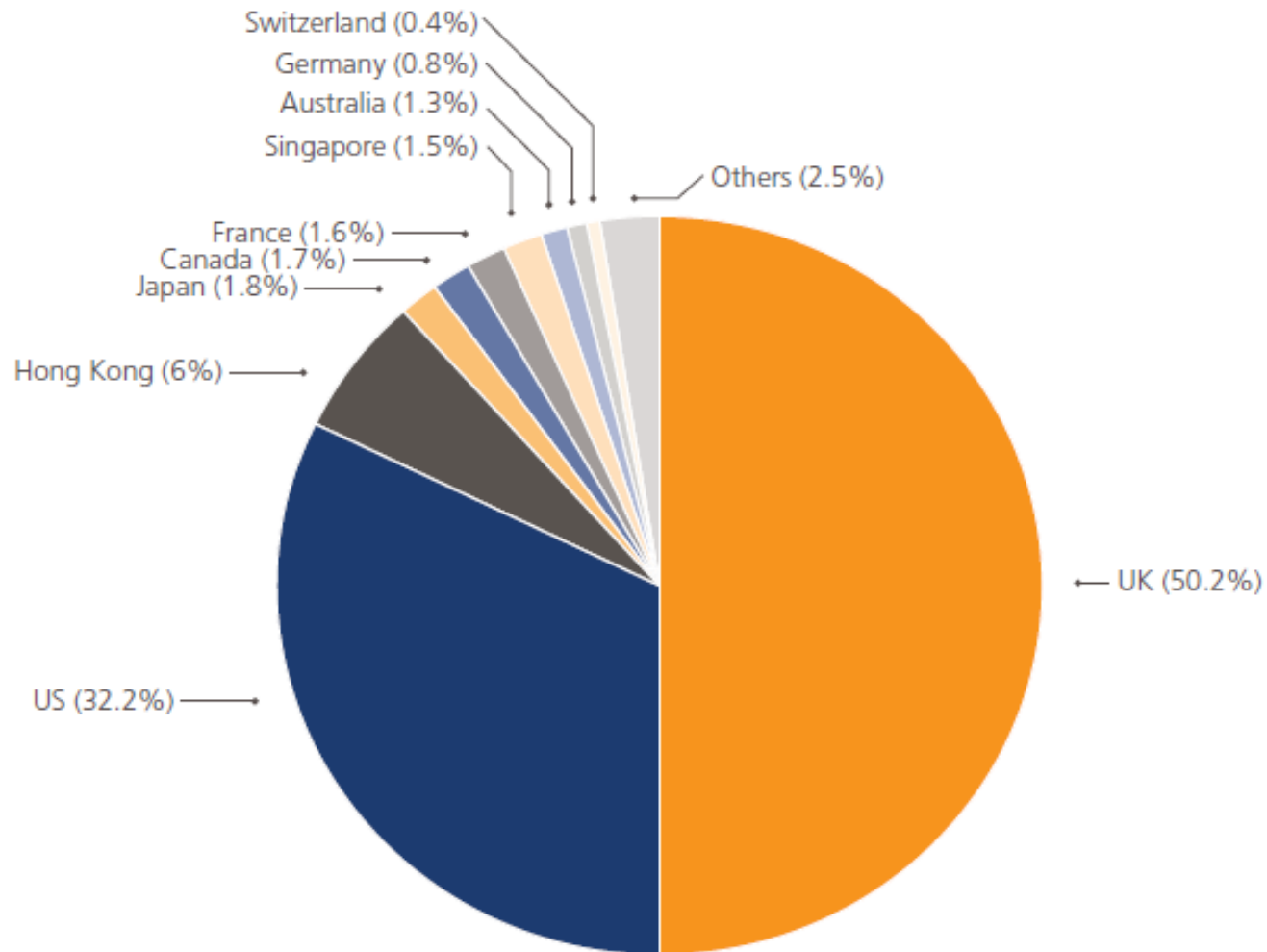


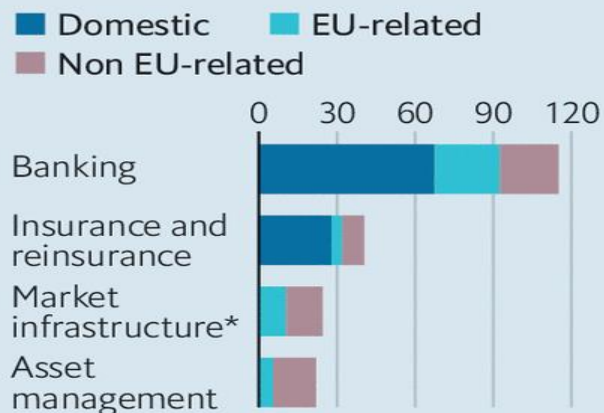
Figure 13: Location of OTC interest rate derivatives daily average turnover, % share, April 2019

Source: Bank for International Settlements



City on a hill

Britain, financial-services revenues, 2015, £bn



Financial-company headquarters relocating from London for EU business post-Brexit[‡]

By destination



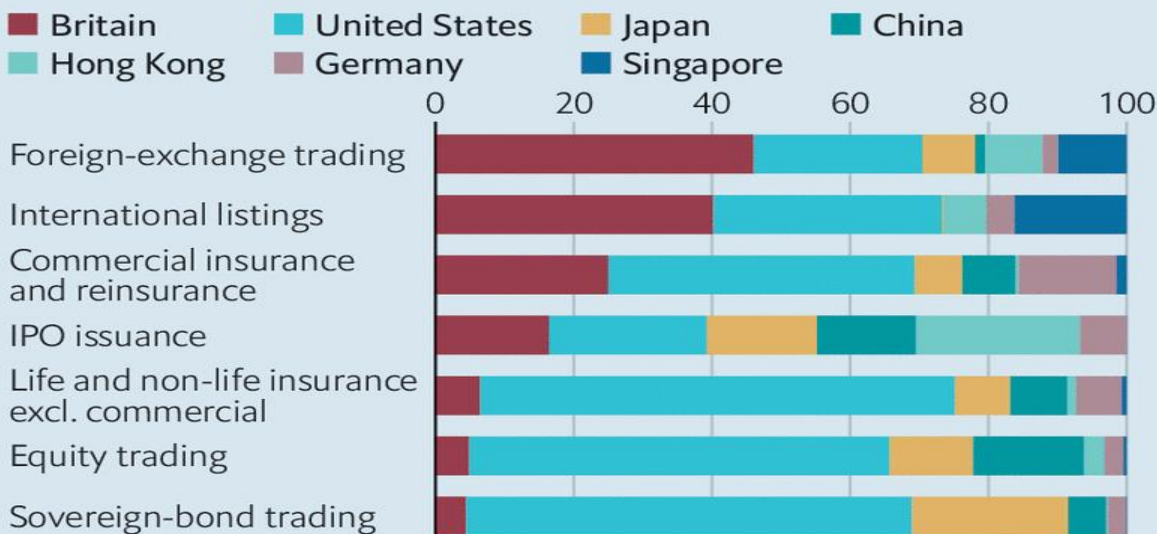
Sources: Oliver Wyman; Z/Yen; New Financial; TheCityUK; PwC

Global Financial Centres Index[†] (March 2019, rank out of 102)



Share of services within the seven leading financial centres

2016 or latest, %



*Credit-rating agencies, payment and data services †Composite of 133 indicators ‡Includes companies destined for London pre-Brexit referendum

| Employees | BAML | Citigroup | Goldman Sachs | JP Morgan | Morgan Stanley | Credit Suisse |
|-------------------|--------|-----------|---------------|-----------|----------------|---------------|
| Belgium | 0.00% | 0.00% | 0.00% | 0.13% | 0.00% | 0.00% |
| Denmark | 0.00% | 0.00% | 0.00% | 0.42% | 0.00% | 0.00% |
| France | 0.00% | 1.70% | 0.00% | 0.27% | 2.12% | 1.72% |
| Germany | 1.19% | 6.48% | 0.72% | 6.39% | 0.12% | 1.38% |
| Greece | 0.00% | 0.00% | 0.00% | 0.00% | 0.02% | 0.00% |
| Ireland | 9.52% | 0.32% | 0.04% | 9.33% | 0.00% | 0.73% |
| Italy | 0.99% | 0.92% | 0.45% | 2.17% | 1.66% | 0.26% |
| Luxembourg | 0.00% | 0.00% | 0.00% | 9.16% | 0.31% | 0.00% |
| Netherlands | 0.17% | 0.00% | 0.09% | 0.00% | 0.12% | 0.24% |
| Poland | 0.00% | 0.00% | 0.54% | 0.00% | 0.10% | 0.03% |
| Spain | 0.00% | 2.11% | 0.43% | 1.00% | 0.00% | 0.13% |
| Sweden | 0.09% | 1.07% | 0.07% | 0.46% | 0.00% | 0.08% |
| UK | 87.06% | 83.84% | 96.68% | 69.78% | 94.19% | 95.43% |
| Other EMEA non EU | 0.97% | 3.57% | 0.99% | 0.88% | 1.36% | 0.00% |
| Total EMEA | 100% | 100% | 100% | 100% | 100% | 100% |

Source: Bruegel based on Goodhart and Schoenmaker (2016) and EU Capital Requirements Directive (CRD IV) country-by-country reports.
Note: The data refers to the banks' investment banking activities in Europe, Middle East and Africa (EMEA).

Who wants what?

- UK seems to want some sort of enhanced equivalence that allows market access in many areas but which allows flexibility and divergence in rules so long as *outcomes* are broadly equivalent.
- The UK puts a major weight on its autonomy of law and rule making.
- EU position seems to be that equivalence means that the rules in the UK would need to follow whatever is in force in the EU. The UK will be a rule taker – and as soon as it diverges from the rule book it is not equivalent.
- In Brexit negotiations so far the EU position has been that the single market is a fragile thing of purity and beauty which cannot be compromised in any way. This is a point of principle.
- Considerations of net benefits (welfare) or of non-economic factors (European security?) seem to be secondary. The principle of the purity of the single market is central – as an outsider the UK will be treated like any other outsider.

Who wants what ?

“We believe an outcomes-based approach is critical to ensuring both the UK and EU can respect *each other’s* autonomy and regulate their markets in line with *their objectives*. Outcomes based equivalence focuses on the key outcomes different regulatory regimes seek to achieve, rather than requiring line-by-line equivalence. Coupled with *the principle of autonomy* this would ensure that the UK and EU remain free to make their own equivalence determinations on the basis of the outcomes of each other’s regimes, while retaining flexibility to address specific needs of the individual markets.”

(my italics)

UK Financial Conduct Authority

The Political Declaration of Withdrawal Agreement

“The Parties are committed to preserving financial stability, market integrity, investor and consumer protection and fair competition, while respecting the Parties' regulatory and decision-making autonomy, and their ability to take equivalence decisions in their own interest. This is without prejudice to the Parties' ability to adopt or maintain any measure where necessary for prudential reasons.

..... cooperation should be grounded in the economic partnership and based on the principles of regulatory autonomy, transparency and stability. It should include transparency and appropriate consultation in the process of adoption, suspension and withdrawal of equivalence decisions...”

October 19 2019

Who wants what ?

The EU has since maintained a strong public line on its approach to equivalence, in particular highlighting the importance of continued close regulatory alignment. In December 2019, Valdis Dombrovskis, the European Commission executive vice-president who oversees financial services, reiterated this position:

He said that the European Commission would be especially vigilant in checking that British rules for ensuring financial stability and protecting consumers remained aligned to the EU's own standards, and would act decisively in the event of any lapses. Access will depend on Britain "not starting to engage in some kind of deregulation", said Mr Dombrovskis, one of the new commission's three executive vice-presidents. "The more systemically important the market is for the EU, the more we import potential risks, [and] the closer the regulatory alignment that is expected." ...

Financial Times, December 2019

Why does UK want ability to diverge on rules and is it a danger to EU?

In many areas UK has tougher financial regulations and supervision than much of the rest of Europe – eg on bank capital.

Ironically, the UK lost a battle years ago when bank capital rules were enshrined in EU Directive and were made maximum harmonisation. The UK wanted the flexibility to impose *higher* capital controls on its own banks.

UK resistance to bonuses caps in the financial sector was **not** driven by an aim to be generous to financial firms – rather a belief that bonus caps were a bad policy that would create higher fixed salaries and make banks more fragile.

Over the years the UK has seen (or at least thinks it sees) EU financial regulation and supervision rules shaped by national interests of some countries who want to defend their domestic institutions.

Where next? Some cynical observations on politics

The EU position has been one of protecting the sanctity of “the single market” at the expense of all else - for example the value of the security and the defence partnership between the UK and other EU states.

It has made the Brexit negotiations more protracted and made the UK leaving more likely; it is now inevitable.

Perhaps once the UK leaves this will change.

A more sympathetic and pragmatic line on financial services is in the interests of both sides. But there is no sign this will happen.

Data issues – security less important than queuing nicely?

“The UK is at the “end of the queue” for a deal to allow data to continue to flow freely with the EU after Brexit, according to a senior European data official. officials in Brussels have warned that with only 11 months until a transition period ends in December 2020, the window may be too tight for an agreement on data. Wojciech Wiewiorowski, the EU’s new data protection supervisor, said the UK was “13th in the row” of countries that are negotiating data deals with Brussels. Allowing the UK to skip the queue “would be a little bit unfair towards those who have already prepared themselves for this process,” he added.

Mr Wiewiorowski said there remained issues over how British intelligence agencies handled personal data collected in the EU, and whether the UK would comply with EU rules on surveillance.”

The Financial Times, December 26th 2019.

Will economic and security self-interest make a more pragmatic outcome likely?

Will the UK see that demanding freedom to diverge on rules comes at a very high price?

Will the EU national politicians see that the purity of the single market rules may be worth sacrificing for the sake of other concerns – including European security in face of clear threats from neighbours?

Maybe.....but I rather doubt it

But isn't being effectively outside the EU financial market terrible for the UK?

There are about 1.3 million people in the UK working in financial services.

Financial services make up around eight or nine percent of GDP. That is not far off the size of the manufacturing sector.

Most of the people that work in banks, nearly all the people that work in the pension sector, and the great majority of people in the insurance sector are providing services to UK households and UK companies.

They are not exporting financial services to the rest of the EU.

But isn't it terrible for the UK financial sector?

Financial exports from the UK to the EU are, on some estimates, about 25-30 billion pounds – 1.5% of UK GDP.

Suppose you are very pessimistic. You thought that because the UK was going to be outside the single market, so doesn't get passporting rights, you lose half of exports, forever.

That might be around 0.75 of one percent of GDP. Not tiny – but not big.

Some people will move from London to the EU – house prices in very expensive areas of London will be lower and it will be easier to get into expensive London schools and restaurants.

UK non-financial companies will not notice much.

What about the EU?

There will be more financial sector jobs in several European financial centres.

This is not likely to bring unemployment down but it may mean more smart young employable Europeans go into finance than into science, technology, medicine, the arts etc.

House prices may be higher than they otherwise would be in some European cities.

None of these things are worth much.

Non-financial firms and households will find some financial services a bit more expensive.

None of this need have happened.

My guess is that it will happen.