'Brexit':

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FORUM PAPER

‘Brexit’: ‘The City’ and EU capital markets

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Abstract
This paper considers the implications of the UK leaving the European Union (EU) for ‘The City’ of London and the wider UK financial sector and for the EU’s Capital Markets Union (CMU) project. The extent of the impact of Brexit through job losses in London and gains in EU financial centres and the relocation of financial sector business will depend on the degree of ‘hardness’ or ‘softness’ of Brexit and indeed whether an exit treaty deal is struck or ‘no-Brexit’ follows a second referendum. At the time of writing (in November 2018) the likely denouement was far from clear. For the EU’s flagship CMU project, the loss of the core London capital markets will require the construction of a more fragmented system based in a number of cities within the EU. In this digital age, the various hubs can perhaps be fully networked whilst better serving distinct regional needs.

1 ‘Hard’, ‘Soft’ or No ‘Brexit’?

Following the historic vote (in the June 2016 referendum in the United Kingdom (of Great Britain and Northern Ireland) to leave the European Union (EU) in June 2016, a ‘straw poll’ taken at the 34th GdR (European Money Banking and Finance) Symposium, Paris Nanterre 5th July 2017 revealed that a significant majority believed there would be ‘No Brexit’. The next most popular option was a ‘Soft Brexit’.

By February 2018, Prime Minister Theresa May (PM) and the Chancellor Philip Hammond (HM Treasury) seemed to favor remaining in a customs union for goods but not for services (80% of the UK economy and 40% of exports to the EU) and hoped to do a special deal for financial services including ‘mutual recognition’ of regulations for the sector. In July 2018, a modified and more detailed version of the proposal (for a ‘facilitated customs arrangement’), was seemingly accepted (at Chequers, the country House of the Prime Minister) by the ‘Cabinet’ of ministers of the United Kingdom (UK) government. The aspiration for ‘mutual recognition’ (rejected by the EU’s negotiating team led by Michel Barnier and undermined by divisions within The City, was replaced by ‘enhanced, extended or expanded equivalence’ of regulations for the

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financial sector. However, subsequent to the publication of a 'White Paper' proposing legislation to Parliament, there were prominent resignations from the government by 'Brexiters' (who seek a 'hard', or possibly a 'no-deal' Brexit) and pro-Brexiter modifications were made to the proposals to gain Parliamentary approval. These proposals formed the basis of the final round of pre-Brexit (March 2019) and (currently 20 months from March 2019 'transition period') negotiations, even though the separation of goods from services, given the significant interactions between the sectors, did not seem wise.

The UK's 'Chequers' proposals are a variant of a 'customs union' option and related to the 'Canada model' in excluding services; and hence access by financial companies based in the UK the UK to the 'Single Market' in financial services through 'passporting', and in treating the UK as a 'third country'. As such, it represents a soft(ish) Brexit. A broader trade deal involving some service sectors and more enhancements to 'equivalence' for the financial sector would create a softer Brexit.

The degree of hardness or softness relates not just to the trading arrangements, but also to restrictions to free movement of people between the UK and the EU, the size of the UK contribution to the EU budget, and the extent of the jurisdiction of the European Court of Justice (ECJ) in dispute resolution. The UK could attempt to 'buy' more access to EU markets by adopting a variant of the 'Norway model', which involves membership of the European Economic Area (EEA) and making contributions to the EU budget in return for privileged access for financial services etc. Ultimately, the degree of 'hardness' depends on the agreed trade-offs between budgetary contributions, immigration restrictions, free trade in goods and/or services and the jurisdiction of the ECJ.

The difficulty in reaching an agreement between the EU and UK on these complex matters, about which both sides have 'red lines', including the desire by the EU to maintain its four 'freedoms' (of movement of capital, citizens, good and services) is compounded by the need to reach a 'backstop agreement' to resolve the Irish border problem. The EU is insisting on maintaining a 'free' border between Northern Ireland (NI) and Eire, and the UK wants to avoid a border with the EU in the Irish Sea; and not to create a precedent for Scotland to seek enhanced independence within the UK. The government relies for its majority of the votes in Parliament on members of the Democratic Unionist Party (DUP) of NI, who want to remain in the UK and for them any border checks between NI and the rest of the UK is a 'red line'. However, many ('Republican', as opposed to 'Loyalist') people in NI want to remain as close to the EU and the Republic of Ireland as possible. If his issue cannot be resolved amicably a flare up of the historic 'troubles' could result.

One possibility might be to agree the general Brexit parameters in Autumn 2018 and then to work on detailed resolution of outstanding issues, including those relating to Ireland, subsequently and before the end of a (possibly extended) transition period. Other options include a failure to reach an agreement (the 'no deal' option) or parliamentary rejection of the agreed deal (or 'no deal'), perhaps leading to a second referendum with a revised question outlining options put to voters. The Brexiters' opposition to any sort of customs union derives from the concern that it would severely restrict options to develop trade deals not involving the EU.

At the time of writing, early November 2018, the negotiations between the EU and the UK had reached an impasse and the PM mooted an extended transition period through to sometime in 2021. This would extend the period of uncertainty and was not well received either by hard 'Brexiters', or by some 'Remainers'; or indeed by business representatives, who expressed frustration with the government. Opinion polls indicated that there had been some shift by the public towards remaining, but there was no clear majority either way. Any extension of the transition period would also involve further UK contributions to the subsequent financial year's budget of the EU and would thus open up further negotiations and be anathema to the herd Brexiters. The probability of a 'no deal' Brexit seemed to have increased substantially, but a soft(ish) Brexit (or even 'no-Brexit') was still possible. The outcome of the 'Brussels' negotiations is expected to be known and voted upon by Parliament before Christmas 2018.

In the meantime, the banks and other financial firms have been setting up offices in various EU cities and moving staff to them, given that 'passporting' will be ended, unless there is no-Brexit after all. In the no-deal case, we can expect more staff and functions to be moved because 'enhanced equivalence' will be off the table.

The banks have anyway been required by their supervisors at the European Central bank and the bank of England to prepare for the no deal eventuality in March 2019. It was reported in the Financial Times (p.17, Weekend 27/28 October 2018) that the Royal Bank of Scotland (RBS) had attributed a £100 m impairment under the new (IFRS9) accounting standard as a forward provision against losses resulting from Brexit and other (world trade related) uncertainties. RBS would also maintain higher capital and liquidity ratios than required by the regulators) as a buffer against Brexit.

2 Who's 'City' is it anyway?

Before the Brexit vote in June 2016, there were already concerns within the 'Eurozone' about the location of euro denominated clearing business (central counterparty clearin houses, or CCPs) in London.

The Bank of England successfully challenged (ironically in the ECJ) an ECB initiative to relocate euro clearing inside the 'Eurozone'.

The desire to relocate euro clearing inside the Eurozone reflects growing acknowledgement that the liquidity of 'clearing houses' (Central Counterparty Clearing houses, or CCPs) requires central bank underpinning. The Frankfurt-based ECB, as issuer of euro, would need to provide it as the Bank of England is not an issuer of euro within the EU and certainly would not be post Brexit.

Further, 'The City' is a truly international (European and 'Global') financial centre. As a European financial centre, it should expect EU financial regulators to have some jurisdiction and, as a global financial centre, the regulatory authorities of banks and other financial institutions in countries with well-developed financial sectors expect to be consulted about regulatory changes initiated in London.

Since the 2007–2009 financial crisis, asset management in London has grown substantially and so the key EU regulators are European Securities Management Authority (ESMA) and the European Banking Authority (EBA, which is to move from London to Paris) and the key external supervisor of banking is the ECB.

The UK financial regulatory authorities (the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA)) anyway conform to the BASELIII/IV proposals of the Basle Committee of Banking Supervisors (BCSB) and proposals of the Financial Stability Board (FSB), which was until recently chaired by Mark Carney, Governor of the Bank of England. The FSB has coordinated banking and wider financial sector regulation initiatives since the 2007–9 financial crisis.

3 Regulatory conformity post Brexit

New EU regulations relating to banking and asset management include: the second Marketing of Financial Instruments (MFID II); the second Payments Services Directive (PSD2); and the General Data Protection Regulation (GDPR). These regulations are in the process of progressive implementation.

The UK has tended to 'gold plate' financial regulation (as has Switzerland, another potential post-Brexit model, especially for the financial sector) and the UK's Retail Distribution Review, implemented form 2012, shares a number of the subsequent MFID II requirements.

The UK's Competition and Markets Authority (CMA) has required UK banks to implement 'Open Banking' from January 2018, when the GDPR was also implemented in the UK. Open Banking, and related remedies addressing competition issues in retail banking, cover the PSD2 requirements, but with significant enhancements.

On February 5th, the Deputy Governor of the Bank of England (Sam Woods) stated that there would be no "bonfire of banking regulations" in order to improve the 'competitiveness' of The City (relative to the EU) after Brexit - regulatory standards would be maintained "at least as high as today". In other words, there would be no return to 'regulation with a light touch', which had preceded the financial crisis.

4 Brexit and the UK economy

The substantial post Brexit depreciation of the pound sterling benefited exports, particularly of goods, and enhanced dollar denominated capital earnings from overseas. The 'pound' subsequently fluctuated against the dollar, but remains well below pre-Brexit levels. There has been no substantial 'rebalancing' of the economy to reduce its reliance on financial services, but tourism has benefitted considerably.

In the run up to the financial crisis, the contribution of the financial sector to UK GDP growth was significantly overestimated, perhaps by as much as 50%, according to Office of National Statistics(ONS) and Bank of England estimates. In banking, some of the overestimation was the result of the practice of pre-booking of anticipated profits to be earnt in the future, which, in the event of the crisis, they were not. Nevertheless, government enjoyed substantial tax revenue from the sector prior to the crisis, which may have encouraged regulatory forbearance. The post crisis shortfall ameliorated first by a post crisis special 'Bank Levy' and subsequently by an 8% corporation tax supercharge, or bank profit 'supertax' in an attempt to make banks make a 'true and fair contribution' during the post crisis period of 'fiscal austerity'.

Initial Treasury scenarios of the impact of the Brexit vote on the economy proved too pessimistic as consumer expenditure (and debt) increased, whilst real wages and productivity growth remained stagnant. Monetary policy 'normalisation', which the

Bank of England has begun tentatively pursuing by raising interest rates, can be expected to curb the growth in consumption.

In February 2018, 'leaked' Treasury projections (from its upgraded post Brexit referendum model of the economy) continued to show substantial loss of growth under various Brexit scenarios; increasing with the degree of hardness of Brexit (and including negative effects of reduced immigration). These projections were dismissed by hard Brexiters, as 'Project Fear II'; a re-run of the Treasury's seemingly over-pessimistic pre Brexit projections from its old model.

5 Brexit and the financial sector

To the extent that Brexit reduces growth in the UK (and the EU) it will impact negatively on the banking, and the wider financial sectors', business with the 'real' economy (the firm, or business, and household sectors).

The negative impact of Brexit on the business sector is compounded by the uncertainty surrounding the Brexit negotiations. With a clear outcome still not in sight over two years after the referendum, investment proposals have been abandoned or postponed.

The proposed 'Transition Period' after March 2019 (itself two years after Article 50 was triggered) is a 'double edged sword'; reducing short term uncertainty, but increasing long term uncertainty; as long as there is no clear final outcome. Current uncertainty over the length of the (possibly extended) transition periods compounds uncertainty further.

Unless a good 'second best' solution can be negotiated (and accepted by Parliament), with substantial concessions agreed to assure financial stability in the EU, and beyond, along with continued EU access to cheap and efficient financial, particularly capital market, services provided by The City; the loss of 'passporting' from the UK will have substantial further negative effects. It will also complicate, hinder, and possibly derail the EU's flagship Capital Markets Union (CMU) project.

6 After the single market

If the 'third best' solution of regulatory and supervisory 'equivalence', without significant enhancements, prevails, then significant relocation from London to other EU financial centres, to preserve passporting within the EU, is likely. Given the continuing uncertainty, some job relocation has already been announced by banks and is now underway. With more substantial the enhancements (now much less likely), less relocation is likely to occur (estimates range from 3500 to 12,000 short-term job losses).

Because equivalence rules do not currently exist for all parts of the financial sector, some mutual agreements will be required. Third country financial centres such as New York and Singapore must self-certify the equivalence of their rules to those of the EU, but the EU has the right of veto and this may inhibit regulatory reform in the UK.

Early indications are that Frankfurt is most attractive to banks, but Dublin, is most attractive to insurers; whilst Paris has made a strong, and seemingly successful, pitch for asset management; whilst unit trusts (UCITS-Undertakings for Collective Investments in Transferable Securities) might be attracted to Luxembourg and, to a lesser extent, Dublin. Amsterdam and Madrid are also pitching and any fragmentation of capital markets after Brexit may favour country and regional capital cities.

The City thrived at the expense of Wall Street following the introduction in the US of the Sarbanes-Oxley Act (2004), which tightened corporate governance, in its pre-crisis 'light touch' regulation period. However, under President Trump, a relaxation of US financial regulations is underway. Hence, The City may also lose out to Wall Street; which now holds most of the investment banking cards, with UBS, Deutsche, and Barclays scaling back their investment banking operations.

7 Damage to the UK financial sector

In terms of value added as percentage of GDP, the UK financial sector contributed 6%, compared to around 3.5% in Germany and France, but this may be a substantial overestimate. The UK's share of financial activities across the EU ranged from 82% (interest rate OTC derivatives), 78% (forex trading), 49% (hedge fund assets), 50% (funds management). Being more capital market oriented, and thus potentially a key component of the EU's Capital Market Union project, London's share of EU bank lending is around 26%. The share of financial services to UK GDP is allegedly 23%, but may be half that. London's importance in OTC derivatives globally is 39%, second only to New York (41%) and well ahead of Paris (5%) - figures from Patrick Artus, NATIXIS (as presented at the aforementioned conference in Paris-Nanterre in July 2017). Brexit and the City', Newsletter, Issue No 179, October 2017, p 15-16, Royal Economic Society (http://www.res.org.uk/view/resNewsletter.html).

So what are the likely effects of Brexit on The City? The UK (London and Edinburgh) hosts 2250 firms using MFID passports covering investment banking, trading and fund management and 212 firms under AIFMD (Alternative Investment Fund Managers Directive) passports for hedge fund and private equity fund management, as well as the three major credit rating agencies. London conducts 80% of the clearing of euro denominated derivatives 'passported' under the EMIR (European Market Infrastructure Regulations). Further, the EU's 'single passport' regime involves numerous additional regulations (e.g. for UCITS).

'Third country rules' (TCR) are likely to apply to the UK, if the EU were to recognise the UK's post Brexit regulatory regime as 'equivalent' to the EU's. But, existing TCR agreements (e.g. with Switzerland) do not grant full access to the 'single market' in financial services.

The share of UK financial sector business linked to the EU is approximately 25%, whilst international business not linked to the EU is approximately 30% and domestic business, 45%. The overall impact of Brexit would thus be proportional to the EU 25% plus damage to the UK economy affecting the domestic 45%.

What might be the consequences of Brexit for The City's asset management sector? ESMA issued an 'opinion' in May 2017 on 'delegation' stating that there would be no automatic recognition of existing authorisations granted by the NCAs (National Competent Authorities) of the EU27. Special attention would be paid to the establishment of 'letterbox entities' in the EU27 and outsourcing and delegations to third countries (such as the UK) would only be allowed under strict conditions. NCAs should ensure that 'substance requirements' are met, assuring that key activities and functions are inside the EU.

This has again raised the question of whether euro clearing can remain in London! US regulators, and lobbyists from the US, UK, and Asia, and some from the EU27 (e.g. Luxembourg), have pushed back against restrictions on delegation, but France has been pursuing a compromise allowing delegated outsourcing, but no letterboxes within the EU. This seems to have prevailed, so the current delegation arrangements benefitting the The City seem like to remain, at least initially. However, US regulatory authorities are keeping a watchful eye on changes to the treatment of US based financial institutions operating in London and have already signalled unease about EU regulatory oversight of euro clearing extending to The City.

8 The final outcome for The City?

The politicians will ultimately decide (unless there is a second well-defined referendum) and there are numerous potential trade-offs between the EU and the UK (and the DUP) 'red lines', as outlined above. With some blurring of the 'red lines', there is possibility of 'horse trading' across them; involving the financial and non-financial sectors and the degree of freedom of movement people between the EU27 and the UK and other matters. At present (November 2018), however, the Irish border issues discussed above are proving hard to resolve given the desire to negotiate a common solution for the whole of the UK (Great Britain (including Scotland) and Northern Ireland) and the EU (including the Republic of Ireland).

President Trump's call for a doubling of contributions by EU countries to NATO makes the UK a significantly more important strategic security partner with the EU27. This may strengthen the UK's bargaining position.

The EU27 currently benefits from access to The City's capital markets and there is some risk to financial stability of an abrupt change, so this too strengthens the UK's hand. A bigger risk for the EU is the derailment of its CMU project.

Under the no-deal scenario, President Trump's negative attitude towards the WTO trade dispute resolution makes reliance on WTO trade rules precarious and his bi-lateral trade policy makes the prospect of a good trade deal with the US uncertain. Anyway, the EU is itself pursuing bilateral trade deals with a number of the countries with which the UK hopes to conclude deals. It already has a deal with Canada, and is currently negotiating with Japan, for example.

9 The denouement for the UK and the EU27

The City is a well-established global financial centre, and is currently the most important financial centre in the EU. It has well known advantages (time zone, legal system, language, and London as an attractive city). It may well, in the longer run, re-align its international business, following some loss of business to other European centres, and continue to thrive; but there is also likely to be a continued 'tilt to Asia' and a re-assertion of Wall Street as the global financial centre!

As regards the EU27, the biggest risk, apart from increased costs of some financial products and services currently produced efficiently inside the Single Market for financial services in The City of London, and increase risk of financial instability during the immediate post Brexit transition period, is damage to its flagship CMU project.

The project launched under Lord (Jonathon) Hill, as European Commissioner for Financial Stability, Financial Services and Capital Markets Union in November 2014. Lord Hill resigned from the position after the Brexit referendum. The CMU project was conceived after the 2007–9 financial crisis and the subsequent 2010–2012 Eurozone crisis in recognition of the heavy dependence of the EU (particularly the EU27) on its fragmented banking sector; which was proved by these crises to be fragile.

This contrasted markedly with the US (and to a lesser extend the UK) in which debt (bond) and equity capital markets are much further developed and provide a much greater share of finance to the business sector. The prompt recovery of the US financial sector and the country's ability to deal with the post-crisis bank bad debt problems quickly and effectively contrasted with the EU where the capital markets were under-developed outside The City and significant bank bad debt problems remain, even as Brexit is being negotiated.

Ongoing negotiations between the EU and Italy over its budget have illustrated that the 'doom loop', which was a feature of the Eurozone crisis, has not been resolved. The Italian government relies on selling bonds to Italian banks and other financial institutions, whose value depends of the credit standing of the government. A number of Italian banks have high bad debt ratios and rely on holding government bonds as safe coupon bearing assets. As government risk ratings and bond yields rise, the value of the bond portfolios fall, making it more likely that the government may have to save help the banks. The rise in such contingent government liabilities further raises the risk premium on government bonds, and so on.

In response to the Eurozone crisis, the EU devised a Banking Union project for the Eurozone member countries. The project involves establishing a common bank supervisory system, a common bank resolution regime with supporting institutions and a common deposit guarantee scheme as well as a European Stablility Mechanism (ESM). This is all in place except the establishment of a single risk-related deposit insurance scheme, which will involve taxpayers in one country (say Germany) potentially guaranteeing depositors in banks in another country (say Italy) and thus quasi fiscal transfers between countries. French proposals for developing the ESM to form a European Monetary Fund (EMF), to underpin stability and sustain growth also involve greater fiscal pooling and potential transfers between member states. With the Banking Union incomplete, the risks of damage to banks from Brexit are perhaps higher than they would otherwise be.

The CMU aims to achieve a 'better' allocation of capital in the EU and to reduce reliance on banking. This would take advantage the free movement of capital pillar of the EU and potentially reduce the fragmentation of small and medium-sized enterprise (SME) financing by banks serving their local markets at differential locally prevailing (risk-related) rates. The better allocation will in part reflect enhanced corporate governance mechanisms and good stewardship practices rewarding good policies with regard to the environmental impact, social goals and good governance practices and the UN Sustainable Development Goals (SDGs), as well as profitability and productivity and growth enhancement. To be successful, consistency would need to be achieved in the application of bankruptcy laws with some sort of bankruptcy protection along the lines of the US 'Chapter 11' procedures. Further 'benchmark' (ideally zero risk) bonds and bills for the capital markets would need to be established. There are numerous proposals concerning how such 'Eurozone bonds' might be created through joint issuance by participating states. So far, opposition has tended to come from states with stronger credit ratings, such as Germany.

The capital markets would operate more efficiently if taxes, especially on the profits of corporations and interest, capital gains and dividends, and securities trading etc. were harmonised. In addition, the bias within tax systems towards debt (through interest 'expensing' or 'deductibility') relative to equity financing, should be addressed. The OECD is overseeing an international imitative with regard to this and it is under consideration in the US.

A no-deal Brexit would prevent The City from performing it natural central role in the CMU project. If a deal is negotiated between the UK and Brussels and accepted by Parliament, then the softer the Brexit, the greater the role The City can play. But a likely post Brexit scenario is a tendency for more capital market fragmentation than at present with various financial centres specialising in different financial spheres developing and major cities (perhaps Bilbao, for example) hosting regional capital markets. Capital markets would become more dispersed, but there would be much more widespread participation than in the prevailing City of London dominated system. This may possibly accelerate the switch away from banking dominated systems in the EU27 and better serve the regions. Further, in this digital age, the EU27 cities serving as capital market hubs could be fully networked to form a genuine Capital Markets Union.

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