Centre for Policy Studies

Number 83

7 September 2016

Economic Bulletin

THE CITY BOYS ARE HERE TO STAY

- UK's strengths will mean that London continues to be Europe's leading financial services centre. London is ranked the most competitive in the world for financial services, while closest EU rivals rank at 15th and 19th.

- Brexit negotiations need to offer reassurance about passporting, which allows many British financial service firms to operate across the EEA. The UK could achieve third-party status in many financial service areas, but it may struggle in others.

- Incomplete single market in services offers limited benefits. Services make up 70% of Europe's economies and generate more than 90% of new jobs, yet services account for just 20% of intra-EU trade.

- Brexit opens up new opportunities for UK financial service firms. Bilateral trade agreements with emerging financial centre such as Hong Kong and Singapore are now possible.

- Brexit also offers opportunities to opt out of punitive EU regulation. This includes the Market Abuse Regulation, which inter alia requires directors with inside information to notify closely associated persons in writing, including illiterate children.

Click here to subscribe to the CPS eNewsletter

1. UK'S NATURAL ADVANTAGES IN FINANCIAL SERVICES

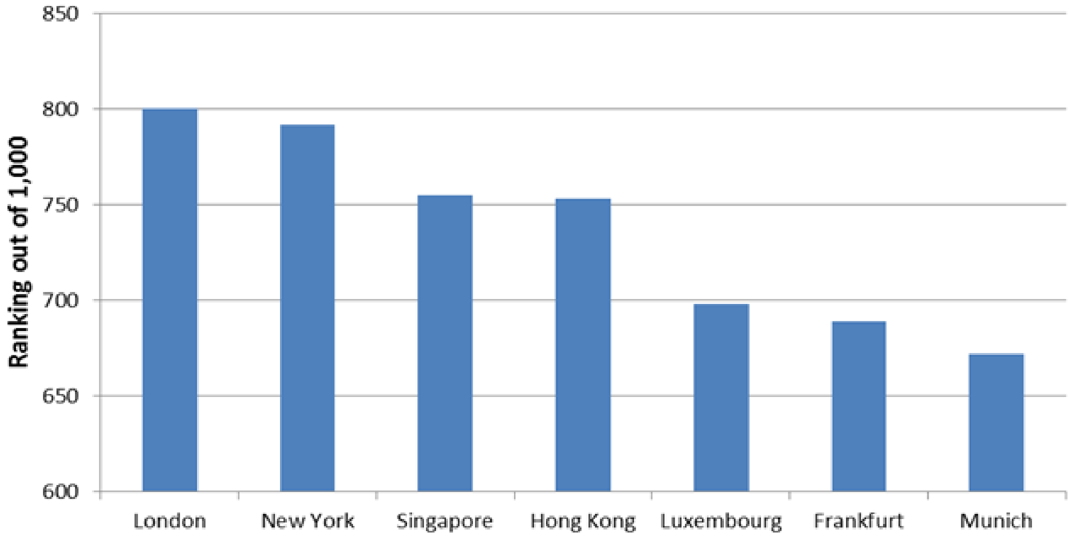
The UK's strengths as an international financial centre are extremely well established. The UK has the strongest financial services sector in the EU by reason of history, timezone, language, legal system, critical mass of skillsets, expertise in professional services and London's cultural appeal.

The Global Innovation Index ranks the UK as the 2nd most innovative country in the world, making the UK excel in areas such as the digital sector and financial services. Furthermore, the UK is Europe's leader in terms of its higher education sector and in the protection of creditors. Despite claims to the contrary, this means that there is little prospect of London being dislodged as Europe's leading international financial centre. The inherent advantages and large network of financial and professional services are hard to replicate elsewhere in Europe.

The UK's tax competitiveness has also dramatically improved over the past few years, with the number of UK companies seeking to relocate activities out of the UK falling sharply over the period 2012 – 2015. It is also estimated that 58% of financial service industry firms now view the UK as a 'top three' tax regime, making the UK the second most attractive regime in Europe, according to KPMG's analysis. The decision to cut corporation tax has been particularly welcomed by businesses. Cutting corporation tax to 19% in 2017 and 18% in 2020 will further support the UK's competitiveness in tax policy compared to other G7 countries, all of which currently levy a higher rate of corporate tax than the UK's existing rate of 20%.

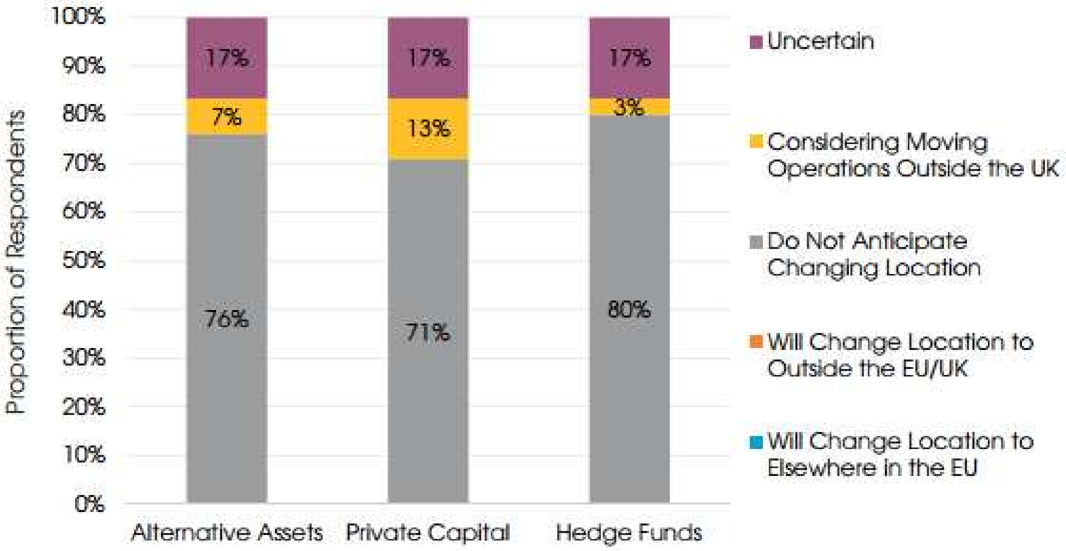
These factors will mean the UK continues to be a competitive place for financial services firms. According to the latest Global Financial Centres Index, the UK ranks the most competitive place for financial services in the world with 800 points out of 1,000 (see Figure 1). Its closest EU rivals are Luxembourg in 15th place with 698 points and Frankfurt in 19th place with 689 points. Moreover, many financial firms are still seeking to expand in the UK – for example, the Hedge Fund Skybridge capital has recently announced plans for expansion while Wells Fargo has announced it will invest nearly $400 million for a City of London office. It is also notable that the vast majority of UK-based fund managers will not change the location of their business operations post-Brexit (see Figure 2).

Figure 1: Competitiveness of selected international cities in financial services (2015)



Source: Global Financial Centres Index link

Figure 2: UK-Based Fund Manager Views on whether Brexit will lead to a change in location of their business operations



Source: Prequin Special Report (July 2016) link

2. WHAT ARE THE KEY CONCERNS RELATING TO BREXIT?

The primary concern about UK financial services is the issue of "passporting". Passporting means that a British financial service firm can provide services across the European Economic Area from its UK home. Importantly, it also means that a Swiss or a US operation can do the same from a subsidiary established in the UK. Current single market rules mean that financial service firms authorised in one member state can operate across the EU.

While unlikely it is not impossible that the loss of the passport system for UK financial institutions may trigger some migration of global firms' EU headquarters. For example, it has been claimed that loss of passporting rights could see UK exports of financial services to the EU halve to around £10bn. This could be problematic in the short-term by exacerbating the UK's record current account deficit. A rapid solution to continued passporting arrangements between the UK and the single market should therefore be a high priority in 'Brexit' negotiations.

Other concerns include that start-ups in EU countries will no longer look to expand in London, perhaps preferring other European financial centres. Furthermore, there are also concerns about a slowdown in the attraction of EU talent for the purposes of working in UK financial service firms. For example, 20% of Bulgarian and Romanian nationals in the UK work in banking and financial services, according to The UK in a Changing Europe.

3. ARE THERE ANY SOLUTIONS?

There are some prospective solutions to the problems faced by UK financial service firms in a post-Brexit world. The UK could establish 'third party' status in many areas. A recent measure by the European Securities and Markets Authority (ESMA), for example, could provide a blueprint for UK financial service firms. ESMA's passporting rules now mean that asset managers in some countries outside the EU can continue offering services to investors across Europe, replacing the previous system of country-by-country private placement authorisation. It should be noted, however, that third party arrangements do not exist in some areas such as payment systems providers, which could prove to be more problematic.

In addressing concerns about immigration, the UK Government will almost certainly seek to make provisions for skills in the financial services industry within its new so-called "points based" system.

4. IS LEAVING THE EU THAT BAD FOR FINANCIAL SERVICES?

Many financial and banking rules are now set by global regulators, limiting the impact of Brexit on financial service firms. Since the financial crisis, initiatives have focused on implementing the work of organisations such as the Financial Stability Board of the Basel Committee on Banking Supervision in areas such as resolution, prudential requirements and centralised clearing in the derivatives world.

Furthermore, the single market in services is imperfect, reducing its potential benefits to UK financial service firms. Services make up 70% of Europe's economies and generate more than 90% of new jobs, yet services account for just 20% of intra-EU trade, according to the UK's Department for Business, Innovation and Skills.

Global financial services firms are adept at dealing with local market variations and hidden barriers to trade, such as competing regulatory and tax regimes, offering reassurance that UK financial service firms will be relatively unaffected by Brexit in the medium to long term.

5. OPPORTUNITIES: NEW NON-EU TRADE

According to the Office for National Statistics, nearly 60% of the UK's exports in financial services go to countries outside the EU – which is a far higher proportion compared to overall exports. The UK's exit from the European Union could further promote trade with countries outside the

EU. Over the longer term there could be an opportunity to replace any potential loss from falling EU trade by concluding bilateral trade agreements with emerging financial centres, such as Hong Kong and Singapore, with which the UK has strong historical and cultural ties.

6. OPPORTUNITIES: REGULATORY DIVERGENCE

UK firms could also benefit from regulatory divergence by avoiding burdensome EU legislation, such as the bonus cap, restrictive employment rights and proposals for a Financial Transactions Tax (FTT). These would improve the City's competitive position with other European centres.

The FTT proposal is to tax transactions of shares and bonds at 0.1% and derivatives at 0.01% where there is an established link to the FTT zone. Both the European Union and Oxera have stated that the loss of GDP in the affected area will be greater than the expected tax revenue, according to PricewaterhouseCoopers. Former Governor of the Bank of England, Mervyn King, has also stated that if this tax were imposed in the FTT area, it would lead to more business coming to the City of London.

The UK also has the opportunity to remove itself from the provisions set out by the EU-wide Bankers' Bonus Cap, which limits extra pay to 100% of a banker's salary or 200% if shareholders agree. This has had the distortionary effect of driving up salaries in banks and made top bankers' pay less flexible, making banks and the financial system more fragile, according to the Bank of England.

There are also specific damaging provisions set out by European Union regulation, which the UK will be able to opt out of. These include specific provisions set out by the Market Abuse Regulation, the Alternative Investment Funds Management Directive (AIFMD) and EU regulation more broadly (see Figure 2).

Figure 3: Opportunities for regulatory divergence away from Brussels

Market abuse regulation	AIFMD	EU regulation
The primary purpose of this regulation is to stop insider trading. However, it has landed listed companies and their advisers with hugely complex rules. Directors with inside information are now even required to write to illiterate children if they are deemed to be a Person Closely Associated (PCS).	*"Europe produced the AIFMD to regulate the hedge and private equity industries. It is quite complex, and difficult and expensive to follow, but remarkably I have never yet met an investor who thought it useful – let alone needed. In future UK participants in this market could offer cheaper and more comprehensive products to great competitive advantage"* **Jon Moulton**	*"Generally the EU regulations suffer from a lack of proper Impact Assessments to see if the benefits actually cover the costs of any proposal. Excess regulation of course generates jobs for people – who might otherwise be in more directly productive employment – and that cadre generates the enthusiasm that produces still more need for their services in ever expanding regulation. Rolling back and simplifying regulation could provide a very big boost to the UK financial industry."* **Jon Moulton**

7. CONCLUSION

The UK's natural advantages in financial services mean that London will remain Europe's leading financial services centre. However, Brexit does bring some challenges and opportunities for financial services. An arrangement like the one secured in Norway, which has access to the single market but accepts freedom of movement, is unlikely to materialise. It is welcome that the City of London has accepted this reality.

It is now imperative that the Government examines the best blueprint for the UK's financial services industry. Switzerland has a successful finance industry outside the EEA, showing that alternative arrangements are very possible. London's existing status as a global financial centre means that the UK is in an even better place to reach an agreement – given that EU businesses will also want to retain access to the UK's financial services.

Following Brexit, the government's focus on financial services must be to offer reassurance on the issue of 'passporting', to ensure that new trading opportunities with financial centres outside the EU are pursued and to remove the UK from burdensome and costly regulations.

Daniel Mahoney, Tim Knox and Jon Moulton
Centre for Policy Studies

DISCLAIMER: The views set out in the 'Economic Bulletin' are those of the individual authors only and should not be taken to represent a corporate view of the Centre for Policy Studies

Follow us on:

Twitter **Facebook**

Forward to a friend

Click here to subscribe to the CPS eNewsletter