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Brexit: What is at stake for UK's financial sector?

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Abstract

With Brexit, there is the first case a member state chose to leave the EU. Brexit has a tremendous impact on UK's financial sector especially with a potential loss of passport rights and reduced access to Europe's single market. FDI attractiveness in the UK could decline. A competitive tax reform in the UK might boost the attractiveness to FDI again, but even with lower taxes a reduced access to the single market could have a large impact as a key factor for UK's FDI attraction. Less FDI projects would cause lower productivity and potential economic growth in the UK.

Keywords: Brexit, United Kingdom, Financial Passport Rights, FDI

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List of Abbreviations

ECB – European Central Bank

EEA – European Economic Area

EFTA – European Free Trade Association

EU – European Union

FDI – Foreign Direct Investment

FPI – Foreign Portfolio Investment

GDP – Gross Domestic Product

M&A – Merges & Acquisitions

UK – United Kingdom

WTO – World Trade Organization

Introduction

Now, with Brexit there is the first actual case a member state chose to leave the EU and with the help of the Lisbon Treaty (Article 50) declare its intentions. It is something which never happened before, hence, it is intriguing to have a closer look at the potential implications for the financial sector within the UK and analyse what is at stake for Europe's most important financial capital.

The word Brexit is a merger of the two words ***Britain*** and ***Exit*** and basically is about the UK leaving the EU. The decision by Britain on whether to leave the EU or to remain was made with a referendum on June 23rd, 2016. It turned out that the majority of the British people wants to be more independent and leave (Miethe and Pothier, 2016).

England as well as Wales were strong believers in leaving (53.4% to 46.6% and 52.5% to 47.5%), while Scotland and Northern Ireland voted to remain in the EU (62% to 38% and 55.8% to 44.2%) (BBC, 2016a; BBC, 2016b).

The Pound Sterling has been challenged since the referendum. After the vote the British pound reached its lowest of all time when measured against a weighted currency basket of the UK's trading partners. Moreover, Britain couldn't remain its top credit rating. Shareholders are concerned that Brexit negatively impacts the UK's trade and investment relationships and most importantly hurts London as the financial capital (Bird, 2016).

Britain wants its Brexit because of Eurosceptic – and being critical towards the EU. The UK's Euroscepticism goes back to ever since the first steps towards a European Community were made. They felt held back by the EU and argued that the UK has to pay billions yearly to be a member in the EU but get low in return. When looking at reasons why to leave the EU one is

the current immigration situation and the fact that the UK cannot control its own immigration law and therefore has to add about 500 people to its population every day. For example, there are two times more foreign-born residents in the UK than 20 years ago. By leaving the EU Britain could gain back its full control of who comes in to work and live (Miethe and Pothier, 2016).

Most of the countries within Europe belong to the European Union which benefits positively from globalization for example: free trade as well as free movement of labour and capital across borders (Miethe and Pothier, 2016). The history of the EU started with the idea of bringing the steel and coal industry together after the Second World War to no longer fight each other. The idea was that trading countries are less likely to go to war against each other. However, Britain was never fully on board with this union. They did not join the Union right in the beginning. Especially geographically the UK could have always been seen as a marginal member. Further and probably the best example is the common currency project and the fact that the UK refused to accept the Euro as a single currency (Dinan, 2005).

However, there are also arguments against Brexit. Former Britain's Prime Minister David Cameron, has argued to stay in because he said that leaving the EU would lead to an economic disaster. Europe counts for around half of UK's exports. Furthermore, it would cause great uncertainty by having strong impact on financial markets, investments and the wider economy. To put it in a nutshell, exiting bares economic risks while staying brings concerns.

Article 50 of the Lisbon Treaty, which was created in 2009 yet never used before, states that the two parties (the EU and the UK) have two years to finalize and agree on terms how the

split should happen. The main problem could be that the EU only continues to include the UK in its single market if the UK still accepts free movement with unrestricted rights for Europeans. Trade and immigration policy will be the crucial point in the Brexit negotiations between the UK and the EU (Boffey, 2016). There could either be a soft Brexit and the UK will remain a member of the single market while allowing free movement or a hard Brexit with neither free movement nor free trading (Boffey, 2016; Whitman, 2016).

In the following, possible implications for the UK, in particular for the British financial sector, will be analysed with its consequences. A deeper focus will be on the possible impact on FDI after Brexit.

Methodology & Literature Review

To evaluate the possible impact of Brexit on the financial sector in the UK with the current published data is problematic, especially because the sector includes many subsectors. However, all literature embracing the Brexit topic has one thing in common. They all agree that the UK has a broad financial sector and since the UK has a strong focus in financial services, leaving the EU could have a substantial impact.

The methodology is based and focused on secondary research mainly on journals and reports and some textbooks and background literature. When researching Brexit and UK's financial sector for applicable literature search engines such as (online) libraries are auxiliary. To decide if there is any suitable information each paper which looks informative needs to be skimmed and evaluated. Indeed, a common problem when writing about recent topics such as

Brexit is that as soon as a review, a report, a journal or even a textbook is published there might have been already a change or a new debate.

A new empirical analysis by Bruno, Campos, Estrin and Tian (2016) estimates why foreign investors are more likely to invest in the UK rather than bigger European countries such as France or Germany. The statistical model further estimates the impact on FDI of being in the EU by analysing bilateral FDI flows of 34 OECD countries in the timeframe from 1985 till 2013. It is an alternative to the gravity model as a standard way to look at bilateral flows.

The most important determinants for bilateral FDI flows between two countries are their market size, their geographical distance and variables such as GDP per capita. Most of these variables are quite stable over a long period, hence, it is easy to only determine changes in FDI if one of the countries is joining the EU (Bruno, Campos, Estrin and Tian, 2016).

Already 20 years ago Barrell and Pain (1997) suggested that one of the major drivers that charms FDI projects to the UK is the membership in the EU. The statistics by Bruno, Campos, Estrin and Tian (2016) show similar findings to Campos and Coricelli (2015) as well as Straathof, Linders, Lejour and Möhlmann (2008). All indicate a positive effect of being a EU member. The inward FDI are notably higher. These findings also match PWC's (2016a) estimation that FDI in the UK will be about 25 percent less by 2020 because of Brexit.

Furthermore, according to Dhingra, Ottaviano, Sampson and Van Reenen (2016) and Bruno, Campos, Estrin and Tian (2016) there are no FDI benefits similar of being a EU member by being an EFTA member such as Switzerland. The statistics show no difference between an EFTA member and a country being completely outside the EU.

Barrett et al. (2015) further assessed the possible consequences in the UK and its FDI after Brexit by creating location probabilities for new FDI projects. To understand the FDI's attractiveness after Brexit, different scenarios are considered with a more competitive tax reform and reduced access to the EU's single market for the UK. Since reforms in other EU countries might have an impact as well, the estimations assume all other aspects in the EU remain the same. The results confirm PWC (2016a) and show that even with a more competitive tax regime a reduced access to the single market most likely has a sizeable impact on UK's FDI attractiveness.

To develop a further understanding of Brexit with a focus on the implications of FDI projects, upcoming research and analysis might have a stronger focus on the impact of possible competitive tax reforms in the UK. Another interesting comparison could be between cross-border M&A, brownfield FDI and greenfield FDI in the context of Brexit.

Discussion of the Topic

London has been Europe's financial capital for decades, however, the question is for how much longer (Chrisafis, 2016; Miethe and Pothier, 2016; PWC, 2016b). Even though some of the largest US banks promised help to maintain London's position (Chrisafis, 2016), some, such as HSBC already announced to shift nearly 1,000 jobs out of the UK (The Economist. 2016). Others plan to move in the beginning of 2017 and some of the smaller banks even indicated to leave before the end of 2016 (Boffey, 2016).

Currently, London based financial institutions are able to provide their services within the single market based on passport rights (Dhingra, Ottaviano, Sampson and Van Reenen, 2016).

Over 13,000 financial firms use this English passport to do business (Glover, 2016). There are two main characteristics. London is the most important entry location for capital coming from outside the EU and further the primary hub for wholesale banking for all the large European financial institutions (Miethe and Pothier, 2016).
Since 1973 when the UK became part of what is nowadays the EU (former European Community) London's banking sector has continuously grown (Springford, 2014). Today, Britain's capital is hosting one of the most international and largest financial sectors worldwide. The UK's banking sector's assets are twice as much as the German's measured by GDP and six times more than the US's (Bush, Knott and Peacock, 2014).

If the UK is losing its financial passport rights it is facing some challenges and since these rights only benefit member states of the EU, there is a high change of this happening. Further, if the UK is no longer part of the single market the financial sector is by far one of which have the most at stake.

The financial passport right enables a financial institution which is officially licensed in Britain to legally operate in all member states within the EEA. Neither an additional regulation nor an authorization is needed. The financial organization doesn't even need to be physically present in the member state where the service is provided. All the activities are always and only under the Prudential Regulation Authority of the Bank of England as the supervisor. The member state's regulatory authority only has to be informed about the actions. (Dhingra, Ottaviano, Sampson and Van Reenen, 2016; Miethe and Pothier, 2016).

Barrett et al. (2015) reveal five possible scenarios after the UK leaves the EU all including different rights and obligations.

Firstly (i), the UK could try to join the EEA and EFTA which leads to access the EU single market for goods but does not necessarily fully benefits from the single market with regards to financial services. Further, the UK would be allowed to have their own external trade policy. However, the UK would still have to contribute to the budget of the EU and follow rules for the single market, as well as tolerate the free movement of people within other EEA countries.

Secondly (ii), another possibility could be a combination of a EFTA membership and bilateral agreements. In doing so, trade agreements could be concluded independently and there wouldn't be obligations to translate EU single market legislation into the British legal system. EU rules of origin would apply to exports from the UK to other EU states and the exports would need to fulfil all the relevant European standards.

Thirdly (iii), a Customs Union might lead to a limited freedom for its own external trade policy. The UK could still access the single market but wouldn't need to contribute to the EU budget. Furthermore, the UK would be able to control its own financial sector as well as its borders.

Fourthly (iv), a constellation based on a free trade agreement between the UK and the EU might be an outcome of Brexit. The UK would have the possibility to customise its own trade policy with other EU members and third countries as well as its own tax regime. However, EU rules of origin would apply for exports from the UK to other EU states and the exports would need to fulfil all the relevant European standards.

Fifthly (v), the last option could be a WTO option with basically no strings attached to the EU anymore. The UK would however be subject to the WTO and their related agreements.

UK based firms have already assessed different consequences for a potential loss of the financial passport and therefore direct access to the Europe's single market. One possibility to still do business within the single market could be that the British companies expand to other European countries in order to use the passports of these countries to access the whole single market again. This scenario would involve the WTO and probably cause a licensing gap of over half a year until all regulatory licenses are granted. Since businesses can't afford such a break, if the UK has to face the exclusion of the single market financial firms could not just expand but move business to the EU (PWC, 2016b).

Furthermore, the ECB in Frankfurt already proposed the law that euro-denominated financial transactions must be cleared in the Eurozone (PWC, 2016b). Presently, the most clearing houses in the EU are based in London (The Economist, 2016). If this regulation is followed through even more institutions must move as long as they want to do and stay in business (PWC, 2016b).

However, with such a potential shift Germany and especially France might try hard to get more business into their countries (Dhingra, Ottaviano, Sampson and Van Reenen, 2016). The French Prime Minister, Manuel Valls, already announced his plan to prepare Paris to become the 'financial capital of the future'. Promises have been made in a sense that France is going to have the most attractive tax regime in Europe, as well as benefits for financial institutions which want to move from the UK to France (Chrisafis, 2016; Reuters, 2016).
In addition, Paris has more positive aspects to grow its financial sector. It houses skilled labour and continues to attract more because of its asset management sector which is already huge. Furthermore, office space is cheap and there are already numerous major European banks located in the capital of France. The wider region offers good infrastructure as well as a

high quality of life. This can be an attractive factor, especially for families, there are plans to build new bilingual schools to fulfil international needs to attract more financially skilled labourers and their beloved ones (Chrisafis, 2016).

In 2015, UK's Minister of State for Trade and Investment, Francis Maude, wrote in the 2014-2015 Inward Investment Report:

> "We are again the Number One destination for FDI in Europe. In 2014 the UK attracted the highest number of FDI projects and received the largest value of FDI net inflows in Europe, as confirmed by independent sources."
> "It is clear from these results that all regions of the UK benefit from foreign investment. And it is clear also that foreign investment has great potential to support the priorities of this government. We will look to investors to back our commitment to build a stronger and rebalanced economy […]." (UK Trade & Investment, 2015)

At the time this report was filed there weren't any serious thoughts that the UK might actually lose its financial passport, however, this report shows the importance of FDI for the British economy.

FDI are investments which ownerships include control in a business in another country and involve per definition of the Organization for Economic Cooperation and Development in at least ten percent ownership in the foreign business (Miethe and Pothier, 2016). The ownership can either be by establishing a new business or by simply acquiring assets of already existing companies. Whatever the case may be, the controlling interest in the investment needs to be present. Comparing to a portfolio investment, there is not only capital flowing but also know-

how which makes it an important aspect for globalization and growth (Bhattarai and Ghatak, 2010).

In general, it is said that FDI have positive impacts on productivity, output and wages (Barrett et al., 2015). There are also indirect benefits such as new know-how which can be implemented in domestic firms by foreign companies (Haskel, Periera and Slaughter, 2007; Javorcik, 2004) and for example the supply chains of multinationals (Harrison and Rodriguez-Clare, 2009; OECD, 2013). Whole countries profit from the competitive advantages of multinational companies and their complex supply chains as a driver for productivity and growth (OECD, 2013). The resulting technology transfer leads to gains in productivity and economic growth in the long run (Haskel, Periera and Slaughter, 2007; Javorcik, 2004). Further, sometimes local managers are under pressure to become more productive to keep up with the competition (Barrett et al., 2015).

FDI are important for productivity and consequently thereof UK's economic growth. Multinational enterprises link with their supply chains FDI directly with trade. The combination of these two factors show that UK's future attractiveness to FDI projects is significant for UK's overall economy. While the UK is still the leading country in FDI, there are already other players such as Ireland and the Netherlands acting as an intermediator and holding large positions coming from outside the EU (Bush, Knott and Peacock, 2014). Foreign investors will not stop to participate in the European market even if UK leaves the EU (Bush, Knott and Peacock, 2014). The UK is holding ten percent of the worldwide FDI assets and more than half of it is invested from within the EU. Vice versa when looking at the British banking sector about 50% of the assets are held by large foreign banks (UK Trade & Investment, 2015).

Bruno, Campos, Estrin and Tian (2016) analyse the impact on FDI of being in the EU. The most important determinants for bilateral FDI flows between two countries are their market size, their geographical distance and variables such as GDP per capita. Already 20 years ago, Barrell and Pain (1997) suggest that one of the major drivers that charms FDI projects to the UK is the membership in the EU. A positive effect of being an EU member is indicated and inward FDI are distinct higher (Bruno, Campos, Estrin and Tian, 2016; Campos and Coricelli, 2015; Straathof, Linders, Lejour and Möhlmann; 2008). Moreover, PWC's (2016a) approximation shows that FDI in the UK will be 25 percent less by 2020 because of Brexit.

Some of UK's biggest counterparts are Ireland, Luxembourg and the Netherlands due to probably their tax structure (Barrett et al., 2015; Chrisafis, 2016). International companies tend to use these countries for their tax planning based on lower corporate taxes and some regulatory loopholes in comparison to other EU member states. Financial capital is moved in large numbers between the UK and domestic subsidiaries in other member states. This might be the reason why Ireland, Luxembourg and the Netherlands are seeking for a softer Brexit. If the UK loses its financial passport rights these three countries have a lot to lose too (Barrett et al., 2015; Miethe and Pothier, 2016). However, PWC (2016b) conducted an analysis where the overall exports from other EU countries were measured relatively to the size of their economy (GPD). The results revealed that the UK relatively imports by far the most from Ireland, thus, Ireland is the country which has the most to lose (PWC, 2016b). These results also match Barrett et al. (2015).

Dhingra et al. (2016) associate three possible FDI-related implications on the economy in Britain after Brexit. Firstly, there is uncertainty (i) about how or whether the UK continues to have access to the single market. This uncertainty causes a lower attractiveness for FDI

(Dhingra et al., 2016). Since FDI increase productivity and growth the opposite might happen when the UK receives less FDI projects (Javorcik, 2004). There might be a high possibility for lower growth, lower import demand as well as lower export activities for the UK outside the EU (Barrett et al., 2015). Furthermore, a more restricted access to the European single market could cause a reduced integration (ii) of supply and value chains within and outside the EU (Barrett et al., 2015). The possible loss in integration might lower productivity and growth. Finally, a more competitive tax reform (iii) in the UK could substitute for a potential loss in FDI projects and lead again to higher productivity and growth (Barrett et al., 2015).

The UK depends on London's financial sector. In the last decade trade in services was the only positive part and the major role was played by the export of financial, insurance and pension services. In 2015 almost a quarter of UK's service exports were financially based which underlines London's importance (PWC, 2016b). Consequently, London's current global position is essential for the UK.

There are two risks the UK probably has to face when losing its financial passport rights and easy access to the single market. If the UK does not benefit from free trade anymore the attractiveness for domestic financial institutions is smaller for foreign investors. This might lead to an overall negative net balance since the financial service sector is the only positive element. Furthermore, by being less attractive the UK could obtain less capital inflows such as FDI and FPI. These risks show the importance for the UK, even when leaving the EU and the single market, to negotiate terms and arrangements like the current ones (Glover, 2016). Another indication for London's importance and current leading position is the OTC turnover. Over a third of the worldwide OTC derivative contracts are placed in the UK (Bank for International Settlements, 2016).

It is a given that the UK needs to remain accessible to the single market to keep London's current state with regards to its financial sector, which is crucial for the overall economy in Britain. An analysis by PWC (2016b) indicates the attractiveness of major European cities as financial centres. The used key features identified for a financial hub are based on a research published by the City of London. It is divided into six areas: Financial market infrastructure, critical mass (domestic credit to private sector in percent of GDP), the employment with tertiary education, the business environment itself, the strength of legal rights and most importantly connectivity. Connectivity is the market access by way of passports. A financial centre needs to be well connected not only electronically but also physically. The research is limited, for instance, the attractiveness of the city or region such as living conditions are not taken into consideration (Bourse Consult, 2013).

PWC (2016b) reveals if London loses its access to the single market it most likely also loses its number one ranking as financial center in Europe. Dublin, which is currently second place could take over the lead and Luxembourg could narrow the gap on third. Even with a more competitive tax regime a reduced access to the single market will most likely have a sizeable impact on UK's FDI attractiveness (Barrett et al., 2015; PWC, 2016a). There are no FDI benefits similar of being a EU member by being a EFTA member. The statistics show no difference between a EFTA member and a country being completely outside the EU (Dhingra, Ottaviano, Sampson and Van Reenen, 2016; Bruno, Campos, Estrin and Tian, 2016).

Conclusion and evaluation

It is a given that the UK needs to remain as accessible to the single market as possible to keep London's current state with regards to its financial sector, which is crucial for the overall

economy in Britain. Nevertheless, one way or the other, the Brexit referendum will probably bring some tremendous changes to Europe. The trading costs will most likely increase after the UK leaves the EU. The costs are based on the UK's trade agreements with the EU and will depend on UK's relationship with the EU after Brexit occurs (Barrett et al., 2015). The five possible exit scenarios all include different rights and obligations. The more integration in the single market the higher the attachment to the EU and its policies.

The potential loss of Britain's financial passport rights may cost London its position as an entrance point for foreign non-European financial institutions and investors to the EU and the capital coming with it. Furthermore, it is doubtful that the large European banks will continue to use London as the central financial hub for their wholesale banking activities. These changes within the European financial landscape might affect further member states in different ways. Future major entry points for FDI and FPI in Europe might become Luxemburg, Ireland or the Netherlands since these countries have already a higher financial integration with Britain today (Chrisafis, 2016). Frankfurt (Germany) might also become a more important financial center based on the European Central Bank as well as Paris (France) with its European Securities and Markets Authority (PWC, 2016b) and the current lobbying which is already taking place.

Now, it looks like that the only possibility for London to retain the benefits of the financial passport rights after UK's leaving of the EU is to enter the EEA. The only problem with that option would be that it could come with a price, which was for most voters one of the reasons why they wanted to leave the EU in the first place – free movement of labour and the possibility that EU citizens can choose where to live and work, including the current immigration policy. Moreover, the EU would most likely ask for payments and general EU

regulations still needed to be fulfilled to be part of the EEA. After all, not much would change (PWC, 2016b).

Some things would actually change. According to Dhingra, Ottaviano, Sampson and Van Reenen (2016) and Bruno, Campos, Estrin and Tian (2016) there are no FDI benefits similar to being in the EU by being a EFTA member. The statistics show no difference between a EFTA member and a country being completely outside of the EU. Hence, negotiating a wide-ranging free trade deal is not a suitable alternative for full EU membership.

The uncertainty about the future access to the single market could cause a lower attractiveness for FDI projects which might decrease productivity and growth. There might be a high possibility for less import and export activities. Besides, a more restricted access to the European single market could cause a reduced integration in supply and value chains within and outside the EU. The possible loss in integration might further lower productivity and growth (Barrett et al., 2015).

To boost FDI attractiveness in the UK the government might reform their corporate tax system in an even more competitive manner than already planned. A more competitive tax reform could substitute for a potential loss in FDI projects and lead again to higher productivity and growth. The current corporate tax rate of 20 percent is already one of the lowest in Europe, however, as already announced it will be cut to 19 percent in 2017 and to 18 percent in 2020. The lower the tax rate the more FDI will most likely be attracted, consequently, according to Barrett et al. (2015) and Chassany (2016) an even lower tax rate could be imagined. Nevertheless, it still needs to be kept in mind that even with competitive tax reforms a reduced access to the single market almost certainly has a large impact as a key

factor for UK's FDI attraction. It might not be a perfect compensation. PWC's (2016a) estimations show that FDI in the UK will be 25 percent less by 2020 because of Brexit.

Furthermore, as soon as the UK leaves the EU they can't challenge the European Court of Justice anymore and won't be able to stop new regulations (Dhingra, Ottaviano, Sampson and Van Reenen, 2016). Regulations such as the proposal of the ECB that euro-denominated financial transactions must be cleared in the Eurozone (The Economist, 2016).

The financial stakes for the UK are tremendous if it loses its passport and the access to the single market. Concerns are raised that Britain might arbitrage with offshore financial centres located in the Crown dependencies and Britain's overseas territories.

All this, especially the UK's connection to offshore centres should be kept in mind for further negotiation between the EU and the UK. The terms of the UK's exit package will play a critical part. However, PWC (2016b) states correctly that London's current position as an important financial capital does not only depend on the financial passport rights, even though they are playing the main part. International companies also take further microeconomic and macroeconomic country specific aspects into consideration for their location selection (Barrett et al., 2015). Further reasons are, for example, the legal system and skilled labour. These aspects, as well as more access to the EU market the better, could help Britain's capital to continue being a global leader in the financial sector in the future.

With a ground-breaking speech at the Tory Party conference on October 2nd, 2016 Prime Minister Theresa May shared UK's most recent intentions over Brexit and indicated a hard Brexit to control immigration. The immigration policy has a higher priority than the access to

the single market. Consequently, in that case the UK would not continue to be part of the single market and most likely lose its passport rights. May further outlines a deadline to trigger Article 50 of the Lisbon Treaty to the end of March 2017 to start first Brexit negotiations with the EU. Since the period is determined to be two years the UK might have already left the EU by the end of March 2019. However, the notion of “is two years enough” is disputable.

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