Would Brexit be the final straw for financial services in the UK?

20/06/2016

*Nearly 2.2m people work in financial services in Britain, which is a global centre of excellence in the industry. What impact would leaving the EU have on the sector? **Robert van Geffen** looks at whether UK banks would continue to be able to 'passport' services across the EU and, if not, how they might get around the problem. Even assuming they were able to do that, he writes, the UK would no longer be able to influence EU financial regulation. Furthermore, it is unlikely to cut back on regulation as a result of Brexit.*

When Jamie Dimon, the CEO of JP Morgan, recently warned that a British decision to leave the EU might force his company to relocate up to 4000 employees from the UK to the continent, reactions on social media suggested that not everyone considered that to be a bad outcome. The financial meltdown in 2008 and the economic recession it triggered had made a lot of people lose their trust in the banking system – something from which the industry still has not recovered completely.

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New scandals in recent years, such as LIBOR, and the many fines that regulators have handed out have certainly not helped in this regard. Even though financial services, which are broader than just banking, are a key asset of the UK economy, many shrug their shoulders when banks warn that a UK vote to leave the EU could lead to job losses in the sector.

But should the UK be worried? What might be the impact of Brexit on the ability to provide cross-border financial services from the UK? Are the threats of banks, and other financial institutions, to leave the City and move elsewhere realistic and could these risks be mitigated?

Significance of the financial services sector in the UK

Nearly 2.2m people in the UK work in financial services, which include banking, insurance, fund management and related professional services. HMRC collects around £70bn in taxes from the sector and the UK accounts for 24% of

all EU financial services activity, more than any other European country.

Given the considerable size of the traditional retail banking model of saving and lending in countries like Germany, Italy and Spain, this figure underestimates the dominant role that the UK plays in the wholesale market financing of medium and large-sized corporates across the EU. The UK, and particularly the City, is a central hub for channelling savings, for example from pension and insurance funds to Europe's corporates in the form of debt or equity financing. In this, the UK strongly outperforms its European rivals like Frankfurt and Paris and is a global centre of excellence.

The UK also plays an important regional function, with 46% of the EU's equity capital being raised in the UK. Europe's corporates and investors manage their risks by buying derivative instruments in the UK and they execute a significant proportion of their foreign exchange transactions in the UK. Of all foreign exchange transactions in the world, 41% are done in the UK, with nearly half of all Euro transactions flowing through London. This central hub function of the UK has enabled market players to become more efficient by concentrating their activities in one place.

"Passporting" of financial services

But would any of this be put at risk in the event of a Brexit? Important here is to what extent banks would be able to continue to "passport" their services from the UK across the EU. Banks require a licence from their national regulator before they can conduct banking operations. EU legislation has enabled banks, by a process known as "passporting", to be authorised in one member state while providing cross-border services to other member states without the need for additional authorisation by local regulators. Many banks have therefore concentrated their wholesale activities in the UK, from where they passport their services across the continent, saving costs and increasing competition. It has enabled big global banks from the US and Asia to base their EU operations efficiently in once place; half of the world's financial firms have chosen to base their European headquarters in the UK.

Some in the Leave campaign have argued that if banks in the UK lost their ability to passport their services across the continent in the event of a Brexit, they could easily set up a subsidiary in one of the remaining EU member states. That could be done by simply putting up a little brass plate, according to some. Setting up a subsidiary is, however, rather more complicated than that. Subsidiaries would need to obtain a licence in the relevant member state. In order to get this, the entity would need to be sufficiently capitalised and comply with the relevant market and corporate governance regulations as well as any additional national rules. This is a complex and expensive exercise which is why many banks have chosen to concentrate their activities in a single location.

Forcing banks to set up subsidiaries elsewhere is likely to lead to a fragmentation of the current banking and wholesale market system in Europe, thereby driving up costs. In addition to the costs of disintegrating activities, the need to set up subsidiaries in other EU member states would also require significant investment in building up the financial infrastructure and attract the necessary talent, all of which would take time and come at an expense.

Could the impact be mitigated?

There are, however, some alternatives that would allow firms to continue providing cross-border services in a similar way to how they do now. If the UK were to become a member of the EEA, like Norway, the single market for financial services should remain in place, allowing banks operating in the UK to continue passporting their services across the EU. This would, however, require a resolution of the current issue between the EU and EEA member states about the new powers of the European Supervisory Authorities, as this has blocked the implementation of EU financial services regulation in EEA countries in recent years.

Assuming that this issue can indeed be settled, a key concern of many with this proposed solution is that the UK would lose all its influence on financial services legislation, as this would be set by the remaining EU member states. During the 2009-14 period, when Michel Barnier was Commissioner for financial services responsible for

implementing the post-crisis reform agenda, UK officials held key positions (e.g. Jonathan Faull in the Commission and Sharon Bowles in the European Parliament) meaning they were able to influence legislation that is of crucial importance for a key sector of the UK economy. Losing decision-making power on legislation that would continue to affect the UK would seem to be at odds with what the Leave campaign seeks to achieve and should be of particular concern to a country so dependent on financial services.

Bilateral arrangements in the context of financial services that are in place with other countries only provide part of the benefits that passporting has created, as in many cases the parties to the arrangements can still set additional rules or standards. Increasingly, though, recent EU legislation includes an equivalence regime for third countries. These regimes give non-EU firms access to the EU, provided that the regulatory regime in which they operate is deemed to be equivalent to that of the EU. This could be achieved, for example, if the UK continued to implement EU financial services legislation.

Even though this equivalence regime could mitigate the impact of Brexit, it still means that the UK would need to stay in line with EU legislation over which it would have no say. Moreover these equivalence regimes do not exist for all types of financial services activities. For example, although they cover investment services to professional clients (covered under the so-called Markets in Financial Instruments Directive II), they do not include activities that fall outside MiFID II such as lending, deposit-taking or foreign exchange processing. This is an important limitation, the effect of which should not be underestimated; last year the open access to the Single Market enabled British banks to lend out over a trillion in Euros and take in over a trillion Euros in deposits from the EU.

Could the UK become an offshore haven instead?

Some have argued that instead of trying to hold on to passporting, the UK should become an offshore financing centre with looser regulations than the rest of the EU, enabling financial services activity to flourish. This idea appears to have attracted some hedge funds to support the Leave campaign. But it is unlikely, and probably undesirable, that this will happen.

After the financial crisis in 2008, the UK has been one of the leading nations in developing a regulatory framework for financial services. Instead of trying to push back on additional regulation, the UK has been at the forefront, arguing for the right to introduce higher capital charges if deemed necessary and introducing legislation that ringfences certain activities in banks with the Vickers rules. Both the Bank of England and the FCA have already said that in the event of a Brexit there will be no “bonfire of regulations”. The UK can be expected to continue leading on, for example, the conduct agenda and completing the work to address the Too Big To Fail issue.

Conclusion

The single market in financial services has enabled banks to provide services to their clients across the EU from one central hub, thereby operating more efficiently. Whether one likes it or not, financial services are a key asset for the UK economy, contributing significantly to GDP and the exporting of services. Losing the ability to use the passporting mechanism could force banks to set up subsidiaries in remaining EU member states, significantly weakening the UK’s position as global financial centre and attractive place to do business.

Developing a single market in financial services would be a lot harder to achieve, with its biggest player having left the table, as UK Commissioner Hill also recently said. The risk of the disintegration of banking and wholesale market activities means that there is a great deal at stake in the referendum on 23 June. The potentially disruptive impact of a vote to leave on financing of the European economy is something which seems to have received only limited attention in the debate so far, but should be of primary concern – both to the UK as well as to the rest of the EU.

This post represents the views of the author and not those of the BrexitVote blog, nor the LSE.

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