Impact of EU exit on the financial services sector

Financial services and the UK economy

1.1 The financial services industry generates a substantial share of UK economic activity. The financial and insurance sector contributed eight per cent (approximately £127 billion) of the total value created in the UK economy (in cash terms) in 2014 (measured using gross value added (GVA)).[1] Financial and insurance services creates roughly a fifth of London's GVA; which accounts for more than half the UK's total GVA in the financial and insurance services industry.[2]

1.2 The financial services industry generates a large trade surplus for the UK. Financial services together with insurance and pension services ran a £55 billion trade surplus in 2015 (+2.9 per cent of GDP), which was almost two thirds of the overall trade surplus in services. This trade surplus helped to offset some of the trade deficit run by other sectors, though the UK still runs a trade deficit overall, which in 2015 was £39 billion (-2 per cent of GDP).[3]

1.3 The financial services industry is also an important source of tax revenue. In 2014-15, HMRC calculated the 'banking sector' contributed seven per cent of the £291 billion collected from taxes on earnings and onshore corporation tax.[4] A report commissioned by TheCityUK estimated the financial services sector generates more than £60 billion in tax revenues.[5]

1.4 Financial services are unusually important to the UK economy relative to other developed economies. UK financial services trade is twice the EU average and three times the OECD average.[6]

1.5 Despite the financial services importance to the UK economy, it is not a big employer. Only three per cent (1.1 million) of UK workforce jobs are in the financial and insurance sector. In London, the financial and insurance sector accounts for seven per cent of the total number of jobs in London. However, the sector does support jobs in other related professional services.

London's role as a leading global financial centre

1.6 London is Europe's financial centre and a leading global financial centre. London consistently ranks top of the Global Financial Centres Index, ahead of New York, Hong Kong and Singapore.[7] London's share of the global financial services sector is large and well diversified, both in terms of markets and

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[1] Regional Gross Value Added (Income Approach): December 2015 (ONS 2016)
[2] Regional, sub-regional and local gross value added estimates for London, 1997-2014 (GLAE, 2016)
[3] The Pink Book: 2016 (ONS, 2016)
[4] The EU Single Market: The Value of Membership versus Access to the UK (IFS, 2016)
[5] The impact of the UK's exit from the EU on the UK-based financial services sector (Oliver Wyman, 2016)
[6] Why is the UK banking system so big and is that a problem? (Bank of England, 2014)
[7] Global Financial Centres Index 20 (2016)

activities. It employs more than 700,000 people[8] and is home to over 250 foreign banks – the highest concentration in any financial centre.[9] London is Europe's leading centre for management of hedge funds, sovereign wealth funds and private equity funds. It is also the European headquarters for many companies: 40 per cent of the top 250 companies have their global or regional headquarters in London. In contrast, Paris, the second most important host city, has eight per cent.[10]

1.7 The success of London's financial services industry can be attributed to a number of factors. These factors include its legal system, the English language, established complementary services industries and a flexible labour market in comparison to many other EU countries. London's success is also partly due to EU membership which has brought the financial services sector two key benefits — access to skilled migrant workers (nearly 11 per cent of the City's 360,000 workers come from elsewhere in the union) and a free passport to sell products and services across the region's single market. Following the EU referendum result, both of these benefits could be at risk (sections two and three of this briefing explore these benefits in more detail).

Short-term impact of EU referendum result on the financial services sector

1.8 Some financial institutions are weighing up their commitment to the UK following the EU referendum result. Goldman Sachs, Citigroup and JPMorgan Chase have all said they will review their position when the terms of the UK's exit from the EU are made clear. But HSBC, which said before the vote it would move its headquarters away from London if the UK voted to leave the EU, recently ruled this out.[11] Rival European cities such as Paris, Frankfurt and Warsaw have also made moves to attract business away from London in the wake of the vote.

1.9 Banking stocks dropped sharply following the EU referendum result. Shares in British banks, including Barclays and Lloyds Banking Group, fell more than 30 per cent before rebounding slightly to trade down about 20 per cent at lunchtime the day after the EU referendum vote.[12] More than £20bn was wiped off the market value of the three biggest UK-listed banks.[13]

1.10 In the three months since the EU referendum result, markets have recovered. FTSE 100 companies which generate their revenues abroad (approximately three-quarters) have increased their returns largely because of a ten per cent

[8] This figure includes jobs in related professional services: London Employment Survey Report October 2015 (TheCityUK, 2015)
[9] Key facts about the UK as an international finance centre (TheCityUK, 2015)
[10] London crowned busines capital of Europe (London Futures, 2014)
[11] HSBC rules out leaving London after Brexit vote, The Financial Times (30 June 2016)
[12] Bank shares plunge after Britons vote to leave the EU, The Financial Times (24 June 2016)
[13] HSBC, Lloyds and RBS

drop on a trade-weighted basis for the pound since the vote. Sterling's fall has also helped exporters. According to Alan Wilde, head of fixed income at Barings, sterling's fall has been "the essential safety valve which has protected the economy and financial markets from collapse."[14]

1.11 But a City lobby group has said jobs and tax revenue could at risk if the UK leaves the single market. The report commissioned by TheCityUK said if the UK no longer had regulatory equivalence with the EU, 75,000 jobs and £10 billion in tax revenues could be at risk.[15]

Passporting rights

2.1 The UK financial services industry relies heavily on passporting rights.[16] Data released by the Financial Conduct Authority (FCA) show that nearly 5,500 UK registered companies use passports to access the EU market.[17] And according to Lord Hill, the former EU Commissioner for Financial Stability, Financial Services and Capital Markets Union, passporting has allowed British banks to make over €1,000 billion of loans and to take out a similar amount of euro deposits.[18]

2.2 The UK has become a major hub for non-EU financial services firms because of the benefits of passporting. Typically, non-EU firms wishing to supply financial services in the EU would need to establish a subsidiary in the EU and would also need EU authorisation to confirm the home-country regulation is "equivalent". For this reason, a number of non-EU financial services firms have set up significant offices in London. According to the US International Trade Commission, 40 per cent of US foreign financial services affiliates are located in the UK.[19]

2.3 The removal of passporting could create significant upheaval for UK and non-EU firms with subsidiaries in the UK. If passporting rights were removed UK financial firms would have to establish subsidiaries within the EU. And non-EU (especially Swiss and US) firms with subsidiaries in the UK to service the EU would need to establish an EU subsidiary to service EU customers. One way to

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[14] Brexit vote 3 months on: markets questions still to answer, The Financial Times (24 September 2016)

[15] The impact of the UK's exit from the EU on the UK-based financial services sector (Oliver Wyman, 2016)

[16] Passporting allows firms in one EU member state to trade across the entire Single Market. This arrangements reduces the costs and administration that would otherwise be involved and means UK financial firms can offer services across the whole of the EU without requiring further authorisations or meeting local regulations (for example, requirements on capital or liquidity). Passporting rights also avoid the need to set up a subsidiary as a separate legal entity, which would require its own governance and risk management (see: EU membership and the Bank of England)

[17] Almost 5,500 finance firms use passports to access single market, The Daily Telegraph (20 September 2016)

[18] Commissioner Hill`s speech at Chatham House, the Royal Institute of International Affairs

[19] The EU Single Market: The Value of Membership versus Access to the UK (IFS, 2016)

do this would be to move their existing subsidiary from the UK to somewhere else in the EU.[20]

2.4 The costs from removing passporting without an adequate replacement could also be sizeable. Senior executives and advisors suggest 20 per cent of investment banking and capital markets revenue – approximately £9 billion – could face disruption.[21] But the removal of passporting rights would not just hurt the UK. The FCA data shows that 8,000 companies registered elsewhere in the EU use passports to access the UK. Some of these firms use passporting to run their businesses as "branches" in the UK, rather than as separate capitalised subsidiaries.[22]

2.5 Passporting rights could be retained if London can show its regulatory regime is "equivalent" to that of the EU. A clause in the second iteration of the Markets in Financial Instruments Directive (MiFID 2) provides financial firms outside the EU with a means to provide services to customers inside it. The provision in question allows financial firms from outside the EU to offer trading, brokerage and underwriting services to European institutional (but not retail) clients, as long as the regulatory regime where they are based is deemed "equivalent" to that of the EU. However, the equivalence provision has not yet been tested as the MiFID 2 does not come into force until early 2018. The decision rests with the European Securities and Markets Authority (ESMA), based in Paris. There is evidence the decision could be a protracted process. A similar clause in the European Market Infrastructure Regulation, which governs the trading and clearing of derivatives, was tested between America and EU. It took over three years before American regulations on clearing-houses were deemed equivalent by the ESMA.[23]

Financial regulation

2.6 EU exit could allow the UK to set more of its own financial regulation. Campaigners in favour of leaving the EU said removing some regulations, for example, curbs on bankers' bonuses, would boost London's financial sector. But the global nature of financial regulation could prevent the UK from making any meaningful changes. Most financial regulation is underpinned by the Basel Accords and is shaped politically by the G20. Currently, the UK can protect its interests in financial regulation through four main channels: membership of the International Standard Setting Bodies (ISSBs), representation through the EU which acts as a collective bloc on ISSBs, influencing how EU Directive and Regulations are implemented through its legislative process, and representation on the EU's European Supervisory Authorities. By leaving the

[20] The EU Single Market: The Value of Membership versus Access to the UK (IFS, 2016)
[21] Fifth of City revenues could be hit by 'hard Brexit', The Financial Times (2 September 2016)
[22] Banks fear chill wind of EU 'passport' freeze, The Financial Times (2 September 2016)
[23] Financial tonic, The Economist (9 July 2016)

EU, the UK would lose three of these four channels but remain obliged to implement international standards.[24]

2.7 Similarly, if the UK was to diverge from European regulations it would risk no longer being "equivalent" with EU rules. And a light-approach to financial regulation could also risk setting in motion another financial crash. Xavier Rolet, chief executive officer of the London Stock Exchange Group said the suggestion London could become "a super-competitive environment on the basis of a regulatory race to the bottom" should be treated with caution, and that "competing on the basis of loose conduct or prudential regulation cannot be the basis of a long-term solution."[25]

Recruiting EU talent

3.1 The financial services sector's ability to recruit skilled workers from other European countries could be restricted under a new immigration policy. Approximately, one in ten of the City's 360,000 workers come from other EU countries (see chart below). Professor Sir Charles Bean, former Deputy Governor for Monetary Policy at the Bank of England, told the House of Lords EU financial affairs sub-committee that the City's strength comes from its access to a deep pool of skilled labour; and any restriction to skilled labour would impinge on London's attractions. He said a new policy should retain sufficient flexibility and should not be overly bureaucratic.[26]

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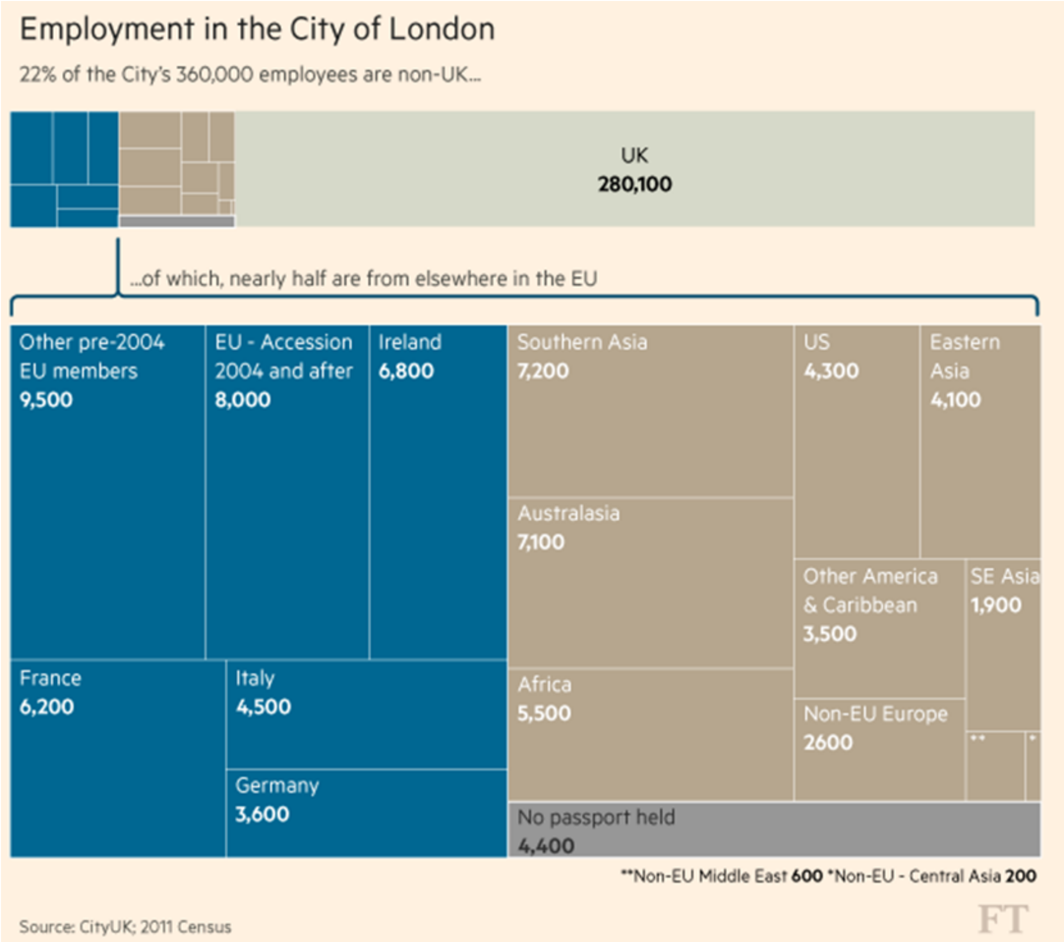
[24] Financial services, the EU, and Brexit: and Brexit (Prof. Niamh Moloney, 2016)
[25] Big Bang II: After Brexit, what's next for the City of London?, The Financial Times (1 September 2016)
[26] Brexit and financial services in the UK uncorrected oral evidence (Financial Affairs Sub-Committee, 2016)



3.2 The Government has not yet set out how its new immigration policy will determine the conditions for EU migrants to work in the UK. However, any new policy is likely to impose conditions on EU migrants similar to those placed on migrants from outside the EU. The criteria used could include: skills, earnings, having a job offer, occupation, or some combination of these; they could also include numerical limits, either overall or from certain countries.

3.3 The Chancellor has suggested high-skilled migrants could be exempt from any future immigration policy. He said the Government would use control over free movement "in a sensible way that will facilitate the movement of highly-skilled people between financial institutions and businesses to support investment in the UK economy."[27]

3.4 But the Home Secretary has announced she will introduce tougher restrictions on hiring people from abroad.[28] She said she would consider introducing measures to force companies to list how many foreign workers they employ in an attempt to "name and shame" bosses who do not take on British staff.[29] Josh Hardie, deputy director-general of the CBI employers' organisation, said: *"At a time when we need strong links globally to seize new opportunities after*

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[27] European bankers will be exempt from migration curbs after Brexit, The Daily Telegraph (8 September 2016)
[28] UK businesses hiring too many foreigners, says Rudd,
[29] Firms must list foreign workers, The Daily Telegraph (5 October 2016)

the [Brexit] referendum, being seen as open to the best and brightest is vital. And we should be clear that business does not see immigration and training as an either/or choice. We need both."[30]

3.5 There is some evidence the uncertainty caused by the EU exit vote has adversely affected hiring plans in the financial services sector. According to the Institute for Public Policy Research, a think-tank, there was a 13.6 per cent downturn in jobs advertised in the financial services sector in London in July and August compared with May and June.[31]

3.6 London could introduce its own visa system to allow EU skilled workers to remain in the capital. The City of London Corporation has commissioned a study into a regional visa system. And the Mayor has said he will consider the proposals.[32] However, David Davis, Secretary of State for Exiting the European Union ruled out a separate EU exit deal for London and the City.[33] Variations of regional work permits have been used in other countries. Shanghai recently made it easier for foreign citizens to gain permanent resident status, as part of a package of policies aimed at establishing the city as a leading innovation economy. And in Canada, while provinces must follow national immigration minimum criteria, they can set their own policies for the migrants they want to attract.[34] A visa system was also put in place in Scotland in 2004 to allow foreign citizens who studied there to stay for two years, but the scheme ended in 2008. A Scottish government cross-party group said last year the work visa should be reintroduced but the Home Office has said there are no plans to reintroduce the scheme.[35]

The future of the City and London's economy and the role of the Mayor

4.1 London's could expand its global reach to protect it from the fallout of the UK leaving the EU. London already accounts for more than 40 per cent of global foreign-exchange trading[36] and two-thirds of all renminibi payments.[37] Some industry experts have suggested London could become the "Greater Guernsey" by expanding off-shore finance for global, non-EU markets.

4.2 But operating on a smaller scale could result in London losing its competitive edge. Martin Sandbu, a Financial Times journalist, suggested London could

[30] UK businesses hiring too many foreigners, says Rudd, The Financial Times (5 October 2016)
[31] Slump in finance sector recruitment in aftermath of Brexit vote (IPPR, 2016)
[32] Mayor wants post-Brexit work visas for capital, The Times (28 September 2016)
[33] Blow for Sadiq Khan as David Davis rules out separate Brexit deal for London, International Business Times (4 October 2016)
[34] We should regionalise immigration decisions – starting with a London visa, City AM (26 August 2016)
[35] Solution to student work visa row 'possible', BBC News, (3 March 2016),
[36] Key facts about the UK as an international finance centre (TheCityUK, 2015)
[37] The official currency of the People's Republic of China

thrive if its operations were scaled back, but raised concerns about whether this would "dry out some of the liquidity pool and cluster advantages that makes the City so competitive outside Europe." [38] He also questioned whether non-European jurisdictions such as China would continue to do business with London under these terms.

4.3 London could strengthen its position as a hub for fintech after the UK leaves the EU. Companies such as Transferwise, Zopa and Funding Circle are transforming how companies and individuals raise, lend and transfer money. Banks are increasingly competing for talent with Google, Facebook and start-ups as artificial intelligence and robotics transforms the world of work. According to Daniel Kimmelman, co-founder and chief executive of tech company DueDil, EU exit offers an opportunity to galvanise London's fintech industry to redesign its entire infrastructure.[39]

4.4 EU exit could provide an opportunity for the UK to rebalance its economy away from services. Currently, services make up around 80 per cent of the UK's economy. Lord Mervyn King, the former governor of the Bank of England, said sterling depreciation since the EU exit vote could lead to a rebalancing of the economy with UK goods becoming more competitive on global markets. And, although there is evidence the fall in the value of sterling is pushing up manufacturers' costs, movements in the currency market since 23 June have been broadly positive. But Andrew Sentance, a former MPC member, said he "always thought it was unrealistic to expect a march of the makers" in terms of traditional manufacturing activities, such as steel production. And that it was in services where the UK will retain the biggest comparative advantage.

The Mayor's role

4.5 Following the EU referendum result, the Mayor set out his asks to Government. In a letter to Theresa May and Andrea Leadsom – then Conservative leadership candidates – he called for a guarantee that EU citizens already in the UK could stay once Britain leaves; a commitment to staying in the single market; the retention of passporting rights; and a seat at the negotiating table for London in Brussels.

4.6 The Mayor has also called for more powers to be devolved to London. He said: "We urgently need more devolution so we have more power to improve our city, including tackling issues around housing, air quality, health and crime."[40] The Mayor has relaunched the London Finance Commission to develop a set of devolution proposals to put to Government.

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[38] Can the City of London thrive after Brexit?, The Financial Times (9 July 2016)
[39] Three scenarios for the City after Brexit, The Financial Times (9 July 2016)
[40] Sadiq Khan must have a seat the table during the EU negotiations, LSE blogs (2016)