Submission for House of Lords European Affairs Committee on the UK-EU relationship in financial services

About New Financial:

New Financial is an independent and apolitical think tank launched in 2014 to make the case for bigger and better capital markets across Europe. We do not represent any particular sector of the industry or any particular financial centre.

The impact of Brexit on the City of London and on EU capital markets has been a significant part of our work since before the referendum in 2016, and since then we have hosted more than 40 events (mainly with UK and EU policymakers) and published more that 15 papers and reports on the implications of Brexit for the City and for the EU. Links to the most recent and most relevant reports are included for reference at the end of this submission.

In this submission we have focused on three areas where we hope we can add value to the debate:

- The impact of Brexit
- Current and future UK-EU regulatory cooperation
- Prospects for and the impact of divergence

1) The impact of Brexit so far on the UK financial services industry, across different sub-sectors.

A big impact: Brexit has had a significant impact on the financial services industry in the UK. We think it is too early to tell what the eventual impact will be: we expect it will be significantly less than some have predicted in the past six years, but significantly more than the measurable impact so far. Our research (as of February 2021) shows that nearly 500 firms based in the UK have responded to Brexit in some form by relocating part of their business, staff, legal entities, or capital to the EU to ensure continuity of access to EU markets and customers in both directions. Banks have moved or are moving more than £900bn in assets from the UK to the EU (roughly 10% of the assets in the UK banking system), and insurance firms and asset managers have transferred more than £100bn in assets and funds.

The impact on jobs: we think the debate about how many staff have been moved so far and whether that is higher or lower than expected a few years ago is something of a distraction (it is virtually impossible to measure and we expect the numbers to increase over time). That said, we identified around 7,400 staff moves or local hires in response to Brexit, but this is derived from only a small minority of firms, and we expect this number to increase in the next few years (we think the real number is closer to 10,000). The bigger issue is not jobs leaving the UK but new jobs in the EU being created in future that might otherwise have been created in the UK.

A long-term view: in the longer term, we estimate that the City of London will be bruised but not fatally wounded by Brexit. We estimate that around 20% to

25% of UK financial services activity is related to the EU and that as much as half of that may need to relocate in some form to the EU over time. This 'bruising' could add up to the loss of around 10% of activity which could translate into around 30,000 to 35,000 jobs. However, the City of London is one of just two global financial centres along with New York, and it will continue to be the dominant financial centre in Europe. Over time, it will play less of a role as the financial centre for Europe.

Sector-by-sector: the impact of Brexit depends heavily on the sector of activity. In some sectors, such as markets and investment banking, adapting to Brexit has been a complex and expensive exercise (firms have had to create new separately capitalised subsidiaries in the EU or expand existing ones, create a new tier of EU level management, and relocate hundreds of staff as well as hiring more staff locally). In other sectors like asset management and insurance it has been an administrative headache. Asset management firms (including hedge funds and private equity) need to ensure they have an EU management company in place with its own board in order to continue to distribute funds to EU customers, while most insurance firms already operated across the EU through subsidiaries. Some sectors of activity, such as FX trading, are largely unaffected.

Mechanical vs actual impact: in many cases the impact of Brexit has been mechanical: as part of the EU single market, certain business could be conducted in London in EU markets or on behalf of EU clients. Now that the UK has left the EU, this business can no longer be conducted here or has to be routed to EU markets and EU clients through a separate EU authorised entity.

While the numbers look big, this does not always translate into a significant shift in jobs. For example, trading in EU-listed equities that used to be conducted in London has move entirely to the EU (mainly to new EU subsidiaries of UK-based firms in Amsterdam) because of EU regulation. On paper, it looks like Amsterdam is now the biggest European centre for equities trading. However, this shift has involved only a handful of jobs and virtually none of the traders, hedge funds and asset managers placing the orders behind this trading have moved from London and are unlikely to do so.

This is also the case in the debate around clearing: while the numbers involved run into trillions, the number of jobs and the revenues / tax receipts involved are minimal. LCH employs around 600 people in the UK and generates revenues of just under €1bn a year. If some or all euro-denominated clearing had to relocate to the EU (where LCH operates a French subsidiary) the shift in revenues and staffing would be minimal.

Not a dollar more: a common theme running through Brexit-related relocations is that most firms will move what they are required to move by EU authorities but not a single employee or dollar of capital more. Over the past 20 years many firms have used the single market to concentrate as much of their European activities in the UK as possible and for economic reasons they will week to retain as much of their operations in the UK as possible. However, firms will happily change their 'UK first' approach if and when the regulatory environment or economics of the business change.

An intangible impact: in addition to the measurable impact in terms of staff numbers and capital being moved, there is a wider and less tangible cost of Brexit. The UK used to play a significant role in shaping the rules for banking and finance across Europe through formal channels such as the European Commission, European Parliament and European Supervisory Agencies (EBA, EIPOA and ESMA). Outside of the single market, the UK has lost its voice at the table and lost influence over the future direction of regulation in its largest single market on its doorstep. There is a risk that the UK will lose influence on the global stage in banking and finance as a smaller independent 'bloc' instead of being able to amplify its influence through the EU.

Three phases of impact:
We think that the industry is currently in the second of three phases of Brexit-related relocation, and that the scale of relocations will continue to rise for the next few years.

> **Phase 1:** in preparation for Brexit, many firms moved a minimal / skeleton number of staff, capital, operations, and legal entities from the UK to the EU to guarantee continued access to EU markets and clients. This phase and these moves are complete and are reflected in our research on the impact so far of Brexit in the City and translate into the relatively low headline numbers of c7,500 jobs that have been affected.
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> **Phase 2:** EU and national supervisors showed considerable discretion in authorising firms on the basis of a minimal initial / pre-Brexit presence in the EU on the condition that these operations increased in scale in future. With many larger firms, the EU agreed a 'target operating model' that mapped out an agreed plan with an agreed timeline. In this phase, firms will move more staff, capital, and operations to the EU to meet these requirements.
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> This is reflected in episodic media coverage that 'Firm X has decided to move another Y staff or capital to the EU and plans to have Z amount in place by the end of 2022'. In most cases, this is not relocation activity that has been decided since Brexit but fulfilling relocations that were agreed with EU authorities before Brexit.
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> Simultaneously, EU authorities are keen to ensure that UK based firms are meeting both the spirit and the letter of the rules around the single market. The ECB's 'desk mapping review' is designed to ensure that firms locate people and function that are subject to EU rules in the EU and is likely to lead to further relocations.
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> **Phase 3:** the EU is keen to 'repatriate' EU activity that is conducted in the UK and in future it is likely that it will seek to require more activity in more sectors to be conducted inside the EU. The sectors that could be targeted in future are:
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> - Asset management: by reviewing delegation rules (while more than 100 asset management firms have increased their presence in the EU

in response to Brexit, conspicuously few actual asset managers have relocated)

- Clearing: the EU is seeking to develop more domestic capacity in clearing by 2025 and will hope that this will attract jobs in the wider ecosystem of trading and risk management.

- Bond markets: roughly two thirds of trading in bonds issued by EU issuers is conducted in London. The EU is considering whether to apply to same rules to bond trading that it has applied to equity trading, and effectively require trading in EU bonds to be conducted inside the EU.

A known unknown: the biggest potential impact of Brexit on jobs is future jobs that are created elsewhere and not in the City. In the longer term, the growth in capital markets activity in the EU means that the number of jobs supporting it will continue to grow. Many of these jobs would previously have been created in the UK, but the majority of them in future will be created in the EU. The measurable impact of this will not be clear for at least several years. As more firms develop a bigger footprint with the operations in the EU, more discretionary investment decisions in future may head to the EU at the expense of the UK.

The occasion not the cause: one underexplored risk is jobs that may relocate from the UK as an indirect result of Brexit but not strictly caused by Brexit. Most of the jobs that have moved so far and that are likely to move in the near future are *because* of Brexit ie. EU rules require a particular function to be conducted inside the EU. However, ahead of and since the referendum, many firms conducted a review of their footprint across Europe as part of their contingency planning. In many cases, this highlighted that many firms employed huge numbers of support staff in expensive offices in London or the rest of the UK when they didn't need to be there.

In the past 10 years, tens of thousands of back-office jobs in banking and finance have been created in countries like Poland, Hungary, Portugal and the Baltics where firms have access to highly qualified but much cheaper staff in much cheaper offices. In this sense, Brexit may accelerate a wider

restructuring of the industry, and support staff in cities like London, Bournemouth, Birmingham, Belfast, Glasgow and Manchester may be at risk.

Two-way traffic? There has been some suggestion that EU firms opening new offices in the UK as a result of Brexit could more than offset relocation activity in the other direction. While this would be welcome, we think this is a false comparison and highly unlikely. Before Brexit, the FCA set up a Temporary Permissions Regime to allow EU based firms to continue to access the UK market under EU passporting rules until 2023 without having to set up a physical presence. As of February last year, just under 1,500 firms had taken advantage of this: roughly 1,000 of them do not have a physical presence in the UK and may therefore have to open an office here in future if they wish to continue doing business in the UK.

However, we don't think this will translate into 1,000 firms opening an office and hiring thousands of staff. The majority of firms using the TPR are relatively small; using the TPR is cost free whereas opening an office is not (particularly when opening an office in the UK only provides access to the UK market, whereas opening an EU office provides access to the whole of the EU); many of these firms are part of a larger group that already has an office in the UK; and many of them are in sectors of activity that are frowned up by the FCA (broking firms in Cyprus and Malta) and are unlikely to want to be supervised by the FCA. It remains to be seen how many firms will set up a new office in the UK, but we think a more realistic forecast is 300 to 500 mainly smaller firms may do so.

2) Current and future UK-EU regulatory co-operation, particularly in the absence of a functioning framework for co-operation as envisaged when the TCA was signed.

There is virtually no formal regulatory co-operation between UK and EU regulators outside of global bodies such as the Financial Stability Board, G7, G20 and IOSCO. It is unclear if and when the 'memorandum of understanding' between UK and EU regulators will be agreed, but any such agreement will do little more than provide a structure for formal and regular meetings between UK and EU regulators. The potential scope of the MOU is less ambitious than the existing agreements between the UK and US (the Financial Regulatory Working Group) or the EU and US (the Joint Financial Regulatory Forum). The UK has agreed a similar arrangement with Japan in the trade agreement concluded in 2020. While the proposed MOU agreed between the UK and EU is likely to be relatively modest, it may form the basis to rebuild trust and future cooperation at a technical and supervisor-to-supervisor level.

The main blockage on future cooperation is politics. While personal relationships between UK and EU supervisors remain close, they have been limited by the politics of Brexit over the past six years and more recently by the enforced isolation of the pandemic. Now that the UK has left the EU, regulators are keen to move beyond a debate characterised by antagonism and confrontation to one based on healthy competition and cooperation. The problem is that Brexit has created a lot of anger, mistrust and enmity between the UK and the EU. The debate on both sides has often been driven by domestic imperatives that Brexit must be presented as a zero-sum game. These tensions will take time to die down: we may have to wait for a lot of the politicians involved in the debate over the past few years to leave the political stage.

In recent weeks there have been some encouraging steps towards 'normalisation' in these relationships: for example, European Commissioner Mairead McGuinness has recently welcomed City Minister John Glen MP in Brussels, as well as Andrew Bailey and Sir Jon Cunliffe from the Bank of England.

3) Prospects for, and the potential impact of, any UK-EU divergence on financial services - particularly regulatory divergence, as well as UK agreements with other partners.

Over the past six years much of the debate on the impact of Brexit has focused on the trade-off between access and divergence. The more access the UK wants, the more aligned in more sectors it will have to be. The more it wants to diverge, the less access it will have and the more activity will need to relocate. However, we think that ship sailed years ago and that this is a false dichotomy. We do not expect the EU to grant any more equivalence to the UK than the very modest and time-limited equivalence that it has granted in clearing and settlement, and therefore it would be misguided to base the future regulatory strategy for the UK on any sense of maintaining access.

We think in many areas the industry should treat the dislocation from Brexit as a sunk cost and take the hit from relocations on the chin. The relocation of some activity from the UK to the EU will provide most firms with the access they need on the other side of Brexit. With this access in hand, the UK will then be free to rethink and recalibrate its supervisory framework to the unique dynamic of the UK financial services industry. This selective divergence will be gradual and inevitable, and in many cases the future UK framework will look remarkably similar to the EU's.

This divergence will take several forms:

- **Passive divergence:** the gradual cumulative effect of both the UK and EU making minor changes to their existing rulebooks will mean that within a few years the framework for the UK and EU will look significantly different even if neither side actively set out to diverge from the other.

- **Accidental divergence:** the UK and EU will move at different speeds in terms of reviewing and reforming their framework. Outside of the EU, the UK should be able to move faster. For example, some of the recommendations from the UK Listings Review have already been implemented less than 16 months after it was launched and less than a year after it was published. In contrast, the EU has just launched its own review of listings rules and changes are unlikely to be implemented until 2024.

- **Parallel divergence:** the UK and EU are reviewing many of the same areas of regulation (such as Solvency II for insurance, Basel 3 for banking, and Mifid II for markets). In most cases, they will diagnose the same problems but at different speeds. However, they are unlikely to agree with other on the solutions, leading to divergence in the same direction – but divergence all the same. In some cases there is a degree of 'shadow boxing' going on: if the EU reviews or changes something, the UK responds with a review or changes of its own, and vice versa.

- **Active divergence:** In the past few years, the UK government has launched a wide-ranging series of reviews into different aspects of the supervisory and regulatory framework that the UK inherited from the EU. It has published more than 30 major reviews and consultations from the UK Listing Review on public equity markets, to the Solvency II review on insurance, the Wholesale Markets Review on trading, and the Kalifa

Review on fintech and innovation. There are currently more than 130 live regulatory briefs underway in the UK.

In many cases these reviews have identified specific regulations that were designed for 28 member states and that are not appropriate for the much more developed UK market. These are mainly regulations that the UK did not fully support while it was a member of the EU, and therefore it is keen to use Brexit as the opportunity to recalibrate them. For example, the Wholesale Markets Review focused on rewriting or removing prescriptive EU measures on equity, fixed income and derivatives trading.

Ultimately, the biggest divergence post-Brexit is likely to be more philosophical than regulatory: the EU is looking to develop its own capital markets by *requiring* certain business to be done in the EU, while the UK is aiming to mitigate the impact of Brexit and attract new business by making the UK somewhere where people *want* to do business.

We have covered specific areas of potential and beneficial divergence in the separate report but would underline an 'acid test' based on intended outcomes that we think the UK should apply to regulatory reform. From a domestic perspective: does the existing framework impede or undermine the industry's ability to support UK companies, individuals, and the wider UK economy? And from an international perspective: does the existing framework put UK firms or firms based in the UK at a clear, measurable, and practical competitive disadvantage to their international peers?

In cases where the answer is 'yes', UK policymakers and supervisors would make a data-led and outcomes-based cases as to how it can be improved or make a clear why it should be retained and on what basis they would review it in future.

For reference:

Here are some links to some of our recent and relevant reports in relation to Brexit and the City:

A reality check on equivalence – Feb 2020

The future of EU capital markets – Sept 2021

Beyond Brexit: the future of banking & finance – Oct 2020

Brexit & the City infographic – Apr 2021

Brexit & the City: the impact so far – April 2021

New Financial Global Financial Centres Index – June 2021

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