Has the City of London benefitted from Brexit?

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Summary and Conclusion

- **Three years after leaving the EU, there are no discernible signs of any benefits for UK finance. Instead, there are multiplying, and worrying, signs of a lack of substance to the initial, bold slogans. Leadership seems to be slipping away from the UK in many fields as the EU continues to exercise its soft power of setting standards that acquire global standing due to its economic scale. There seems no plausible route to significant improvement for the UK outside the European Union.**
- The bravado of fine announcements has given way to the reality of little content in terms of business creation. The flagship Financial Services and Markets Bill has just become an unimpressive Act.
- The MoU on financial service co-operation with the EU is revealed as a talking shop that leaves EU autonomy unfettered.
- The City's global standing is slowly sinking – as the City's leaders recognise with some alarm.
- There are worrying signs about many of the City's core activities: equity trading of EU shares went to Amsterdam and London is now smaller than Paris; new equity listings are declining; risks remain for `delegation' of asset management functions; Solvency II reform (a Brexit war cry!) may be achieved only slightly ahead of the EU's own reform; digital strategy remains fine plans while the EU completes its legislation; `Greening' was meant to be a leadership icon but the UK is on the verge of becoming a rule-taker as the EU's granular legislation comes into force.
- EU enforcement of rules on bank risk management/trading is ramping up and senior roles are shifting to the mainland.
- The location of euro CCPs is set to shift - amid stark warnings about the necessity of preserving the EU's financial stability.
- The financial sector's tax revenues and foreign earnings are under threat while the UK balance of payments remains precarious – relying on the continued "*kindness of strangers*".

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Announcement of plans for the brave new world of global British finance

The UK left the EU at the end of January 2020 – three and a half years after the Referendum. That should have given ample time to prepare careful plans to enable the City to take full advantage of the alleged new opportunities for `global British finance'. There has been no shortage of brave-sounding announcements, but the results so far seem to have fallen well short of the slogans.

The major announcements began - with a lag – in July 2021 with then-Chancellor Sunak's Mansion House speech. He announced plans to make the UK the world's most advanced and exciting financial services hub to create prosperity at home and help the UK project its values abroad. Chancellor Sunak: Mansion House speech on financial services and the EU *"And we need this industry to succeed...You contribute £76 billion in tax a year - enough to pay for our entire police force and our entire state schools' system...You employ 2.3 million people - with two thirds of those jobs outside London, in places like Glasgow, Belfast, Bournemouth and Leeds..."*

Shortly afterwards, `global' Britain trumpeted a deal with Singapore on financial services. Upon inspection, this was just an agreement to deepen bilateral cooperation on fintech and sustainable finance. There is not yet any evidence of tangible results. The UK also trumpeted the opening of negotiations with Switzerland in May 2023. As the Swiss are about to open negotiations with the EU, they are unlikely to agree anything that might prejudice a vastly more significant arrangement with the EU and the EU discussion is certain to be lengthy. The much -vaunted global trade deals seem unlikely to produce any significant benefits to finance in the near future.

The Wholesale Market Review commenced in July 2021 "to take advantage of our newfound regulatory freedoms since leaving the EU." As a result, the Queen's Speech of May 2022 announced plans to revoke EU financial services regulations and replace it with new rules which are "designed for the UK" – nothing less than a bonfire of EU rules.

However, both the Treasury Select Committee and the House of Lords issued reports urging caution. Agile regulation – as operated by Ministerial veto, rather than by independent regulators – took a knock soon after its announcement when opposition grew from the regulators themselves – led by the Governor of the Bank of England. The government had originally proposed a "call-in" power that would authorize it "to direct a regulator to make, amend or revoke rules." But, in November 2022, the government suddenly decided not to proceed with the plan "at this time" when faced with a `regulators' revolt'.

Nonetheless, just over a year after the Queen's Speech commitment, the Financial Services and Markets Bill received Royal assent – becoming FSMA 2023. The Government described it as a `rocket boost' and said, "*The changes enable the delivery of key Edinburgh Reforms, putting the UK on course to be the most dynamic and competitive financial services hubs in the world.*"

The "Edinburgh reforms" – December 2022
These set out more than 30 measures to reform financial services regulation including: wholesale markets; retail and consumer business; asset management and pensions; payments; capital markets; sustainable finance; insurance; individual accountability – SM&CR; ring-fencing; bank prudential rules and regulators' remits

This phase of general `announcements' was probably completed with the long-awaited UK-EU Memorandum of Understanding on Financial Services Cooperation in June 2023. It stated that the participants will "*jointly endeavour to pursue a robust and ambitious bilateral regulatory cooperation*". But when it came to the crunch of power rather than talking, *"The regulatory cooperation should not restrict the ability of either jurisdiction to implement regulatory, supervisory or other legal measures that it considers appropriate."* Thus, the EU continues to maintain its autonomy of action – as was made crystal clear in the aftermath of the 2016 Referendum.

The City's global standing-- sinking slowly

How has the market perceived the standing of the City as a result of all these announcement and commitments? Various surveys and reports attempt to measure the relative standing of global financial centres. Perhaps the best known is Z/Yen's Global Financial Centres Index (GFCI). London and New York have been vying for the top spot for years, but London has slipped recently and was noticeably behind New York in both September 2022 and March 2023 surveys. However, London still remains well clear of the individual EU centres – "*The capital's deep highly-skilled talent pool helped drive it to the top of the European rankings.*"

In asset management, the City's share of European investment management market is larger than Frankfurt, Paris and Zurich combined – making the UK the second largest investment management centre in the world, behind New York City and other US hubs taken as one market – according to the Investment Association.

Moreover, London leads the world as the top destination for foreign investment in financial and professional services. Figures published by the City of London Corporation show that London continues to hold the top spot in attracting foreign investment in financial and professional services, attracting 114 projects in 2021 – well clear of Dubai (104 projects), Singapore (103), New York (54) and Paris (51).

Some bullish momentum from pre-Brexit days is still to be found but the worrying signs are multiplying:

- In March 2023, the City of London warned in a report that fewer companies are choosing to list in London, while existing firms are dropping out of its stock exchange, despite changes to rules. According to Chris Hayward, policy chairman at the City of London Corporation "Our competitive advantage is at risk,…a long-term plan to stimulate growth in the financial and professional services sector is needed." He seems unimpressed by the string of bold statements from no less than four Chancellors in the last four years.
- In January 2022 Reuters reported that "London … lags in key areas. London remains the top global financial centre, according to a study from its own financial district, but is outgunned by New York and Singapore in access to talent, while Paris is adding competition from the European Union."
- In September 2021, TheCityUK worked with 60 financial services groups to set out international strategy proposals to return the UK's financial capital to being the "world's leading financial centre" within the next five years as the City is at risk of losing its status as a global financial powerhouse within five years,
- City A.M. put in a Freedom of Information request about passporting and found "Little appetite among EU finance firms to stay in London as FCA applications disappoint." It appears that many European financial services firms are not interested in continuing to be authorised in the City, as only half of EU firms that were given a temporary license to operate in the UK – immediately after Brexit – have applied for full authorisation.
- In November 2021, the Financial Times described Brexit as a *"slow bleed for the City of London… After a pandemic pause, the movement of jobs and business towards the continent is set to resume."* Shortly afterwards, its description changed to "a slow puncture" but, disturbingly, the reason for the slowness of the puncture is the uncertainty of the EU's political will to complete Capital Markets Union and reduce dependence on the UK. That may very well change at any time.

City activities – worrying signs

Equities trading

… in euro-denominated shares moved from London to Amsterdam at the moment of Brexit – halving London's daily volume. The fall in sterling and rising optimism about French stocks pushed the **market capitalisation** of the Paris Bourse level to equality with London last November and it is now more than 10% bigger.

Equity listings

There is growing concern about the relative attractiveness of London as a marketplace to raise new capital. In late 2021, the government announced plans to review listing requirements for new issues of shares to be led by former EU Commissioner Lord Hill. He reported in March 2022 and the FCA responded with particular alacrity to his recommendation concerning special purpose acquisition companies (**SPACs**) – more commonly known as "*blank cheque*" companies.

However, in March this year, the leading chip-maker – ARM – dealt a blow to the British tech sector and UK markets more generally– by deciding to list only in the US. Immediately, the FCA pledged to review listing rules (again!) to avoid another ARM snub. The FCA promptly set out "*an ambitious vision for potential reform to the way companies list in the UK that aims to attract more high quality, growth companies and give investors greater opportunities."*

But this problem may be symptomatic of a deeper malaise in UK equity markets: de-equitisation as companies buy back their shares and UK institutions reduce their UK equity component and move to Liability-Driven Investment (LDI). The resultant Morningstar headline put the problem pithily: *"U.K. stocks at record 40% discount to Wall Street will force London exodus, says Citi".*

UK insurance and pension funds used to own more than 50% of the UK equity market. Now their share is down to about 4% NO.. it really is 4% - amazing!!! and it is foreigners who own more than 50%. The FCA's plans to make the UK market even more attractive for foreign listings has generated strong pushback from some UK investors. The largest 10 pension funds sent an open letter to the FCA in June arguing that the proposals risked damaging "*fundamental investor protections*" and thus the City's global attractiveness. There seems to be no good solution for the dichotomy between lowering standards to attract listings, and the basic requirement of protecting investors.

Asset management `delegation’

Following the loss of passporting rights after the UK’s withdrawal from the EU, the EU has made it very clear that it will not accept “letter box” arrangements for the management of investor assets that `delegate’ the actual portfolio management or risk management to third countries unless there are careful constraints. The exact constraints have been the subject of bitter debate within the EU and the current revisions of the Alternative Investment Fund Managers Directive (AIFMD) seem to be acceptable to the UK industry. However, the truce is probably only one scandal away from a shift in the balance for the UK industry’s 122,000 employees. Remember, the celebrated MoU is explicit that the EU’s regulatory autonomy is unfettered.

Solvency II

These arcane regulations governing the capital adequacy of the insurance industry were triggered by pressure from the UK’s then-FSA to improve the matching of the insurance industry’s assets to the nature of its liabilities to policyholders. The EU took over many of the UK’s intellectual concepts and Solvency II began its tortuous path in the early part of the century before coming into force in January 2016 - just before the UK’s Brexit referendum.

The UK insurance industry was always unhappy with its constraints and `*reform Solvency II’* became a rather unlikely war-cry of the Brexiteers. Empowered by the final enactment of FSMA 2023, the Bank of England has moved swiftly to consult on new rules: *“streamlining of reporting requirements…and substantially simplifying and improving the flexibility in the assessment of internal models”.*

The Association of British Insurers said the implementation timeline “*would see the UK introducing its Solvency II reforms ahead of the parallel process in the EU*”. The EU started a major review in 2020 – focussing on the rules about infrastructure investments, which are also a major item of the proposed UK changes. It will be interesting to compare the final rules and consider if Brexit has actually enabled the UK to gain an economic benefit in this bizarrely high-profile field. It will be especially interesting to see if the new UK rules would have encouraged insurers to buy bonds such as those issued by Thames Water – now trading at around 50% of par value.

Digital

The UK launched it Digital Strategy in 2017 and updated its Digital Strategy in October 2022 with an impressive list of plans. In 2020, the EU launched its Publication of the agenda to shape Europe’s digital future, a strategy on data and a White Paper on artificial intelligence and is speeding ahead with a plethora of detailed legislative proposals including a Digital

Services Act, Digital Markets Act and the European Digital Identity. The latter is key for EU-wide payment systems.

The two entities show a very different approach: the UK sets out bold plans while the EU is obliged to start at the foundations by producing a legal framework that can enable all 27 Member States to operate on a common platform. But the result is a set of EU standards that can be adopted by other states. That is the essence of the soft power of the world's largest trading bloc - already demonstrated by spreading its standards around the world – whether accounting standards (adopted in more than 90 countries) or mutual funds/UCITS (75 jurisdictions).

Both the EU and UK are considering central bank digital currencies (CBDC) and the global acceptance may turn out to be a useful barometer of the standing of `global Britian' in a post-Brexit world. The Bank of England consultation closed on 30 June while the European Commission published its fully detailed legal proposal for a digital Euro on 28 June. Now the EU's co-legislators have to decide if they actually want to proceed! Could the UK even come to a conclusion, let alone legislate before the next General Election? Or will the field simply be left vacant for any digital euro?

Greening

The UK Government laid out several iterations of its Green Finance Strategy – most recently in March 2023 "*the Strategy sets out how the U K will use our leadership and the expertise of our financial sector.*." However, that leadership vision did not seem to extend to creating its own standards rather than accepting global standards. HMG expressed its support for the International Sustainability Standards Board (ISSB) standards as soon as the first two were published in June 2023. Accordingly, the UK will be a `rule-taker' for these vital standards. In March 2023 "*We will deliver a **U K Green Taxonomy** – a tool to provide investors with definitions of which economic activities should be labelled as green... We expect to consult on the Taxonomy in Autumn 2023."*

In contrast, the EU launched its Action Plan in 2018 with the explicit intention of creating globally accepted standards. It initiated a Technical Expert Group on its taxonomy in 2020; its Taxonomy Regulation came into force in July 2020; detailed Delegated Acts came into force in 2021/2022/2023; corporations are now required to disclose their plans and the EU Sustainable Finance Disclosure Regulation (SFDR) requires asset managers to have their own business plan and to disclose the sustainability of their products. The EU reached political agreement on the Green Bond Standard in March 2023 - providing a voluntary basis for issuers to confirm that bond proceeds meet Taxonomy requirements. The UK has not even started its `consultation' on these issues.

It remains to be seen if the €32 trillion of assets under management by the European Fund and Asset Management Association (EFAMA) members throughout Europe will be drawn to already-existing EU standards - or whether the sub-set of €5 trillion funds managed on behalf of UK investors will be a sufficient draw to UK standards as/when/if they appear. Moreover, UK listed companies that are 50% owned by foreigners may be reluctant to have two sets of disclosure standards. The FCA welcomed the announcement of the ISSB standards "*These standards answer the clear market demand for complete, consistent, comparable and reliable corporate sustainability disclosures."* When the UK has finished it consultations, will there be any room on global investors' radar for a separate set of UK standards. Or will the UK effectively be a rule-taker of the detailed, granular EU rules that implement the detail of the ISSB standards?

Implementation of EU rules – toughening ahead

From the earliest days of the Brexit negotiations, the EU made it very clear that it would take whatever steps it felt were necessary to protect its own financial stability. Chief amongst these concerns was the location of clearing of derivatives (see below), given the vast scale of the risks outside the purview of the EU authorities.

Perhaps the next biggest risk for the City is the location of the trading activities of banks and the ability to oversee and manage the associated risks – avoiding `empty shell' risk management. Throughout 2021 and 2022, there were a steady stream of press articles and speeches about the ECB's need to have a comprehensive view of the potential risks facing as well as the banks' effective capacity to manage and supervise the risks. As the problems of Covid receded, that pressure rose – including threats to make regulatory amendments to cross-border access and remove national discretions.

A desks-mapping review by the ECB was part of that supervisory work to ensure that third-country subsidiaries had adequate governance and risk management capabilities and did not operate as empty shells. The review concluded that some firms lacked sufficient EU-based capabilities. Moreover, the ECB believed that fewer roles than needed had been moved to the bloc after Brexit.

In March 2023, an ECB review spelt out that the key overarching objective was to ensure that all significant institutions have prudent/sound risk management frameworks in place, as well as a local presence which enables effective supervision commensurate with the risks that they take. "*The review of trading desks and their associated risks does not mark the end of the supervisory scrutiny of incoming banks' post-Brexit operating models. Investigations into credit risk-shifting techniques, the reliance on parent entities for liquidity and funding, and internal model approvals are still ongoing."*

The "Windsor Agreement" on Northern Ireland emboldened UK politicians to push to work more closely with the EU on financial services regulation. However, the recent MoU on talking to each other is a far cry from the EU conceding regulatory autonomy to the UK! More of the senior jobs will be located in the EU in the future – together with associated profits. The FT's fears of a slow bleed/puncture seems to be well underway

What are the travails yet to be fully manifested? The location of euro CCPs

Perhaps the major Brexit effect that is yet to be felt is the location of Central Counterparties (CCPs). These are an essential part of the OTC derivatives system and have been the subject of several Federal Trust videos and papers by this author, as well as my Evidence to the House of Lords enquiry. That paper laid out the sheer scale of euro-denominated OTC derivatives – the nominal value of euro contracts cleared in the UK is 47 times the UK's GDP. Hence the EU's concern about its own financial stability if – despite all the regulations to prevent a problem – public funds were needed to prevent a collapse. (Note: The ECB has NOT pre-committed to providing any emergency euro liquidity and the EU's co-legislators have explicitly stated (in CCP RRR) that any ultimate use of public funds would be subject to democratic control procedures – so a political decision.)

Commissioner McGuinness was emphatic when speaking to the FT in May. She said the EU's 2025 date was aimed at ensuring no "cliff-edge" faced the industry and that it gave the EU time to put its house in order. "*I want to underline that this matter is actually not so much about Brexit. The EU needs — for its own sake — safe, robust and attractive clearing for a well-functioning [capital markets union].*" **The warning could not be starker.**

Movement of jobs/taxes to the mainland- permanent losses

At the time of the Brexit referendum, there were fears of a wholesale migration of jobs out of the UK but this has not happened – yet. Instead, the Covid pandemic intervened and "working from home" became widespread. However, the ECB has steadily been enforcing the policy of requiring senior management to be located withing the EU's jurisdiction (see above). The news media are increasingly carrying stories about the number of job re-locations whether by transfer or local hires. For the individuals concerned, this is turning out not to be so traumatic as feared and is increasingly seen as a permanent life-style change with children in local schools and the purchase of long-term family homes.

The contribution of the UK's financial services sector to the UK economy is enormous. The latest City Statistics Briefing provide the headline numbers: "*Financial and professional services produced £278bn in economic output, contributed nearly £100bn in taxes, exported over £128bn..*" UK goods exports cover only about 60% of our goods imports and the surplus on services is vital as it runs at about 5% of GDP. But that still leaves a current account deficit of 3.6% of GDP over the last 12 months and the UK has been close to the worst performer amongst OECD countries for the past decade or more.

If the City's tax revenues and foreign earnings erode over time, it would be a very serious matter for the UK. As former BoE Governor Carney famously remarked, there are risks in being "*reliant on the kindness of strangers*" to fund these deficits. As the deadline for clearing euro derivatives in the EU draws nearer, perhaps global banks will think about minimising their costs by co-locating their dollar and euro business on the mainland. That may be the biggest risk looming over the UK that has not yet begun to crystalise.

After objectively reviewing the evidence, the overall conclusion has to be that, three years after leaving the EU, there are no discernible signs of any benefits for UK finance. Instead, there are multiplying, and worrying, signs of a lack of substance to the initial, bold slogans. Leadership seems to be slipping away from the UK in many fields as the EU continues to exercise its soft power of setting standards that acquire global standing due to its economic scale. There seems no plausible route to significant improvement for the UK outside the European Union.

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