Brexit and the City

Executive summary

Returning the City to the Real Economy - a Golden post-Brexit Era beckons

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Highlights

On 23 June 2016, the British people voted to leave the EU. The prime minister's Lancaster House speech on 17 January 2017 made it very clear that this meant also leaving the single market, the customs union and the European Economic Area, membership of which means accepting freedom of movement.

This has powerful implications for the City:

- It is unlikely that business with the EU27 will be conducted via passports in future.
- Instead, and depending on the degree of co-operation from the EU27, the City should plan its future operations using either:
  - a dual regulatory regime, based on a third-party expanded equivalence model with guarantees about how equivalence will be granted and removed, or
  - the World Financial Centre model where the City 'goes it alone'.
- Transitional arrangements will also depend on the degree of co-operation from the EU27. It is in everybody's interests that any transitional arrangements are kept as short term as possible, no longer than is needed to bridge the gap between the UK's exit from the EU and the conclusion of any formal long-term trading agreement with the EU. If, as seems possible, the EU is not interested in such an agreement, then the UK should exit from the EU immediately this becomes apparent.
- The City should encourage the government to support the development of legally binding regulatory standards at a global level free from political interference. The aim would be to promote global consistency and cooperation between regulatory authorities.
- The City should encourage the government to support the overseas expansion of UK financial services in the fastest growing regions of the global economy.
- The City should encourage the government to introduce a flexible system of work permits for skilled workers that covers workers who are offered a job in the UK and who are located in any country in the world outside the UK.

The most important task for the government when it triggers Article 50 and opens negotiations with the EU is determine whether the EU is willing to co-operate on achieving the best possible outcome for both UK and EU27 citizens. The most important collective task for the City in helping to achieve this outcome is to refuse to move business to the continent.

This paper reviews both the principal issues affecting the City of London following the Referendum vote to leave the EU and the key proposals for the City's future relationship with the EU that have been made. The latter will be examined in the light of the EU Commission's declared negotiating strategy and also what is needed to achieve the best possible outcome for the City and the UK economy.

The City of London is very important.

It is the headquarters of the UK's financial (principally banking and asset management) and insurance sectors which contribute 8% to the UK's total gross value added (GVA) – £126.9bn in 2014 – with 50% of this generated in London. These two sectors contribute around 75% of the UK's trade surplus in services – £62bn in 2014 or around 3.5% of GDP. The figure rises to £71bn when the trade surplus for related professional services – legal services, accountancy and management consultancy – is included. This makes the UK the world's biggest net exporter of financial services, accounting for 12% of the UK's total exports. The City is home to 250 international banks and is responsible for 17% of all international bank lending – more than any other centre. Overall, the UK has the world's fourth largest banking sector, the third largest insurance sector, and is second in the world for assets under management at £6.2trn. In 2013-14, the banking sector alone paid £21.4bn in corporation tax, income tax, national insurance and the bank levy. Overall, UK financial services pay £71bn in tax (11.5% of all tax revenues) and employ around 1.1m people.

Historically, the City knew its place in serving the real economy.

But things started to go wrong in the early 1970s with the introduction of financial derivatives.

Joining the European Union made matters worse.

We entered the Referendum with the City being more than happy to use EU regulations to restrict competitive entry into the industry.

Following the Referendum, the City has become full of whiners concerned only about their own interests.

The Referendum result was a genuine shock to the City. How could the dumb voters of Britain dare to rain on the City's parade! And how did the City respond? It threatened to pick up the ball and walk away to Paris and Frankfurt, feeling thoroughly sorry for itself. We were told that 100,000 jobs would be lost.

The City's pre-Referendum scare-mongering was soon shown up for what it was.

The City's forecasters predicted Armageddon if Britain voted to leave the EU. The City's forecasters' predictions about a recession turned out to be wide of the mark.

The Treasury also got it badly wrong.

The City's scare-mongering was supported, if not encouraged, by David Cameron, George Osborne and the Treasury. Mr Cameron had said a Brexit vote would put 'a bomb under the economy', while Mr Osborne said it would cause a 'DIY recession'. The Treasury warned of a 'massive capital outflow' from the UK if the country voted to leave and an immediate recession. Yet in the month after the Referendum, overseas residents increased their holdings of sterling-denominated deposits in UK banks by £6.6bn. Further, a whole range of indicators suggest that the economy might be strengthening, not weakening.

The Bank of England overreacts.

On 4 August 2016, the Bank of England announced that it would cut the base interest rate to from 0.5% to 0.25% and extend its quantitative easing programme by £70bn. The purpose was to make Brexit a 'success', according to Bank of England governor, Mark Carney. The move was criticised by both Leave and Remain supporters. Jacob Rees-Mogg MP, a Brexit supporter, argued that the Bank acted too quickly in cutting interest rates and introducing a stimulus package before economic data about the impact of the vote was available. Ros Altmann, the former pensions minister and Remain supporter, said it was a 'terrible decision'.

It does not take long for the EU's deep-seated hostility to the UK and its anti-City prejudice to show its teeth.

- British supporters of leaving the EU are perfectly happy to have an amicable and pragmatic relationship with the rest of the EU based on a free trade.

- However, Europe is in no mood to grant our wish for an amicable divorce. The UK is approaching this on a transactional basis, but the EU is approaching it on an existential one: the consensus is you can't make the conditions of leaving too attractive. This means there will be issues concerning non-tariff barriers and other forms of discrimination.

- The posturing and grandstanding comments made by the EU's leaders would appear to support this possibility. For example, Jean-Claude Juncker, president of the European Commission, has stated that the EU must be 'intransigent' in denying British firms free access to the single market if the UK does not accept the free movement of people: 'You can't have one foot in and one foot out. On this point, we need to be intransigent'.

- In December 2016, Michel Barnier, the EU's chief Brexit negotiator, listed his objectives:
    - Maintaining unity among the remaining 27 EU members was his overriding priority
    - The Brexit deal would need to be negotiated in less than 18 months, giving time for it to be ratified by the remaining 27 EU members. A 'new partnership' would be discussed in broad terms and this will influence any transition terms

agreed, but it was unlikely that a full trade deal would be completed within two years and there would be no early commitment to agree transition arrangements that would avoid a cliff-edge. There would be no pre-negotiations before Article 50 is triggered .

- The final deal would have to be 'clear and ordered', would be worse than EU membership and 'cherry picking is not an option'. The separation terms would have to be agreed first, including outstanding commitments to the EU budget. The UK demand for a bespoke deal – such as a sector-by-sector deal covering say financial services and automobiles – would not be acceptable as it just another example of Britain wanting to 'have its cake and eat it'. The four freedoms of the internal market were indivisible. The UK would have to accept both a continuation of both contributions to the EU budget and the decisions of the European Court of Justice. It would only be able to have limited curbs on EU migration as well as face restrictions on what laws it could change.

- Downing Street's response to all this rhetoric is reiterate the desire for a pragmatic outcome. However, the view in Brussels is that British negotiators are in a weak position and can be brought to heel when substantive talks begin.

The City's current relationship with the EU.

- The UK's financial services industry is not only very important to the UK economy, it is also extremely important to the EU economy. Around 40% of UK net financial services exports go to the EU. The UK accounts for 40% of Europe's assets under management (and 85% of hedge fund assets), 60% of its capital markets business, 78% of its foreign exchange trading, and 74% of its derivatives trading. The UK securities market is the biggest in Europe, the UK banking sector is the biggest source of cross-border lending to EU banks and corporates with more than more than £1.1tn of loans outstanding, and the UK is by far the largest market in Europe for 'alternative finance'.

- The Financial Conduct Authority has issued 5,500 passports to UK-registered financial services firms in order to conduct business in the EEA and 8,000 passports to EEA financial services firms to conduct business in the UK. So there would appear to be a strong reciprocal interest here.

- In October 2016, Oliver Wyman released a report, commissioned by the lobby group TheCityUK, which attempted to estimate the costs to the City if the UK lost its passporting rights after Brexit. According to the report, 23% of the City's total revenues comes from EU-related business: £40-£50bn out of a total of £190 -£205bn. The report conjectures that if the UK left the single market without any regulatory equivalence in a so-called 'hard' Brexit, the UK's financial sector would lose up to £20bn in revenue, leading to losses of 35,000 job and £5bn in tax revenue. There would be multiplier effects on the wider UK economy, causing total revenue to drop by another £18bn, another £5bn in lost tax revenue and a further 40,000 jobs. If instead, the UK retained access to the EEA on similar terms (a 'soft' Brexit), so it could continue trading without the need for individual country licences, the City would lose 4,000 jobs and £2bn of revenues a year.

- Data from the ONS suggest that the 23% share of total revenues coming from EU-related business is a gross exaggeration. According to the *Pink Book*, EU exports/total exports = £27bn/£108bn = 25% and, according to the UK's Input-Output tables, total exports/total revenues = £108bn/£200bn = 54%. Hence EU exports/total revenues = 25% of 54% = 13.5%. The Oliver Wyman report adds nearly another 10 percentage points to cover 'domestic activity related to the EU' such as trading in EU equities or clearing euro derivatives which should not be treated as EU export (i.e., cross-border) business at all. A more detailed analysis by Economists for Brexit brings the share down to as little as 9%. Under an extreme scenario of the UK losing 50% of its revenues due to a loss of passporting, the reduction in revenues would be £7.6bn or 4.4% of total revenues.

What does the City want?

- One of the City's two key demands for the Brexit negotiations is access to the single market – via passporting. The alternatives, such as regulatory equivalence, are poor shadows of genuine passporting. They only allow a much narrower range of services, provide much more limited rights at greater cost and can be withdrawn at short notice. In the absence of a deal that gives universal access to the single market, the key City trade groups – such as the BBA and TheCityUK – have been lobbying for a tailor-made bilateral deal that allows all the different sectors of the City to trade with Europe. According to the BBA: 'There needs to be a bilateral deal providing as full two-way market access as possible. Both sides have an interest in making this work, as it is not in the interests of the other EU countries to be cut off from their main financial centre, especially at a time they are all seeking to boost economic growth'.

- A second City demand is access to Europe's best labour talent.

- The City does have differences in view when it comes to over regulation. The large banking and asset management businesses, especially those from the US and continental Europe, value access above all else and are prepared to accept existing EU regulations. Smaller firms and entrepreneurs want to reduce EU red tape and return London to the lighter-touch regime that allowed the City to flourish historically.

What do Remain politicians want?

Andrew Tyrie MP, chair of the Treasury select committee and a prominent Remain supporter, argues that the Brexit negotiations will present a 'formidable challenge' for the UK. He believes that 'A settled relationship with the EU will not be found within the two years specified under Article 50. As such, transitional arrangements may well be required to prevent a sudden reversion to WTO rules'. His preferred solution is to maintain passporting.

What does the UK financial regulator want?

The Financial Conduct Authority:

- Seeks an arrangement that maximises competition in the interests of consumers, while preserving and deepening market integrity and retaining high conduct standards and protecting consumers across all relevant financial markets.

- Recognises some potential advantages for the UK outside the EU: Broadly speaking, countries outside the EU regulatory framework may find that they have greater flexibility to set rules that are specifically tailored to domestic markets and consumers – potentially of benefit in areas of financial services where there is little cross-border activity – but this is also tempered by the need to adhere to shared international standards (for example those set by the Basel Committee on Banking Supervision).

- Is keen on improving global standards. Through the UK's participation in various global level organisations, such as the International Organisation of Securities Commissions (IOSCO), the Financial Stability Board (FSB), and the International Association of Insurance Supervisors (IAIS), the UK is able to improve global standards and cooperation between regulatory regimes.

The UK financial services industry's advantages.

- London is the most competitive city in the world for financial services, according to the Global Financial Centres Index, while its closest EU rivals – Luxembourg and Frankfurt – rank at 15th and 19th. London is also the world's most global city, 'resilient, agile and great at adapting', according to PricewaterhouseCoopers' *Cities of Opportunity* report.

- The UK's financial regulations are either superior to those in the EU or set at a global level:
    - Higher UK regulatory standards lead EU regulation in several areas. Examples include Retail Distribution Review (RDR) implementation in 2013, tougher Bank of England stress tests in 2014 and ring fencing of retail banks from their commercial arms from 2019.
    - UK-based institutions could benefit from lower capital requirements set by the Prudential Regulatory Authority (PRA).
    - UK firms could potentially avoid burdensome EU legislation, such as the bonus cap, restrictive employment rights and proposals for a financial transaction tax, improving the City's competitive position with Asian and US financial centres.
    - Many financial and banking rules are set by global regulators, such as the Basel Committee and Financial Stability Board.

- The UK has the second lowest corporation tax regime in Europe after Ireland, with a 19% rate from 1 April 2017 reducing to 18% in 2020, lower than any of the other G7 countries.

- The UK provides the strongest protection for creditors and shareholders in Europe. In terms of creditor protection, the UK ranks 19th in the world, France 79th and Germany 28th. In terms of shareholder protection, the UK ranks 4th in the world, after Hong Kong, New Zealand and Singapore, with France and Germany coming 29th and 49th, respectively, according to the World Bank's Doing Business project.

- The UK has Europe's most flexible labour market, which is important for the financial services industry which hires and fires tens of thousands of people each year. Further, the government is aware of the importance of being able to recruit skilled workers from overseas. Philip Hammond told a House of Lords committee: 'We will 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'.

- The UK is the second most innovative country in the world, according to the Global Innovation Index, particularly in financial services and the digital economy:
    - London is a leading centre for Islamic finance and the premier western offshore centre for Renminbi trading
    - EY rates the UK as the world's leading fintech centre and the digitisation of banking represents a huge opportunity.

- The UK ranks second behind the US in the Portland 30 Index of Global Soft Power.

- The UK has the best universities in Europe for economics and finance education. According to the Shanghai global ranking on economics education, six UK universities rank among the top 50, compared with only three in continental Europe (one in the Netherlands and two in France). Four of the top five European masters of finance programmes are based in London (the other one is Paris-based INSEAD).

- The UK has the advantage of the English language, the global language of finance, business, accounting and academia, which is spoken at a useful level by 1.75bn people and is set to rise to 2bn by 2020.

- Furthermore, the UK financial services industry is in situ and it is hard if not impossible to move it in whole or in part. There are a number of reasons for this:
    - Scale. Financial services companies benefit from huge agglomeration economies from being physically located near each other in a whole range of ways, from recruiting workers from a highly skilled talent pool – of bankers, lawyers, compliance officers, etc – to having a more effective lobbying voice. While this is possible in Paris or Frankfurt, the scale isn't there.
    - Cost. Banks have spent the 30 years since the Big Bang in 1987 investing in the infrastructure of the financial services industry in London. Not only does that include the buildings and the millions of miles of electronic cables, it also includes a conducive operating environment that comes from 30 years of

political lobbying. All this would need to be replicated in a different European city.
    - Rule of law. The English legal system is the envy of the world. It gives banks the surety that contracts signed will be upheld and interpreted in certain ways. The regulatory framework, with its natural tendency to be light touch, is also admired, even if at times this has turned out to be problematic. A survey by MLex found that 65% of partners in London law firms believe that London will retain its title as a leading legal centre, which no other European city could hope to rival.
    - Culture. The UK offers a business culture conducted in English, broadly similar to that operating in the US. London also has some of the best restaurants, theatres and art galleries in the world.

- These advantages are fully recognised by EU financial institutions based in London: Plan A for banks is to stay in London and move as little as possible.

The UK financial services industry's vulnerabilities.

- The main vulnerability is over passporting which is currently linked to the single market and membership of at least the EEA. A rapid solution to continued passporting arrangements between the UK and the single market should therefore be a high priority in Brexit negotiations.

- Another concern is over the loss of influence over setting regulatory standards for financial services in the EU. The BBA has warned that the 'introduction of new regulatory barriers to business in markets that have up to now operated as a single market will increase costs, raise barriers to entry and reduce customer choice'.

- There is concern about euro trading and euro clearing (i.e., the clearing of euro-denominated derivatives trades) remaining in London.

- EU's most talented workers might be less interested in jobs in London. This risk particularly affects start-ups which might no longer consider London as a launching pad, preferring instead another EU financial centre.

The UK financial services industry's threats.

- European financial centres have used the opportunity of Brexit to compete for London's financial services business. Many commentators believe the threats from Paris and Frankfurt to take London's business lack credibility: 'there is little prospect of London being dislodged as Europe's leading international financial centre. The inherent advantages and large network of financial and professional services are hard to replicate elsewhere in Europe'.

- A potentially more serious threat comes from global, rather than EU, regulators: ‘Regulators around the world are increasingly forcing financial services companies to serve local markets through fully capitalised and staffed subsidiaries’.

- A not unrelated issue is a potential retaliatory protectionist war – over the issue of banks having to have separately capitalised holding companies – between the US and the EU in which the UK could be caught up.

The UK financial services industry’s opportunities.

- The single market is so incomplete in terms of services and is likely to remain so that it offers limited future benefits. While services comprise 70% of the EU’s economy (and 85% of the UK’s), they only account for 20% of intra-EU trade. According to the ONS Pink Book, almost 60% of the UK’s exports in financial services are to outside the EU, a higher proportion than for non-financial exports.

- Any EU business lost because of Brexit could, in due course, be replaced by bilateral trade agreements with emerging financial centres, such as Hong Kong and Singapore, with which the UK has strong historical and cultural ties.

- Brexit also opens up the opportunity for the City to escape from the clutches of both the European Court of Justice (ECJ) and EU regulators and hence enhance its competitive position relative to continental financial centres. For example:
    - The bankers’ bonus cap which limits bonuses to 100% of salary or 200% if shareholders agree and has had the perverse effect of increasing base pay thereby increasing the risk to banks in a market downturn.
    - The Working Time Directive which limits the number of hours a worker can work each week.
    - The proposed financial transactions tax (FTT) of 0.1% on share and bond transactions and 0.1% on derivatives which will reduce GDP by more than the tax revenue raised.
    - The Market Abuse Regulation, which is intended to stop insider trading but which requires directors with inside information to notify a Person Closely Associated in writing, including illiterate children.
    - AIFMD to regulate the hedge fund and private equity markets.
    - More generally, ‘rolling back and simplifying regulation could provide a very big boost to the UK financial industry’.

- The UK will also avoid the EU’s plans for further financial regulation. The European Supervisory Authorities (ESA), the EU’s highest financial regulator, has used Brexit to tighten financial sector regulation. Gabriel Bernadino, the chairman, said: ‘We are considering the possibilities for further enhancing monitoring of financial industries, reinforcing adequate capital or risk buffers’.

- Finally, many believe the City should be doing a lot more to both fight its corner in the EU market after Brexit and grow its business outside the EU.

Why what the City wants won't work and is also unnecessary.

- The City's wish was to preserve passporting, but lawyer Barney Reynolds believes that a grand bilateral deal between the UK and EU involving passporting is 'completely unexecutable'. This is because it would be the kind of 'sweetheart deal' that the hardliners in the EU who want to punish the UK would reject, but more importantly, 'you get back into the four freedoms, giving up sovereignty to the ECJ, …and harmonised application of identical rules effectively by the same people. It's something I don't believe the UK is going to going to accept'.

- Mr Reynolds identifies three main concerns in maintaining passports in a report entitled *A Blueprint for Brexit*:
    - Rule-taking of burdensome EU regulations. In recent times, and in particular following the 2008 financial crisis, EU financial services legislation has become overly-prescriptive. A number of costly initiatives have been introduced which are seen by many as delivering few or no benefits to consumers or regulators. Maintaining the passport would require the UK to be a 'rule-taker' as regards these already inflexible and burdensome standards. The UK would also be required to adopt legislation that in the future would be made without the UK's moderating influence. EU laws are likely to become even more protectionist and problematic for the UK once the UK loses its place on the Council and in the European Parliament (EP).
    - Supranational bodies. Passporting would likely require the UK to sign up to the authority of EU supranational bodies such as the European Banking Association (EBA) and ESMA, and to be subject to interpretations issued by the ECJ.
    - Free movement and financial contributions. Continued access to the single market based on passporting is likely to involve at least some kind of commitment to free movement of people and payment towards the EU budget.

- A whole range of organisations have also said passports are unnecessary, including Moody's Investors Services, the Tax Incentivised Savings Association (TISA) and the Association of Investment Companies. Even TheCityUK has given up hope of retaining passporting, in the light of the government showing little interest in the idea.

- However, it's more than just passporting. A 'soft Brexit' just will not work, according to Stanislas Yassukovich, the Euromarket pioneer who was Chairman of the Securities Association, Deputy Chairman of the Stock Exchange and Chairman of Merrill Lynch Europe, Middle East and Africa during and after Big Bang: '"Soft Brexit" is a mirage. It has as much chance as the proverbial snowball in Hades. For the Masters of the EUniverse to grant concessions to even its most important member would pull the plug on the entire project. The stampede for concessions by the remaining members would be unstoppable. This has been made crystal clear by any number of leading Eurocrats. Yet the dream persists….The quest for "soft Brexit" wastes time and money, delays the necessary reforms of affected economic sectors, and the onset of the clear benefits of leaving the EU….The red herring about access for the City to a totally fictional single market in financial services is slowly drowning in a sea of truth….Even if it finally perceives this truth, through a fog of misleading statements by City lobbyists, the government will spend months trying to do a single market "deal" for physical exports, when the UK's tariff exposure under WTO rules would be less than average fluctuations in exchange rates. In fact, taking into account its contribution to the EU budget, the UK's average tariff in trading with the EU has been more than that suffered by the US – not a single market member'.

What are the alternatives to what the City wants?

A number of alternatives to passporting have been proposed:

- **Expanded equivalence model**. An alternative is the 'third-country equivalence regime' under the EU's MiFID II legislation due to come into force in January 2018. This covers the entirety of investment businesses, including banks doing their investment business. Barney Reynolds proposes an 'expanded equivalence' model which does not import the 'four freedoms' or other concessions on sovereignty. This would involve the UK:
    - Removing the most unnecessarily onerous requirements, provided that their absence would not affect necessary equivalence determinations
    - Moving, so far as possible, while maintaining equivalence, away from the EU's process-focused approach to an approach based on outcomes
    - Re-drafting, so far as possible, while maintaining equivalence, laws in common law style, which would bring with it far greater certainty. This would also remove the additional, more hidden blanket of laws imported by implication into the EU regime by the so-called 'purposive' method of interpretation, in contrast with the more direct textual reading of the relevant provisions under the common law tradition
    - Moving away from poor ECJ decision-making in the financial services context. ECJ reasoning often operates less straightforwardly than judicial practice in the UK, and in any event is too condensed and insufficiently focused on fact-based analysis to provide the clarity that the common law brings with it, and removing laws designed to provide for the EU single market and for regulating competition within the EU.

    According to Mr Reynolds, there would only be two key issues to resolve during the Brexit negotiations:

    - Complete coverage of equivalence-based access. The EU should expand the availability of 'equivalence' regimes to cover certain 'gaps' in the current framework, which largely result from historic reasons. These include lending, primary insurance, insurance mediation, mortgage credit, settlement finality and other matters. Similarly, the UK should ensure that EU institutions can continue to access UK markets through the overseas person exclusion, expanded as necessary and by introducing a reciprocal equivalence regime for branches.

- The EU and UK should treat each other fairly in assessing whether their respective rules are equivalent. It should be recognised that ‘equivalent’ laws are not the same as ‘identical’ laws. The EU has not required third-country laws to be identical for equivalence determinations thus far, and a similar standard should be applied to the UK, without political interference. Even after making some of the changes discussed here, many of the UK's laws should be sufficiently similar to those of the EU on Brexit and thereafter that both the UK and the EU should be able to make reciprocal equivalence determinations, provided that they treat each other fairly and in a depoliticised manner.
- An additional agreement could be sought between the UK and EU on a procedural framework for establishing, maintaining and withdrawing equivalence for the future.

- **Special hybrid (Swiss insurance model)**. The trade minister, Mark Garnier, has suggested that the UK might seek ‘a special hybrid’, a bilateral arrangement that was better than equivalence but different from a passport. It would be similar to the EU-Swiss deal on insurance. However, Mr Garnier conceded that ‘It is entirely possible that we will just have to adopt the rules of the EU as they come down with regards to financial regulation. A new arrangement along these lines would depend on creating the right dialogue to craft a system that works for both the UK and the EU’.

- **Dual regulatory regime (Channel Islands model).** Some have proposed a dual regulatory regime such as that operating in Jersey which, as one of the Channel Islands, is not formally in either the UK or the EU. It has much lighter regulation than the EU, but offers an equivalent regulatory regime for firms that want to access the single market. It would operate as follows:
    - EU equivalence – UK companies providing wholesale investment services — principal and agency broking/dealing, custody services, fund management outside the scope of the AIFMD, and investment advice — to corporates, financial institutions, insurers, funds (including pension funds), fund managers, governments and sophisticated investors in the EU would comply with EU regulations in respect of prudential and conduct of business requirements when operating in the EU. They would only need to set up branches rather than subsidiaries to do this.
    - UK and ROW – the UK would then establish a regulatory framework that is best suited for UK companies operating outside the EU.

- **Multi-layered approach (Country-by-country model).** The Association of Investment Companies supports a multi-layered approach to fund regulation once the UK leaves the EU. European rules would only be imposed if the funds were marketed within the EU. There would be separate rules for funds marketed in the UK and globally, funds accessing the EU on a country-by-country, and those selling into Europe on a passport basis. Investment trusts currently do not have access to a full EU passport, unlike UCITS funds, but does have country-by-country access.

- **Establish a fully capitalised subsidiary (Swiss banking model).** Firms operate through subsidiaries without passporting rights. Such firms also use distribution or servicing hubs within the EU, such as Luxembourg or Dublin. These take advantage of local knowledge and expertise, or deal with indirect obstacles to trade within the single market for services, such as tax. Swiss banks run their European investment banking businesses, via London subsidiaries, which is why this is also known as the 'Swiss banking' model.

- **The World Financial Centre model.** Barney Reynolds recognises that the expanded equivalence model might not be achievable for various reasons: plugging the gaps in existing equivalence regimes is not politically acceptable, equivalence determinations are not forthcoming, the equivalence-based approach is unattractive for certain areas, such as the regulation of alternative investment funds, or the EU requires such a high degree of conformity with EU laws in order to be deemed equivalent that the UK is in practice unable to make the significant and meaningful changes to its rules that the UK is likely to wish to make.

  Under these circumstances, Mr Reynolds believes 'The UK should be ready to adopt the "go it alone" [World] Financial Centre model. That would give the country freedom to design a more attractive regulatory framework, freed of the EU's restrictive policy and process-driven approach, based on global standards. Not only would such a model attract business and liquidity to the UK, which would be operating as an entirely free-market financial centre, it would liberate financial services from the burden and increasing uncertainty of EU regulation. Some business may be attracted from the EU itself to the UK. But more importantly, businesses from around the world, when comparing the UK to the EU (or indeed the UK to other jurisdictions, such as New York), would see a market-friendly regulatory framework, enabling them to flourish, providing for free and clean markets, systemic risk protection and consumer protection….It would be possible for almost all parts of the financial sector in the UK to carry on providing services to EU and global customers without interruption. By building upon the UK's natural advantages, of time-zone, English law and language, and an established financial ecosystem and talent pool, the UK can create a highly competitive (and indeed enhanced) environment for the City outside the EU'.

  Under the World Financial Centre model, the UK would reconsider its entire regulatory framework. This would involve the following changes which go further than the expanded equivalence model:
    - Removing not only those particularly burdensome rules that could be removed under the expanded equivalence model, but also scrutinising and tailoring its regulatory requirements across the board
    - A complete shift from the EU's process-focused approach to a more tailored approach based on outcomes
    - A comprehensive scrutiny and, as appropriate, a re-draft of laws in common-law style. The benefits of the common-law style, as previously noted, are an increase in certainty and the removal of the additional, more hidden blanket of laws which are imported by implication into the EU regime by the so-called

    - ‘purposive’ method of interpretation rather than by a more direct reading of the relevant law, and
    - A complete shift from poor ECJ decision-making in the financial services context, with reasoning that operates sometimes by omission and in any event is too condensed and insufficiently focused on fact-based analysis to provide the clarity that the common law brings with it.

How feasible are these alternatives?

- Barney Reynolds believes any options involving a major bilateral deal for the UK are neither feasible nor desirable, whether for the EU or the UK. Instead, he likes the equivalence regime if safeguards can be built in to stop the EU summarily and suddenly changing rules: ‘The equivalence regimes are far, far broader than many people have acknowledged so far, and that the equivalence package on offer would get the sector to almost the same place [as passporting]. Equivalence comes with sovereignty, and sovereignty comes with doing things our own way’.

- However, a number of commentators have argued that equivalence will be a poor substitute for passporting:
    - It only applies to specific activities, mainly in wholesale rather than retail finance
    - It could also constrain the UK’s ability to alter to financial regulations in the future. If the UK adopted a lighter regulatory framework to encourage more global financial institutions to locate in the UK, the EU might retaliate by saying that this regime is no longer equivalent.
    - Banks are unlikely to rely on equivalence for long-term business planning.
    - The European Commission decides whether UK laws are equivalent to those in the EU and can be subject to political pressure. It can take years to make this decision (as in the case of US firms that clear derivatives transactions) and can revoke its decisions at any time with 30 days’ notice. In November 2016, the EU announced it would reconsider the equivalence regime in the light of Brexit, raising questions about whether the City would be able to fall back on equivalence if the UK lost passporting rights. It wanted to make the approval process more rigorous for systemically important institutions.

- However, whatever model is chosen, the UK must ensure it continues to be a key centre for the trading and clearing of instruments denominated in any globally important currency, including the euro, and should robustly resist any compromises or offers to cease trading or clearing euros within the City.

Transitional arrangements.

- The EU and UK must agree both the exit terms and the terms of their future relationship within two years of triggering Article 50 of the Treaty on EU.

- The arrangements for leaving the EU will be similar to the case of 'state succession' where an existing state splits and the component parts wish to continue existing treaty relationships with other states. Leaving the EU is therefore in principle a straightforward process, as pointed out by Bernard Jenkin MP: 'All the laws and regulations that apply by virtue of Britain's membership can remain perfectly aligned with those of the rest of the EU until they may be changed at a later date. This is how the UK gave independence to the countries of the British empire'.

- Some diplomats believe a full deal might take up to 10 years to complete. However, the idea that negotiations are too complicated to complete in the allotted time is simply not true according to Lawyers for Britain. A permanent deal covering most aspects of Brexit is possible in 2 years, with smaller issues to be resolved later. When the UK joined the common market in 1973, it took less than two years. When Norway didn't join in 1972, it negotiated a trade deal within 8 months

- But if the EU does not accept this and does not agree a bilateral trading relationship with the UK, then the EU-UK trading relationship will, by default, be based on WTO rules, with each side imposing a set of standard tariffs on the other – in the case of the EU, this will be the Common External Tariff. The UK could, of course, continue with zero tariffs on imports from the EU, so long as it also set zero tariffs on imports from all other countries (under the WTO's most favoured nation rules).

Recommendations.

We have five recommendations:

1. The UK financial services industry's future relationship with the EU

Depending on the reaction of the rest of the EU in the Article 50 negotiations, we recommend one of two models for the UK financial services industry's future relationship with the EU:

- If the EU is willing to co-operate, then we recommend a dual regulatory regime, based on third-party expanded equivalence with guarantees about how equivalence will be granted and removed. This could be implemented in one of two ways, via:
    - sectoral agreements of which one would cover financial services (others could involve automobiles and pharmaceuticals, say). These would be under WTO rules and packaged up as a FTA. The EU's existing trade agreements would be adopted by the UK and relabelled under WTO rules – a process called 'rectification'
    - a comprehensive free trade agreement. The UK financial services sector gets meaningful third-party access through a specific chapter of a comprehensive UK-EU free trade agreement.

- But these trade agreement would require unanimity, unlike agreements made under Article 50 which require qualified majority voting (QMV). If the EU is not willing to co-operate, we recommend that the UK adopts the World Financial Centre model.

2. Work permits

We recommend that the government introduces a flexible system of work permits for skilled workers – with proof of fluency in the English language – that covers workers who are offered a job in the UK and who are located in any country in the world outside the UK. A different system would be offered to entrepreneurs who wanted to set up a company in the UK.

3. Transitional arrangements

Transitional arrangements will also depend on the degree of co-operation from the EU27. We recommend that it is in everybody's interests that any transitional arrangements are kept as short term as possible, no longer than is needed to bridge the gap between the UK's exit from the EU and the conclusion of a formal long-term trading with the EU. If, as seems possible, the EU is not interested in such an agreement, then the UK should exit from the EU immediately this becomes apparent.

4. Encourage the development of global standards in financial regulation that are free from political interference

We recommend that the government encourages the development of regulatory standards at a global level – via institutions such as the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO), the Financial Stability Board (FSB), the International Association of Insurance Supervisors (IAIS), the International Monetary Fund and Financial Action Task Force – free from political interference. The aim would be to promote global consistency and cooperation between regulatory authorities. To be effective, these global standards would have to be legally binding.

5. Encourage overseas expansion of financial services

We recommend that the government encourages the overseas expansion of UK financial services. It is important to recognise that the bulk of today's financial business, even its offshore business, is no longer conducted in Europe, even though London remains the largest single centre for most offshore business. Tokyo has overtaken London for offshore banking business, Hong Kong is capturing more foreign exchange business – especially in Asian currencies – and Singapore is taking traders from London.

Another crucial point to recognise is that the EU is becoming less and less important as an economic entity, both globally and to the UK. The European Commission accepts that 90% of future global growth will happen outside Europe's borders. The UK's share of exports to the EU has fallen from 54% in 2006 to 44% in 2015; 56% of the UK's trade in goods and only 40% of its trade in services – which comprise 80% of its economic output – is with the EU. The total value of UK exports to the EU was £134bn in 2015 (compared with imports of £223bn), but US exports were £203bn – and the US is outside the single market and the customs union.

Bargaining chips.

A number of commentators have pointed out that the UK has a very strong hand in the EU negotiations:

- **Economic self-interest and future trading relationships**. The UK's strongest bargaining chip is its trade deficit with the EU as a whole and with key countries, in particular Germany. A study by Civitas has concluded that if the UK leaves the EU without a free trade deal and trade is instead conducted under World Trade Organisation rules, companies in the rest of the EU would pay £12.9bn p.a.in tariffs to export their goods into the UK, while UK companies exporting to the EU would pay £5.2bn p.a.'.

- **The UK's budget contributions and extant net liabilities**. The UK is the EU's third biggest net budget contributor. It has paid £140bn since 1973 and is due to pay another net £60bn to 2020/21, which includes £26.4bn in the two years following the UK's departure date of April 2019. This leaves a big hole in the budget and could raise tensions between remaining net contributors (Germany, France and the Netherlands) and recipients (mostly eastern European states). Government sources state that the UK might be willing, as part of a transition deal, to continue making some budget payments, towards programmes, such as research funding. But the more it contributes here, the less will be available for domestic programmes, such as the health service.

- **Defence and security.** The UK's military muscle will be a key bargaining chip, particularly in view of Donald Trump's attitude to NATO and Russia's increasing aggression and subversion.

There is a great deal to risk if the EU wants to punish the UK for leaving the EU. But as the prime minister, Theresa May, said the EU's posturing leaders will have no choice but to agree a trade deal with Brexit Britain.

The prime minister's Lancaster House speech and reactions to it.

- **The speech:**
  - On 17 January 2017, the prime minister Theresa May set out for the first time her plan to leave the EU at a speech delivered at Lancaster House attended by EU ambassadors. She said she wants: 'a bold and ambitious free trade agreement with the European Union. This agreement should allow for the freest possible trade in goods and services between Britain and the EU's member states'.
  - She ended with this warning: 'But I must be clear. Britain wants to remain a good friend and neighbour to Europe. Yet I know there are some voices calling for a punitive deal that punishes Britain and discourages other countries from taking the same path. That would be an act of calamitous self-harm for the countries of Europe. And it would not be the act of a friend. Britain would not

– indeed we could not – accept such an approach. And while I am confident that this scenario need never arise – while I am sure a positive agreement can be reached – I am equally clear that no deal for Britain is better than a bad deal for Britain'.

- **Reactions from the UK:**
  - The prime minister's speech was strongly supported by leading Brexiteers.
  - The City's response was much calmer than in the days after the Referendum: 'A lot of the City wasn't fully prepared for the Brexit vote, or at least had not thought through a strategy if the country was to vote to leave. But as time has gone on more and more firms have started to develop their plan, and they have started to see things in a new way'.

- **Reactions from the EU:**
  - The immediate reactions from the EU were quite disparaging. While welcoming the 'clear impression' given by the prime minister about what she wanted from the exit negotiations, European leaders were critical of the speech in four dimensions: the perceived implausibility of reaching a UK-EU trade deal before Brexit in 2019; unrealistic expectations of Britain's 'frictionless' trade with the EU, while also able to set independent tariffs; the request for a smooth 'phased' exit without making significant budget contributions or accepting the jurisdiction of the ECJ; and the threat to walk away and pursue a low tax model if Britain is unable to secure a good, fast-track trade deal.
  - All this was regarded as attempts by Britain to 'cherry pick' a deal. German chancellor Angela Merkel said she would block any attempts at British 'cherry picking' during the negotiations: 'The be-all and end-all is that Europe doesn't let itself be divided, and we will ensure this through very intensive contacts'. Donald Tusk, the European Council president, wanted to continue a 'close partnership' with the UK, but warned that there 'will be no cherry-picking' and that the Brexit deal must leave everyone in 'no doubt' about the benefits of EU membership. Jean-Claude Juncker, the European Commission president, said that Brexit talks would be 'very, very, very' difficult.
  - Within a matter of days, however, European leaders were striking a much more conciliatory note. For example, Mr Schäuble accepted that: 'We have to minimize the damage for the United Kingdom and Europe. The German government will work in the negotiations always in this direction, to minimize any risk for both of us. A sudden rupture at the end of the two-year talks - after Article 50 is invoked - must be avoided at all costs. We are very concerned that it will not happen, and we will be engaged. It would be a disaster for all of us. We will do whatever we can to avoid such a situation'.

How much damage does the EU want to do to itself?

- The EU has done precious little to make itself popular with its voters. Indeed, it has systematically ignored their concerns as expressed in various referenda over many years. In terms of the UK Referendum, it offered David Cameron no concessions prior to the vote and has done a lot of finger wagging after the vote and repeatedly pointed to the inviolability of the 'four freedoms' when it comes to access to the single market. Further, the EC has threatened the following: no trade deals until exit terms have been negotiated, no transitional arrangements considered until the terms of trade have been agreed, with everything having to be ratified in all member states within two years of triggering Article 50, leading to concerns about a 'cliff edge' departure from the EU in April 2019.

- Not only has the EU proved itself to be incapable of reforming itself, it also seems incapable of recognising the economic damage it is doing to Europe and its citizens by its actions – the most egregious of which was the introduction of the euro in 1999.

- **The European financial services industry.** There is growing concern amongst financial service practitioners that if handled badly, Brexit will threaten European capital market integration. The EU claims it wants capital markets that are as deep and liquid as those in the US (in line with its programme for capital market integration). More generally, it claims it wants the EU to be a leading centre for financial services. Yet EU regulations tend to be protectionist, excessive or not effective.

- **Can the EU survive?** The apparent determination of the EU to punish the UK even if it also involves itself in significant self-harm, raises the question about whether the EU has much chance of surviving long term:

    - Sir Bill Cash MP, chair of the European Scrutiny Committee, says the EU is 'doomed. The monetary union system is full of internal contradictions and it can't work'.
    - Even those at the heart of the European project are beginning to recognise the risks. Professor Otmar Issing, the European Central Bank's first chief economist and one of the founding fathers of monetary union, admits that the ECB is becoming dangerously over-extended and the whole euro project is unworkable in its current form.
    - The Brexit Referendum has opened the eyes of European citizens to the possibility of having their own Referendum on the EU.
    - Edward Lucas goes so far as to argue that: 'From Putin to the euro, every aspect of the European order is under threat…Timid, deluded and divided, Europe's different entities are facing disaster. Yet the European ruling elites have missed countless chances to avert it. And they are so convinced of their own rightness, and of their right to rule, that they show no sign of changing course – or of listening to the rumble of the approaching tumbrils. Everything is not going to be fine'.
    - As Roger Bootle notes, it's not too early to start planning for the end of the EU.

Alternatives to the EU, the single market, the customs union and the EEA

The entire economy of the UK is being distorted by its membership of the EU and the EEA. Only 15% of our economy (and 6% of our companies) involves trade with the EU/EEA, but 100% of our laws are determined or at least influenced by the EU. Yet the EU has since its foundation involved in some of the most serious misallocations of economic resources of any institution in recorded history – recall the wine lakes and the butter mountains. Add to that the failure of the euro – which has resulted in permanent recession outside core Europe ('Kerneuropa') and the fundamentally undemocratic nature of EU institutions. Add also the hubris of the EU leaders – they have been warned many times that the EU is like the Titanic with an iceberg just ahead of them, but they have ignored these warnings, believing that political will is strong enough to pass through iceberg. And you have before you all the ingredients of an economic catastrophe – if not a failed state. So what are the alternatives that the UK might embrace outside the EU?

- **Global free trade.** A free trade agreement is designed to have zero import tariffs and quotas on an agreed range of goods and services that are traded between the counterparties to the FTA, and to reduce as much as possible non-tariff barriers, such as customs and regulatory procedures, that add to the cost of cross-border trade. However, standard FTAs focus on goods and tend to have much weaker coverage of services and especially financial services, and would certainly not include the same automatic market access afforded by passporting.

- **New Prosperity Zone.** This is a proposal of Shanker A. Singham, Chairman of the Legatum Institute Special Trade Commission and Director of Economic Policy to '*bring together countries around the world that believe in free trade and competition'.*

- **New Atlantic Growth Pact**. This is a proposal from Kristen Silverberg – who served as US ambassador to the EU from 2008-09 – and Phil Levy – who was senior economist for trade at the Council of Economic Advisers during the George W. Bush administration. It would involve the US, the UK and the EU and be '*an agreement to remove regulatory barriers to trade, including those in financial services, and to spur cross-border investment could help invigorate all three economies…. A relaunched trilateral deal [following the stalling of the Transatlantic Trade and Investment Partnership talks] would spur growth'.*

- A **US-UK free trade** deal '*could set the stage for a major rethink of trade policy that could set the stage for productive liberalisation in the future'.* In his first interview with a UK newspaper since being elected president, Donald Trump said he would offer the UK a quick and fair trade deal with the US within weeks of taking office to help make Brexit a 'great thing'.

- **Continental Partnership**. This is a proposal from Bruegel which involves a new form of collaboration that is 'considerably less deep than EU membership but rather closer than a simple free-trade agreement'.

Conclusion

Brexit is a golden opportunity for Britain. It is also a golden opportunity for the City of London to escape the clutches of the EU as a World Financial Centre and take the lead in the new digital revolution of blockchain and fintech. But to do this, the City has to address some uncomfortable issues:

- It needs to recognise that its place is to service the real financial needs of businesses and individuals in the UK, Europe and the rest of the world and that this is best done outside the EU which, because of its protectionism, its excessive regulation and the folly of the euro, is destroying growth and innovation in the EU member states. In order to do this, it needs to deal with the criticism made after the Global Financial Crisis by Lord Adair Turner, then chairman of the Financial Services Authority, namely that many of its activities – in particular those surrounding complex financial instruments – are 'socially useless'.

- It must end its constant whining. Instead, it should agree a 'consistent and forward-looking Brexit strategy' in order to secure a 'bold, bright, buccaneering post-Brexit future', as demanded by the Lord Mayor of London, Jeffrey Mountevans, at the City Banquet at Mansion House on 26 October 2016. He also said that Brexit is chance for the City to demonstrate its relevance to the rest of society: 'We must conceive a vision of the UK's place in the world, in five, ten, twenty years, covering everything from regulation to infrastructure. Not only for our own use, not only to inform a government that already carries a heavy burden in the negotiations, but to further secure trust among a public that craves stability'.

- It must end its spinelessness and widespread apparent ignorance of the legal situation surrounding Brexit – see box below. An unnamed close colleague of Michel Barnier was interviewed by Nick Watt, the political editor of BBC's *Newsnight* on 5 January 2017. He said that the UK was effectively coming to the negotiating table as a 'supplicant'. And this is precisely how much of the City has reacted following the Referendum. It is ridiculous in this day and age for anyone to insist that you have to be physically located in a market to do business. It is as ridiculous to expect that the City of London will move to Paris or Frankfurt after Brexit as it is to expect the French wine industry or the German car industry to move to the UK after Brexit. As the financier Miles Morland points out, there is more investment banking expertise on the Isle of Dogs than in the whole of continental Europe put together.

What international law allows countries to do and not do in terms of international trade

The arrangements for leaving the EU will, in practice, be similar to the case of 'state succession' where an existing state splits and the component parts wish to continue existing treaty relationships with other states.

The UK can negotiate a two-way zero-tariff Free Trade Agreement with the EU. This might be better for both sides than the only alternative that gives zero tariffs on trade flows between the two regions which is a customs union agreement.

Further, a FTA could be implemented within two years by virtue of the Great Repeal Act (also known as the Cut-and-Paste Act) which will incorporate all EU law into UK law, thereby creating a status quo ante situation at the point of departure. The argument that the EU makes that this would be impossible to achieve this in two years, because it takes an average of 7 years to negotiate a FTA and that the UK does not have sufficient trade negotiators, is a political one, not a legal or practical one.[1]

The UK can in practice roll-over all EU trade agreements with third countries by analogy with the 'principle of continuity' under international law, unless these countries positively object – and there is no reason to think that they will. The UK does not have to withdraw from those agreements and start negotiations again.

The UK can negotiate FTAs with third countries before formally leaving the EU – they just cannot come into force before Brexit.

The Maastricht Treaty specifically promotes capital market integration, not only within the EU, but between the EU and third countries. The treaty, in particular, recognises the importance of free capital mobility in order to make the monetary union work. Any attempts by the EU to restrict UK-based financial services companies operating in the EU might, therefore, be incompatible with this treaty.

The global principles established by the G20 in 2009 after the Global Financial Crisis to reduce systemic risk recognised that the free flow of capital was critical for the real economy. Any attempts by the EU to restrict UK-based financial services companies operating in the EU might, therefore, be incompatible with these principles.

The European Central Bank, like the Bank of England, is a member of the Bank for International Settlements (i.e., the central bank to the world's central banks) and this supports a level playing field for all its members (implying that the EU cannot discriminate against UK-based companies).

The EU has no jurisdiction outside its own borders. The EU cannot therefore prevent firms in third countries trading or clearing euro-denominated instruments. This has been confirmed by the ECJ, but, in any event, these activities are not legally classified as cross-border activities, over which the EU can claim jurisdiction. However, the EU might attempt to regulate or prevent the participation of EU resident entities in euro clearing activities outside its borders.

[1] The evidence for this comes from Guy Verhofstadt who has said that if the UK ever wanted to rejoin the EU, this could be fast tracked (Peter Foster (2017) UK might be offered speedy return to EU, *Daily Telegraph*, 28 January.

All major economies are locked into legally-binding commitments not to raise tariffs. They can only reverse these measures if they compensate other WTO members.

The Vienna Convention on the Law of Treaties states that 'acquired rights' cannot be taken away suddenly. The ability of one country to trade with another on the basis of zero tariffs could be interpreted as an 'acquired right' under this convention.

The prime minister's Lancaster House speech enables the UK to have a very 'clean' Brexit from the EU: the implications of this are given in the box below.

Implications of the Lancaster House speech for a 'clean' Brexit

On 23 June 2016, the British people voted to leave the EU. The prime minister's Lancaster House speech on 17 January 2017 made it very clear that this meant also leaving the single market, the customs union and the European Economic Area, membership of which means accepting freedom of movement.

This has powerful implications for the City:

- It is unlikely that business with the EU27 will be conducted via passports in future.
- Instead, and depending on the degree of co-operation from the EU27, the City should plan its future operations using either:
  - a dual regulatory regime, based on a third-party expanded equivalence model with guarantees about how equivalence will be granted and removed, or
  - the World Financial Centre model where the City 'goes it alone' (as proposed recently by Barney Reynolds).
- Transitional arrangements will also depend on the degree of co-operation from the EU27. It is in everybody's interests that any transitional arrangements are kept as short term as possible, no longer than is needed to bridge the gap between the UK's exit from the EU and the conclusion of any formal long-term trading agreement with the EU. If, as seems possible, the EU is not interested in such an agreement, then the UK should exit from the EU immediately this becomes apparent.
- The City should encourage the government to support the development of legally binding regulatory standards at a global level free from political interference. The aim would be to promote global consistency and cooperation between regulatory authorities.
- The City should encourage the government to support the overseas expansion of UK financial services in the fastest growing regions of the global economy.
- The City should encourage the government to introduce a flexible system of work permits for skilled workers that covers workers who are offered a job in the UK and who are located in any country in the world outside the UK.

The most important task for the government when it triggers Article 50 and opens negotiations with the EU is determine whether the EU is willing to co-operate on achieving the best possible outcome for both UK and EU27 citizens. The most important collective task for the City in helping to achieve this outcome is to refuse to move business to the continent.