Brexit and the City

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Abstract

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

The report concludes that Brexit is a golden opportunity for the City of London to escape the protectionist clutches of the EU in order to maintain its position as a World Financial Centre leading the new digital revolution of blockchain and fintech.

But to make the best of Brexit, the City needs to address the following issues. First, it should 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.

Second, 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.

Third, it should build on the protections afforded by international law to counter the EU's demands that providers of financial services to EU citizens and companies need to be physically located in the EU to do business. It is just as absurd to expect the City of London to 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. There is more investment banking expertise on the Isle of Dogs than in the whole of continental Europe put together.

Finally, it should aim to quickly recover the competitive edge that it has lost in recent years. The WTO has estimated that the City's share of China's imports of financial services (mainly insurance) was 3% in 2015, unchanged since 2011. Over the same period, the US share increased from 11% to 28%.

Implications for the City of leaving the European Union

On 23 June 2016, the British people voted to leave the EU. This is due to take place on 29 March 2019. The prime minister's Lancaster House speech on 17 January 2017 made it 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 third-country enhanced equivalence model with guarantees about how equivalence will be granted and removed,
    - mutual recognition of financial regulations with mutual market access, or
    - a World Financial Centre model where the City 'goes it alone'.
- The City should make the most of the transitional or implementation period between 30 March 2019 and 31 December 2020 to secure existing commercial relationships and initiate new ones, now that it will no longer be a rule taker from Brussels.
- 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.

Table of contents

1. Introduction

The United Kingdom is due to leave the European Union on 29 March 2019. In December 2017, the key principles underlying the withdrawal terms and costs were agreed,[1] with the withdrawal being implemented by 31 December 2020. However, Michel Barnier, the EU's chief Brexit negotiator, has made it clear that the conclusion of a deal setting out the future trading relationships between the EU and the UK would take much longer than the two years allowed under Article 50 of the Treaty on European Union, even longer than the end of 2020.[2] In the meantime, EU member states have been bidding for large chunks of the City of London's business. And EU financial regulators are attempting to exercise significant influence over what business remains in London.[3] The Square Mile risks becoming a wounded lioness with the vultures hovering overhead.

There is an alternative vision of the future for the City of London and that is as a World Financial Centre outside the over-regulated protectionist European Union. Exiting the EU provides a golden opportunity for the UK financial services industry to again know its place in the world.[4] And that is as a servant to the real economy – by oiling its wheels and helping to facilitate the economic transactions of individuals and companies in the UK and across the globe. In recent years, it has not performed this function at all well. Instead, it has been more interested in its own profits and bonuses than in meeting its customers' real needs.

This new vision is not helped by the reaction of various City lobby groups. Typical is the attitude expressed by Mark Boleat, chair of the policy and resources committee of the City of London Corporation: 'As you'd imagine, firms have undertaken a significant amount of contingency planning ahead of official divorce proceedings. With the government remaining tight-lipped on negotiations, they have been planning for the worst while hoping for the best. They have to have plans in place for a worst case scenario – the UK with no special access to the single market or bilateral trade agreements in place, among other things. Some have already applied for licences outside the UK in case they need to move parts of their business, and most have prepared detailed plans for any necessary restructuring of their companies….[T]here's a desire for firms to stay in London. Not for any sentimental

[1] Joint report from the negotiators of the European Union and the United Kingdom Government on progress during phase 1 of negotiations under Article 50 TEU on the United Kingdom's orderly withdrawal from the European Union, TF50 (2017) 19, 8 December 2017.
[2] Article 50 states that 'the Union shall negotiate and conclude an agreement with [the leaving] State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union'. This must be completed within two years of triggering Article 50 on 29 March 2017.
[3] Christine Largarde frequently said when she was French Finance Minister that she not only wanted the City to be regulated from Paris, she wanted to bring large chunks of it to Paris as well (see, e.g., evidence given by André Villeneuve, Chairman, International Regulatory Strategy Group, City of London, on 16 November 2010 to House of Commons Treasury Committee on Financial Regulation, https://publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/430/10111603.htm).
[4] Michael E. Porter (1991) Know Your Place: How to Assess the Attractiveness of Your Industry and Your Company's Position in It, *Inc.* 13, no. 9, September.

reasons – facts and pragmatism in contingency planning reign supreme; emotional and historic ties count for very little'.[5]

Similar sentiments have been expressed by Anthony Browne, then CEO of the British Bankers Association (BBA).[6] In October 2016, he said that 'London's position as Europe's financial capital should not be taken for granted'. He expected banks to start moving jobs from the UK 'in the coming months' and that international bank bosses were 'planning for the worst case scenario' with their hands 'poised, quivering, over the relocate button': 'many smaller banks plan to start relocations before Christmas – bigger banks are expected to start in the first quarter of next year'.[7] He then demanded – presumably as an inducement to steady those quivering hands – that the bank levy and banking corporation tax surcharge should be phased out as soon as possible.[8]

Fortunately, these dire warnings have been dismissed as 'nonsense' even by the banks themselves. UK retail banks hardly do any business in the EU, so as one said: 'Brexit is a bit of a non-issue for us'. Santander said their Spanish owners were happy to have operations located outside the EU. Further, the Dutch bank ING has moved all its traders from the continent to London and Wells Fargo announced a new £300million headquarters in London. Jacob Rees-Mogg MP said 'The BBA has gone from being a lobbyist for British banks to a lobbyist for the European Union. It worships at the shrine of the EU and does not believe anything can work outside it. It is not doing a good job of representing the British financial industry'. Richard Tice, co-chairman of the pressure group Leave Means Leave, pointed out that 'similar apocalyptic predictions were made when the UK took the sensible decision to not join the euro'.[9]

There is, of course, a great deal at stake, so it is important to get it right. According to the *Financial Times*, banks that use the UK as a gateway to the EU employ more than 590,000 people, have more than £7.5trn of assets and make annual profits of more than £50bn.[10] In addition, passports will play a big role in the negotiations concerning the City. On the one hand, there are the passports of the 3.3 million non-UK EU citizens[11] working in the UK: their future has been secured in the withdrawal agreement, but whether EU citizens coming to work in the UK after December 2020 will need work visas has yet to be determined. On the other hand, there are the 5,500 outbound passports that UK financial services companies currently have to have to be able to provide their services across the EU, as well as the 8,000 inbound passports of the EU firms that operate in the UK.

[5] Mark Boleat (2016) City firms are preparing for the worst from Brexit – but hoping for the best, *City A.M.*, 19 December.

[6] Subsequently renamed UK Finance.

[7] Tim Burke (2016) BBA chief: 'Banks planning for worst case Brexit scenario', *Financial News*, 20 October.

[8] Anthony Browne (2016) Why the Chancellor needs to cut banking taxes – and fast, *CAPX*, 20 October.

[9] Daniel Martin and Holly Black (2016) It's nonsense! Banks dismiss gloom-laden claim they'll quit the UK after Brexit, *Daily Mail*, 24 October.

[10] Laura Noonan, Patrick Jenkins and Harriet Agnew (2016) City's special relationship with EU finance system revealed, *Financial Times*, 25 September.

[11] https://www.migrationwatchuk.org/briefing-paper/354

What follows is a review of 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. We will also consider what is needed to achieve the best possible outcome for the City and the UK economy. We begin by placing the City in an historical context.

2. The City used to know its place

The City of London is, of course, 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.[12] 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.[13] 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.[14] Overall, UK financial services pay £71bn in tax (11.5% of all tax revenues)[15] and employ around 1.1m people.

While we all prepared to recognise the importance of the City of London in both the domestic and global financial system, there was a time when the City of London knew its place in serving the real economy.

At the beginning of the 16th Century, first in Amsterdam and then in London, banks began to accept deposits from customers for safekeeping in exchange for a fee. Shortly after, these banks began to offer the service of paying out to individuals carrying a written instruction from the depositor. So began retail banking with its core products of current accounts and cheque books – truly magnificent financial innovations. Two centuries later, at the Five Bells tavern in Lombard Street, clerks would gather to exchange their banks' cheques and settle any difference in cash – marking the start of the key financial support services of clearing and settlement. In 1778, the Royal Bank of Scotland (RBS) allowed one of its customers, a

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[12] The UK's overall current account deficit is 5.5% of GDP.

[13] In 2014, the next exports of financial services in the UK were $95bn, compared with $36bn for the US, $24bn for Switzerland, $23bn for Luxembourg, $15bn for Singapore, and $13bn for Hong Kong.

[14] https://www.thecityuk.com/news/thecityuk-uk-trade-surplus-in-financial-services-highest-ever/; Gloria Tyler (2015) *Financial Services: contribution to the UK economy,* SN/EP/06193, House of Commons Library; http://researchbriefings.files.parliament.uk/documents/SN06193/SN06193.pdf.

[15] George Parker and Martin Arnold (2106) Hammond and Davis promise City 'smooth and orderly' Brexit, *Financial Times*, 6 December.

merchant called William Hog, to take £1,000 more out of his account than he had in it, thereby inventing the overdraft.[16]

In the 15th and 16th Centuries, a different kind of bank – which became known as a merchant bank and later an investment bank – emerged to help companies finance their working capital, by selling bills of exchange to other merchants and small investors. Later, in the 18th and 19th Centuries, these banks were joined by overseas banks – such as Barings, Rothschilds, Schroders, Hambros, Kleinwort and Morgan – to finance long-term loans to governments, via the sale of bonds.

In the early 17th Century, merchant banks began to help companies raise long-term capital by issuing corporate stock. However, this was for government-chartered monopolies, such as the East India Company. The modern form of company share issuance did not begin until the incorporation of joint stock companies under the Limited Liability Act in 1856 and the Companies Act of 1862. To help promote initial placements, investors needed reassuring that they could subsequently sell their securities. Merchant banks therefore began to provide additional services, such as securities dealing, broking, investment advising, commercial banking, and currency trading – and in the process turned into modern 'universal banks'.[17] The efficient operation of financial markets is supported by technology – an early example of which was the laying of a transatlantic cable in the mid-19th Century which enabled transactions between sterling and the dollar to be executed, giving rise to the slang name 'cable' for sterling.

The first part of the 20th Century until the 1960s was not especially good for the City as a result of two wars, an intervening recession, debt, and post-war nationalisation (which meant fewer productive investment opportunities). However a renaissance started in 1963, when S G Warburg started the Eurobond market – now better known as the cross-border debt capital market – in London with the issue of a $15m bond with a 15-year maturity and an annual coupon of 5½% for Autostrade, the Italian motorway network.[18]

The two other great financial activities are insurance and asset management. Property insurance began to develop after the Great Fire of London destroyed 13,000 houses in 1666. Nicholas Barbon started the first fire insurance company, the Insurance Office for Houses, behind the Royal Exchange in 1681. A formal insurance market began in Edward Lloyd's Coffee House in Tower Street in 1688. The place became popular with merchants and ship owners when Lloyd began providing first shipping news and then marine insurance – and this marked the beginning of the London (insurance) market, dominated by Lloyd's of London. This market deals mainly in general insurance. Life insurance began following the development of the first life table by Edmund Halley in 1693. The first life policies were offered by the Amicable Society for a Perpetual Assurance Office, established in London in

[16] Rosie Murray-West (2013) A 300-year history of British banking and the rise of current accounts, *Daily Telegraph*, 12 September.
[17] Caroline Fohlin (2014) *A Brief History of Investment Banking from Medieval Times to the Present*, Working Paper, Emory University;
http://economics.emory.edu/home/documents/workingpapers/fohlin_14_16_paper.pdf
[18] http://www.icmagroup.org/About-ICMA/history/history-of-the-eurobond-market/

1706. The world's first mutual insurer, the Society for Equitable Assurances on Lives and Survivorship, was set up in 1762, offering age-based premiums derived using formal actuarial methods.

The first asset management company was established in Scotland in 1873 to invest in North America.[19] Asset management is a much more recent business which now divides itself into two broad categories, institutional and retail. Institutional asset management comprises traditional investment advisors and managers, hedge funds and private equity funds. This grew in the 20th Century, particularly after the Second World War, to service the medium- and long-term investment needs of insurance companies, pension funds, family offices and sovereign wealth funds. Institutional asset management companies have their origins in the insurance industry (e.g., Royal London Asset Management and Legal & General Investment Management), the banking industry (e.g., Schroders and UBS Asset Management) and as independent businesses (e.g., Aberdeen Asset Management, BlackRock and Hermes Investment Management). Retail asset management typically involves collective investment schemes, such as unit trusts and exchange-traded funds.

3. But then it began to behave very badly

So far, so brilliant. So when did things start to go wrong? We would date this from the early 1970s and two unrelated events – the introduction of financial derivatives and the UK's joining of the European Union.

The market in financial derivatives started following the collapse of the Bretton Woods system of fixed exchange rates in 1973. This led to a period of unprecedented interest and exchange rate volatility and investment banks started selling derivatives to hedge this volatility. Initially, this example of financial innovation was a success and made a valuable contribution to the real economy. Over time, however, banks introduced more complex derivatives that their clients did not understand and whose only real purpose was to generate revenues for the banks and bonuses for the bankers.[20] So began a journey that led to the widespread exploitation of both retail and corporate clients. And worse, there was outright fraud – which was considered to be a growth industry in the 1970s. According to Sir David Walker, a former executive director for finance and industry at the Bank of England, these developments 'outstripped the ability of regulators to understand [them]'.[21]

In the case of retail and small business customers, there were the scandals involving the mis-selling of endowment mortgages and annuities, interest rate swaps, and payment protection insurance (PPI). More recently there has been the poor treatment of fraud

[19] Keith Skeoch (2014) UK can rule the world in asset management, *Daily Telegraph*, 16 August.
[20] Kevin Dowd and Martin Hutchinson (2010) *Alchemists of Loss: How Modern Finance and Government Intervention Crashed the Financial System*, Chichester: Wiley.
[21] Iain Martin (2016) *Crash Bang Wallop: The Inside Story of London's Big Bang and a Financial Revolution that Changed the World*, London: Hodder & Stoughton.

victims,[22] the issue of excessive overdraft charges and, in particular, the unscrupulous treatment of borrowers by the RBS's turnaround division, Global Restructuring Group.[23] Endowment mortgages cost the banks £1.9bn in compensation between 2002 and 2006, while interest rate swaps cost them £4.8bn between 2012 and 2015 – with 90% of the swap contracts failing to meet regulatory standards. The banking industry has had to pay out £37.3bn in compensation for PPI mis-selling to date.[24] More than 200,000 retirees in poor health who should have been sold enhanced annuities were mis-sold standard annuities which paid out up to 50% less in the case of serious illnesses such as cancer or strokes – with typical compensation of £500 per annuitant, according to the Financial Conduct Authority.[25] Research by New City Agenda shows that banks and building societies have been charged £53bn in fines since 2000. RBS, for example, has paid out £6.4bn in fines and also paid £3.8bn in staff bonuses, but shareholders have received no dividend since 2008. Similarly, Lloyds Banking Group paid £14bn in fines and £2.1bn in staff, and only £500m in dividends between 2010 and 2014. Lord John McFall, one of the founders of New City Agenda, said: 'The profitability of UK retail banks has been imperilled by persistent misconduct and an aggressive sales based culture. This has made every citizen poorer through our pension funds and our ownership of the bailed-out banks…. [Shareholders] should be leading the campaign to change bank culture and raise professional standards and demand significant clawback of bonuses for accountable managers'.[26]

In respect of corporate customers, there have been the scandals involving LIBOR-fixing and the manipulation of exchange rates. In 2012, banks were found guilty of setting LIBOR in order to make profits from their own trading activities and had to pay £14.5bn in fines. In 2014, US and UK regulators found there was a 'free-for-all culture' on the trading floors of RBS, HSBC, Citibank, JP Morgan and UBS, and fined these banks £2.6bn for conspiring to manipulate foreign exchange rates. In 2012, Standard Chartered was accused of helping Iran hide $250bn of transactions and paid a $340m fine to the New York State Department of Financial Services, and a further $300m two years later after failing to improve its money laundering controls. In 2015, HSBC was accused of helping companies evade tax.[27]

Yet all this pales into insignificance compared with the cost to the world economy of the Global Financial Crisis (GFC) between 2008-11, originating in the US sub-prime mortgage market, but spreading across the globe. The UK was particularly badly affected with its crisis

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[22] A recent example is HSBC's refusal to compensate a victim who transferred £8,500 into a HSBC account set up by an eBay fraudster, despite HSBC being made aware that this account was associated with criminal activity four days previously (Amelia Murray (2017) Take banks to court for abetting crime, fraud victims told, *Daily Telegraph: Your Money*, 14 January).

[23] RBS put viable businesses into financial distress by cutting off their credit, so it could profit from their difficulties by charging exorbitant turnaround fees and then used RBS's property division, West Register, to purchase the businesses' assets at greatly reduced values. This case was reviewed by Lawrence Tomlinson (2013) *Banks' Lending Practices: Treatment of businesses in distress,* Department for Business, Innovation and Skills, 25 November; http://lexlaw.co.uk/wp-content/uploads/2013/11/Tomlinson-Report.pdf

[24] This could rise by another £22bn according to the *Financial Times*.

[25] Katie Morley (2017) Pension firms agree payouts for 200,000 sick retiress, *Daily Telegraph*, 25 February.

[26] Emma Dunkley (2016) Ten biggest bank scandals have cost £53bn in fines, *Financial Times*, 11 April.

[27] Five other banking scandals since 2008; http://www.channel4.com/news/five-other-banking-scandals-since-2008, 9 February 2015.

beginning a year earlier in 2007 with the collapse of Northern Rock building society. The Organisation for Economic Cooperation and Development (OECD) estimated that the median loss in potential output in 2014 for the 19 countries which experienced a banking crisis was 5.5% of GDP.[28] If lower stock market valuations are also taken into account, the cost rises to $15trn or 20% of global GDP, according to some estimates.[29] On top of this were the bailouts from taxpayers for an industry whose representatives openly declare that emotional and historic ties count for very little.

But, it is not just the behaviour of banks and insurance companies, there is also the behaviour of investment managers over hidden costs. Recent studies have shown that hidden costs are at least as high as visible costs, if not much higher. These hidden costs include transactions costs (such bid-offer spreads) and market impact costs, which increase the more frequently a customer's portfolio is turned over. The studies show that most active fund managers subtract value from (rather than add value to) their customers' assets.[30]

The situation was not helped by the introduction of the 'Big Bang' on 27 October 1986. On the positive side, Big Bang led to the ending of a number of restrictive practices in the City, such as fixed commissions and the requirement that the roles of broker and jobber should be kept separate. It also made it easier for outsiders to compete and enter on the basis of merit what had previously been a closed shop.[31] However, there were 'unintended consequences', such as encouraging short-termism within the investment industry. Martin Gilbert, CEO of Aberdeen Asset Management, argues that Big Bang 'probably accelerated a trend towards short-termism and certainly did not nurture a more long-term approach. Capital markets are far more short term in their thinking now than they were'. Another unintended consequence was that, when the de-regulation went badly wrong, as it did spectacularly in the GFC, there was a massive increase in regulation. Mr Gilbert comments: 'The most influential forces in the City now are the regulators. That is rightly the case given what happened in the financial crisis. But it does reflect the fact that the City today is not the embodiment of free markets and low barriers that some people think of it as being after the Big Bang'.[32]

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[28] Patrice Ollivaud and David Turner (2014) The effect of the global financial crisis on OECD potential output, *OECD Journal: Economic Studies*, 2014: 41-60; https://www.oecd.org/eco/growth/The-effect-of-the-global-financial-crisis-on-OECD-potential-output-OECD-Journal-Economic-Studies-2014.pdf.

[29] Al Yoon (2012) Total Global Losses from Financial Crisis: $15 Trillion, *Wall Street Journal*, 1 October. Based on global GDP in 2012 of $74 trillion; http://www.statista.com/statistics/268750/global-gross-domestic-product-gdp.

[30] David Blake (2014) *On the Disclosure of the Costs of Investment Management*, Discussion Paper PI-1407, Pensions Institute, May.

[31] As Simon Nixon points out: 'London was a backwater, a largely domestic capital market, dominated by domestic firms and presided over by an old-money elite sustained by fat, fixed commissions, elaborate barriers to entry and rampant insider trading' (Simon Nixon (2016) No Quick Fix to City of London's Brexit Conundrum, *Wall Street Journal*, 28 September).

[32] Tom Eckett (2016) Aberdeen's Gilbert – The unintended consequences of the 'Big Bang' 30 years on, *Investment Week*, 27 October.

4. Joining the European Union made matters worse

1973 was also the year that the UK joined the EU. Despite the pretence of promoting competition in the single market, the EU is a fundamentally anti-competitive and protectionist organisation. The single market is the internal market of a customs union. The customs union imposes high external trade barriers that reduce effective competition from abroad. Within the single market, regulations are harmonised. In principle, this should encourage more competition, but the regulations favour large corporations, making it difficult for small new entrants to compete.

This was confirmed by Daniel Hannan in the Oxford Union Brexit debate on 9 June 2016:[33] 'The biggest surprise to me as a newly elected MEP was the extent to which these giant corporations [such as Goldman Sachs, JP Morgan, Citibank and Morgan Stanley] wanted more regulation. I had innocently supposed, being elected as a Conservative, that being private enterprises, they would want freedom of action. I was disabused of that within a week of arriving. They love regulation because they can afford the compliance costs more easily than their smaller rivals. They have captured the Brussels machine and used it to raise barriers to entry. Very good news for the cartel of established multinationals. Very bad news for the innovator, the start-up, the entrepreneur'.

On 12 October 2015, two articles in the financial trade press showed the striking contrast of views about the City's future inside or outside the EU. The first reported a study by New City Initiative which shows that ten incoming EU regulations, such as the Alternative Investment Funds Markets Directive, the Financial Transaction Tax, OECD Common Reporting Standards, Solvency II and Basel III, are 'stifling innovation at smaller firms and restricting competitiveness as their regulatory burden continues to grow'.[34] The second reported that the City's Remain camp believes 'there is no doubt a Brexit would do considerable damage in the short term. According to the chief executive of one European bank, if the UK voted to exit, his bank would move thousands of staff out of the country within a year'.[35]

How can both views be reconciled? Very easily. What became clearer by the day in the lead-up to the Referendum was that the arguments in the City about EU membership were really about size and competition. The large firms in the City welcome the kind of EU regulations that prevent new small companies competing against them. This is being dressed up as being in the UK's national interest. It is not. It is very much against the interests of the City's customers who will see even lower investment returns as the large firms swallow up the small firms so they can no longer compete against them. And this anti-competitive attitude explains why the EU economy is falling further and further behind in the world. As Daniel Hannan states: 'The year we joined – 1973 – the 28 countries that now make up the EU were 36% of the world economy. Last year, it was 17% and falling'.

[33] https://www.youtube.com/watch?v=rJcuKfcxo9w

[34] Laura Dew (2015) Think-tank warns regulatory burden stifling fund management innovation, *Investment Week*, 12 October.

[35] David Wighton (2015) For Europhiles to keep shtum on Brexit is a high-risk play, *Financial News*, 12 October.

So we entered the Referendum with the City having a reputation for poor customer service as well as being more than happy to use EU regulations to restrict competitive entry into the industry.

5. Following the Referendum, the City was only concerned about its 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, feeling thoroughly sorry for itself.

Here are some reactions to the vote:

- *Asset managers have renewed their warnings that some UK jobs will have to move…following the UK's vote to leave the European Union.*

  …Andrew Breach, a director of recruitment firm Page Executive's financial services practice in London, said: 'In terms of the direct impact on the City, there will undoubtedly be financial services firms that would have moved to London as a launch pad into Europe that will now move to [the likes of] Luxembourg, Frankfurt and Paris. There will be banks and funds that will move some of their teams to Europe'.

  Amin Rajan, chief executive of asset management consultancy and research house Create-Research, said 'job cuts are inevitable, as are changes in the way funds are passported. Asset managers are wedged between a rock and a hard place. Over time, the centre of gravity will shift from London. It will lose its pre-eminence in the European fund industry. Dublin, Frankfurt, Luxembourg and Paris will be the main beneficiaries'.

  Saker Nusseibeh, chief executive of Hermes Investment Management, said he was concerned about London-based firms' ability to continue to attract the best talent: '[If freedom of movement ends] that would affect our ability to recruit because it makes it more difficult, and that's true across the board for all the City. I think people [potential EU job applicants] will stop going to London and look elsewhere'.[36]

- *Britain's largest fund managers face bigger risks from the UK leaving the EU than previously anticipated, with new data showing mainland European investors account for up to a fifth of their assets under management.*

  … 'The UK investment management [industry] wants access to the EU market, period. It is the overwhelming view from most of us that this is a good thing', says Robyn

[36] Mark Cobley and Andrew Pearce (2016) Fund managers predict job moves to Dublin and Luxembourg, *Financial News*, 27 June.

Grew, chief administrative officer of Man Group, the world's largest listed hedge fund company.

Ashmore, Man, Schroders and Aberdeen have the greatest reliance on mainland European clients, which account for 28%, 21%, 20% and 19% respectively of their total assets.

… UK-based fund managers … run £1.2tn on behalf of mainland European investors.

… The biggest risk for the asset management industry is the potential loss of the so-called MiFID[37] passport if Britain no longer has access to the single market.

… This passport … enables asset management companies to register UCITS[38] funds in Luxembourg or Dublin and sell them across the continent and internationally, while keeping the vast majority of their staff, including fund managers, marketing and sales teams, in London.

To delegate investment management services back to the UK, fund companies need a MiFID licence — which also governs segregated mandates — from the UK regulator.

If there is a hard version of Brexit, any MiFID licence that has been granted by the UK regulator will become void.

… Asset managers with big staff bases in mainland Europe — such as Schroders, Fidelity International and Franklin Templeton, which employ 400, 820 and 1,000 staff on the continent respectively — are expected to face fewer obstacles in obtaining passporting rights from EU authorities.

But fund companies with large EU client bases and low headcount in mainland Europe are expected to encounter more difficulties. This is potentially problematic for Henderson, Ashmore, Baillie Gifford, Man, LGIM, Jupiter and Vanguard.

According to Owen Lysak, senior associate at Clifford Chance, the law firm, fund companies that want absolute certainty now about their ability to access mainland European clients in future will be 'strongly looking at adding people in the EU'.

He adds: 'For asset managers, this is urgent. If you are an alternative investment fund manager and don't have a presence elsewhere in the EU, you will have problems marketing into the EU [in the event of a hard Brexit]. If you manage Luxembourg-based funds from the UK, you will potentially have a problem'.

There are also question marks over whether regulators in Luxembourg and Ireland — where nearly half of Europe's 30,000 UCITS funds are registered — will continue to

[37] Markets in Financial Instruments Directive – see Appendix 5.
[38] Undertakings in Collective Investment in Transferable Securities – see Appendix 5.

tolerate asset management companies putting a handful of back-office staff in those locations and delegating investment management back to the UK.

Iain Anderson, executive chairman of Cicero, the public policy firm, says: 'An awful lot [of investment staff are] in London managing money that is routed through UCITS funds that are registered in Luxembourg and Dublin. The question is whether or not you can keep those managers in London, or whether some of the managers need to move to EU'.

'Asset managers [previously] put a lot of resources into Brussels — it has been the primary port of call for a lot of their lobbying efforts', Mr Anderson says. 'Now they are putting [those resources] into London to beef up their conversations with the government, and are looking to recruit public policy people in Berlin and Paris'.

… 'The worst-case scenario would mean getting no equivalence and UK firms would not be able to market funds across Europe. Potentially negotiations could go very badly indeed. But we don't think they will, and the government will have a very strong position', says Jorge Morley-Smith, director at the Investment Association.[39]

- *There is a 'broad range' of possible outcomes from the UK's Brexit vote, the London Stock Exchange Group has said. It's just that those possibilities all look like they could be pretty bad.*

  'In the longer term, a UK exit from the EU would diminish the UK's ability to influence changes to EU regulation and may result in a divergence of regulatory frameworks which may have an impact on the operation of financial services markets in the UK and across the European Union'.[40]

- *At least 100,000 jobs across the country will be under threat if the European Union demands that euro-denominated clearing cannot take place in the UK following Brexit, the chief executive of the London Stock Exchange has warned.*

  Xavier Rolet said that the [market for] clearing euro-denominated financial products … is huge, handling some $570bn of derivatives every day, and LSE is a key player because it controls LCH, which is the world's biggest clearinghouse.

  'We estimate, conservatively, that at a very minimum 100,000 jobs, in risk management, compliance, middle office, back-office support functions, by the way not just in London, up and down the country, are implicated in supporting this business and clearly could be at risk', Mr Rolet told Bloomberg Television.

[39] Madison Marriage (2016) Access to single market crucial for Britain's big fund managers, *Financial Times*, 13 October.
[40] Samuel Agini (2016) The LSE's prophets of gloom, *Financial News*, 3 August.

The loss of the market would deal a blow to London's status as a global financial hub. While European cities such as Frankfurt and Paris are eyeing the lucrative clearing market, Mr Rolet argued that the US would be the most likely destination and that 'there are very, very few financial centres around the world that could accommodate such a global business'.[41]

- *Morgan Stanley will be forced to move some employees and their families out of London as a result of the UK vote to leave the European Union, and resulting disruptions will be a headache for the firm, CEO James Gorman said.*

  'From our perspective, just narrowly from the financial sector and from our institution, there's nothing good about Brexit', Gorman said Tuesday in an interview with Bloomberg Editor-in-Chief John Micklethwait at Bloomberg LP's The Year Ahead Summit. 'Now we're going to have to have our headquarters in Europe, in addition. We are probably going to have to have, with our legal entities there, more capital and liquidity trapped in those legal entities. None of this is good'.[42]

- *'Confidence in the financial sector, by those who know it best, fell off a cliff in 2016', according to* Financial News' *Job Satisfaction Survey for 2016. Only 14.2% of respondents believed the industry's prospects were either positive or very positive; 44% of those with more than 20 years' experience said things were negative or very negative, compared with 31% of new arrivals to the industry who felt the same. Despite predicting gloom for the City, 77% said they were not concerned about their own futures, with another 8% claiming their company could not do without them.*[43]

- *A survey conducted by PwC in November 2016 found that 70% of investment managers believed that they will not be able to sell their UCITS funds freely within the EU after Brexit, because they are unlikely to retain full 'passporting' rights. Some 85% of respondents thought it would be necessary to relocate some UK-based staff to the continent, with 7% saying their companies had already moved staff and 25% saying their companies had plans to do so.*[44]

- *Jeremy Browne, a former minister of state in the Foreign and Commonwealth Office and now the special representative for the City to the EU, has also said that the UK would lock itself out of the single market if it insisted on controls on European immigration. He said: 'The City still thinks that it will be such a soft version of Brexit. I am not at all sure that the Europeans will be willing to deliver something that easy and palatable to us. I can't see any way that any politician could interpret the Referendum result in Britain as a mandate for no change whatsoever on European*

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[41] Ben Martin (2016) At least 100,000 finance jobs face clearing threat following Brexit, warns LSE boss, *Daily Telegraph*, 23 September. By November 2016, this figure had been revised down to 'as many as 83,000 jobs' (Latest clearing report: 83,000 jobs could go, *Financial News*, 14 November 2016).

[42] Hugh Son and Jordyn Holman (2016) Morgan Stanley CEO James Gorman Sees 'Nothing Good About Brexit', *Bloomberg News*, 25 October.

[43] Elizabeth Pfeuti (2016) Confidence in finance industry's prospects nosedives, *Financial News*, 21 November.

[44] Chris Flood (2016) 70% of asset managers fear Brexit fund passport loss, *FTfm*, 5 December.

migration policies to Britain. So if the Europeans are telling the truth that being in the single market relies on absolute observance of the Four Freedoms,[45] *then it is not possible for us to be in the single market'.*[46]

The European Securities Markets Authority (ESMA) is also ramping up the fear level by arguing that the outlook for European markets is worsening amid intensified political risks: 'The risk outlook has deteriorated following the result of the UK Referendum on EU membership. Market, liquidity, and contagion risks may rise going forward'.[47]

Eighteen months after the Referendum, a study by *Financial Times* estimated that around 4,600 financial sector jobs might be moved from the UK to the EU, which is just 6% of those working in the City and 0.6% of the total number working in UK financial services.[48]

6. 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. Here's what they said before or just after the Referendum:

- JP Morgan (3 June): *Brexit is a terrible deal for the British economy and jobs*
- Goldman Sachs (26 June): *We now expect the economy to enter a mild recession by early 2017.*
- Credit Suisse (January): *If the UK votes to leave the EU, it is likely to entail and immediate and simultaneous economic and financial shock for the UK.*

Here's what they said three months later:

- JP Morgan (5 September): *The rebound in August takes out the risk of recession*.
- Goldman Sachs (5 September): *We now expect the UK economy to avoid even the technical recession that we had foreseen immediately after the Referendum*.
- Credit Suisse (6 September): *The impact of the vote to leave the EU on the UK economy seems to be materially less negative than we expected*.[49]

The City's forecasters' predictions about a recession turned out to be wide of the mark. According to Matthew Lynn of MarketWatch, it is the reputation of these economic doom-sayers that is suffering the most after the vote. He argues that they were so personally committed to the UK staying in the EU that they could not imagine anything other than

[45] The EU's Four Freedoms are the freedom of movement of capital, people, goods and services.
[46] Andrew Pearce (2016) City's EU rep - Get ready to be locked out of single market, *Financial News*, 4 August.
[47] Julia-Ambra Verlaine (2016) Outlook for European Markets Is Worsening, Watchdog Says, *Wall Street Journal*, 30 August.
[48] Laura Noonan (2017) Banks set to move fewer than 4,600 jobs over Brexit, *Financial Times*, 13 December.
[49] Reported in Hugo Duncan (2016) Wall Street banks eat their words on Brexit: Humiliating U-turn as they admit recession forecasts were wrong, *Daily Mail*, 7 September.

disaster if the country left.[50] The US investment banks donated £1.25m to the Remain campaign.

Angela Knight, then CEO of the BBA between 2007 and 2012, said: 'I was amazed that the City was so amazed that the UK voted out. I come from the North of England, my links are all the way through the North and the Midlands, and there was no way that anybody there was going to vote really in favour. Well, of course, *they* [the City] did, but the reality was that the view outside London was very different. So for the financial services industry to suddenly wake up with this huge fright I thought was very, very surprising because it actually showed that there'd not been enough listening and we'd all been talking amongst ourselves'.[51]

Further, the panicky reactions of the UK financial services industry and ESMA is not reciprocated on the continent if the results of the following survey are anything to go by. Universal-Investment, a Frankfurt-based investment company, conducted a poll of about 100 institutional investors managing more than €400bn on the impact of Brexit on continental Europe's capital markets. It found that 44% expected no impact, 19% thought the effect would be positive, while 37% thought it would be negative. Respondents were more concerned about the actions of the European Central Bank (ECB): 84% of respondents thought the ECB's monetary policy would be the cause the next European financial crisis, compared with 66% in 2014.[52]

7. 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'.[53] 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.[54]

A whole range of other monetary indicators – such as broad money growing at 7% – suggest that 'the economy might be strengthening, not weakening', according to Graeme Leach, CEO and chief economist at Macronomics Global. 'There's little or nothing in the wider

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[50] Reported in Bernard Goyder (2016) The big casualties of Brexit: Economic doomsayers, *Financial News*, 24 August.

[51] Keynote debate: Could Brexit positively impact UK financial services?, Misys Connect Forum, 20 September 2016; http://misys.kulu.net/view/XG1zcTzFEDU

[52] Samuel Agini (2016) Brexit repercussions for European capital markets? Nein (probably), *Financial News*, 24 November.

[53] David Blake (2016) *Measurement Without Theory: On the Extraordinary Abuse of Economic Models in the EU Referendum Debate*, June; http://www.economistsforbrexit.co.uk/publications/ and http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2819954

[54] Tim Wallace (2016) Foreign investors pour into Britain, *Daily Telegraph*, 30 August; Mike Bird (2016) UK Treasury's warning of bank outflows falls flat in post-Brexit data, *Wall Street Journal*, 31 August.

economic statistics to challenge this view either. Consumption, retail sales, consumer confidence, industrial output and manufacturing are showing a strong head of steam'.[55] Joe Staton, head of market dynamics at GfK, said: 'British consumers appear to have shrugged off Brexit fears about the economy as wages continue to grow faster than prices, rising employment boosts income, and low interest rates encourage people to spend rather than save'. [56]

Industrial output is at the highest level for 23 years[57] and manufacturing exports are at their highest level for two years.[58] A survey of manufacturers indicated Brexit was not perceived as a risk by 74% of those surveyed, with 29% believing there will be no impact and 45% saying it will have a positive impact.[59] The service sector, which comprises 80% of the economy, grew by 0.8% in the third quarter of 2016, supporting the view that 'there has been no sign of an immediate shock to the economy' according to the Office for National Statistics (ONS).[60] Even investor confidence is showing signs of recovery after initially falling following the Leave vote, according to Lloyds Private Bank's Investor Sentiment Index. Within two months, it stood at the highest level of the year.[61] Business investment increased by 0.9% between the second and third quarters of 2016 to £44.2bn.[62] The trade deficit for goods and services narrowed by £1.6bn between July and September 2016 to £11bn, as a consequence of a 6.1% rise in goods exports – the ONS said the data indicated that net trade was on course to make a small positive contribution to UK economic growth of 0.5% in the third quarter.[63] In his 2016 Autumn Statement, the chancellor Philip Hammond said that the UK was the fastest growing major economy, beating the rest of the EU, the US, Canada and Japan. The GDP growth rate was 1.9% in 2016, making it, along with

[55] Graeme Leach (2016) 'You can see Brexit everywhere but in the statistics', *City A.M.*, 1 September; Wiktor Szary (2016) U.K. Consumers Shrug Off Brexit Vote: Sentiment recovered in August after steep fall in Referendum's aftermath, *Wall Street Journal*, 30 August; Szu Ping Chan (2016) Upbeat on EU confidence little changed after the vote, *Daily Telegraph*, 17 December.

[56] Bernard Goyder (2016) Consumer confidence bounces up: GfK's barometer of public optimism shows shoppers shrugging off Brexit woes*, Financial News*, 30 September.

[57] Covers manufacturing and mining. Tim Wallace (2017) Manufacturing surge helps bolster economy, *Daily Telegraph*, 11 November.

[58] Phillip Inman, Sarah Butler and Sean Farrell (2016) UK economic indicators defy Brexit fears, *Guardian*, 24 August; Britain's economy is BOOMING: Brexit joy at GDP boost thanks to manufacturing surge, *Daily Express*, 25 October 2017; Larry Elliott (2017) UK factory orders hit four-year high, *Guardian*, 1 December; Russell Lynch (2018) UK manufacturers bring New Year cheer as weak sterling gives exports shot in the arm, Evening Standard, 4 January. Exports are 7.7% higher than in 2015.

[59] RSA (2016) *Future Impacts*, November; http://www.imeche.org/news/news-article/brexit-is-not-seen-as-a-threat-by-74-of-manufacturing-businesses?utm_source=BrexitCentral+Mailing+List&utm_campaign=9f3ff42879-Mailchimp+bulletin&utm_medium=email&utm_term=0_23a30e67d9-9f3ff42879-18935675/

[60] William Schomberg and David Milliken (2016) UK service firms defy Brexit, put BoE on spot over rates, *Reuters,* 30 September. By the third quarter of 2017, service sector confidence was at levels below those seen before the June 2016 Referendum, although there was an improvement in the balance of firms reporting improved sales abroad (Jasper Jolly (2017) Manufacturers receive 'welcome' boost but services outlook flat says British Chambers of Commerce, *City A.M.*, 13 October).

[61] Victoria McKeever (2016) Investor sentiment 'bounces back' post-Brexit: Investor sentiment index hits 2016 high, *Professional Adviser*, 17 August.

[62] Nicholas Megaw (2016) Business investment holds up after Brexit vote, *Financial Times*, 25 November.

[63] Szu Ping Chan (2016) Trade to push up economic growth in UK*, Daily Telegraph*, 8 November.

Germany, the fastest growing economy in the G7 that year. The OECD forecast lower growth in 2017 (1.6%) and 2018 (1%), as a result of lower consumer spending,[64] but noted that export prospects had been helped by a lower pound. Indeed, exports grew by 10% during 2017.[65] Business investment continued to grow in 2017. For example, it rose by 2.5% in the second quarter of 2017 (compared with the same quarter in 2016) to £45.7bn.[66] GDP growth was 0.4% in the third quarter of 2017 or 1.7% pa; even productivity grew by 0.9% during this period, the biggest quarterly rise since 2011.[67] A survey by the Institute of Chartered Accountants in England and Wales in November 2017 found that profits and exports were both growing at the fastest rate since 2015 and that capital investment spending was at a two-year high. In the same month, EY's Global Capital Confidence Barometer found that the UK was third most popular targets for acquisitions, behind the US and China, and ahead of Germany and Australia.[68]

Not everything is rosy, of course. There has been a slowdown at the top end of the housing market, especially in London. This was another one of George Osborne's predictions if the UK voted Leave.[69] But this is not due to Brexit. Rather it is the result of the former chancellor's decision in December 2014 to increase stamp duty on homes worth more than £937,500 from April 2016.[70] Some investors in commercial real estate panicked after the Brexit vote and tried to sell their holdings leading to a suspension of trading in a number of open-ended real estate funds. However, within three months, the market had stabilised and investors are showing 'no signs of abandoning the UK anytime soon'.[71]

Small company shares also performed badly in the immediate aftermath of the Referendum. However, Harry Nimmo, manager of the Standard Life UK Smaller Companies Investment Trust, is confident about the future of this sector: 'an unusual succession of high quality companies newly listing on the London Stock Exchange [is] leading me to the view that for smaller companies at least capitalism is alive and kicking and creating wealth and jobs within the United Kingdom and beyond where innovation and business development are being correctly rewarded'.[72] This is confirmed both by the FTSE 250 index of mid-cap stocks reaching a new high in February 2017 and by a survey of small and medium-sized companies which found that they are increasingly optimistic about profit and revenue

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[64] The key explanation for lower consumer spending is the 'squeeze [on] household disposable income' caused by a combination of an increase in the cost of living and slowing wage growth (Miles Dilworth (2017) UK consumer spending falls to lowest levels in nearly four years, *Independent*, 9 July).

[65] Gemma Tetlow (2017) Weak pound boosts demand for UK manufactured goods: BoE survey suggests economy is less reliant on consumer spending for growth, *Financial Times*, 9 August; Anna Isaac (2017) OECD holds steady on growth forecast for UK, praising good export prospects, *Daily Telegraph*, 20 September.

[66] Gavin Jackson (2017) Why business investment rose after the vote for Brexit, *Financial Times*, 8 October.

[67] Tim Wallace and Anna Isaac (2018) UK defies the Brexit gloom with strong GDP growth, *Daily Telegraph*, 23 December.

[68] Tim Wallace and Alan Tovey (2017) UK businesses are flourishing despite Brexit uncertainty, *Daily Telegraph*, 6 November.

[69] House prices would fall by 18% (relatively).

[70] Hugo Duncan (2016) Stamp duty, NOT Brexit, hit top prices: George Osborne blamed for slowdown in the housing market, *Daily Mail*, 6 September.

[71] Brexit: real estate investors commit to the UK, *IPE Real Estate*, September/October 2016.

[72] Gavin Lumsden (2016) Nimmo: small cap 'new wave' will banish 'Brexit' fears, *Citywire*, 2 September.

growth in 2017.[73] The same is true for London's financial technology (fintech) startups which produce banking apps and high-tech tools for traders: 'There's been a few hundred years of finance history — trading, infrastructure, legal and everything else. That's just not going to go away overnight', according to Jeremy Sosabowski, CEO of AlgoDynamix, a financial software developer. Chris Gledhill, CEO of challenger bank Secco, went further and said: 'We should take this opportunity to relaunch the UK as a startup in its own right. We can do all sorts of cheeky, awesome stuff'.[74]

Lord Robert Kerslake, former head of the civil service, released a report in February 2017 in which he claimed that George Osborne's 'project fear' forecasts about the economic risks of leaving the European Union have undermined public confidence in the Treasury and left it ill-equipped to influence Brexit.[75] As one commentator said 'anyone who predicted utter chaos following the Referendum was always going to look rather foolish. For now, we are still inside Europe, unemployment is still falling and wages are still rising, so what's not to like? The Referendum was, at best, a distraction from the overriding question of how we break out of the current cycle of monetary intervention and asset pump-priming'.[76] Which brings us to the role of the Bank of England.

8. 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 (QE) 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'.[77]

The move was also criticised by some City economists and financial advisers. For example, Richard Jeffrey, CIO of Cazenove, said: 'I feel the Bank of England's response was entirely inappropriate. It implied there are major problems which require drastic action when there is no evidence of that. I do not see how it can be argued it was a good idea. The Bank should have tried to normalise interest rates by edging them up as the economy was recovering. That way, if we needed to cut rates, it would have had a bigger impact because we would be

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[73] Michelle McGagh (2017) Mid-caps catch up: FTSE 250 shakes off Brexit woes, *Citywire*, 9 February; Neil Johnston (2016) Companies shrug off Brexit vote, *The Times*, 19 December.

[74] Quoted in Viktor Reklaitis (2016) Brexwhat? Why Brexit won't necessarily kill London's fintech scene, *Financial News Market Watch*, 31 August.

[75] Heather Stewart (2017) Osborne's bleak Brexit forecast 'has undermined the Treasury', *Guardian*, 12 February.

[76] Peter Toogood, investment director at The Adviser Centre, quoted in Victoria McKeever (2016) Three post-Brexit investment scenarios to consider, *Professional Adviser*, 18 August.

[77] Michelle McGagh (2016) Carney- interest rate cut will make Brexit a 'success', *Citywire*, 8 September.

starting from 2% rather than 0.5%. The last five years of policy decisions have been very poor. The Bank has become too political and worried about public reaction'.[78]

Peter Toogood, investment director at The Adviser Centre, added: 'The authorities believe that they can manipulate the economy and the markets, but those of us of an old-fashioned disposition believe that this manipulation will eventually fail. Distorting gilt yields, and therefore forcing down borrowing costs, is yet again bringing forward future consumption and encouraging the adoption of even more debt. It's quite a party for now, but the hangover will be thumping'.[79]

The move was also implicitly criticised by Mervyn King, Mark Carney's predecessor as governor at the Bank between 2003 and 2013. Speaking before the announcement he said: 'Central banks are approaching the limits of what they can do…I'm not sure that much more easing will achieve very much. It might achieve a little but it simply is not going to provide the ultimate solution'.[80]

In fact, it could be worse. In trying to save the banking system, QE is destroying growth. Investment in the physical capital stock is needed to grow the real economy. But the only long-run source of investment is long-run savings. When nominal interest rates are zero and real interest rates are negative, savings will be very low and so, as a consequence, will real investment. While it is true that borrowing rates are also very low, very little of the borrowing seems to have gone into productive investment. A positive real rate of interest is needed to encourage adequate long-term savings.

Andrew Sentance, a former member of the Monetary Policy Committee, argues that there is a strong case for building into the Bank of England's remit the objective of a positive real interest rate, implying that the inflation rate target should be periodically adjusted in response to what is happening with nominal interest rates.[81] Mr Sentance also believes that the UK should follow the lead of the US Federal Reserve and begin to raise interest rates gradually back to normal levels.[82] Yet the Bank continues to warn about the UK's financial stability as a result of a slow-down in transactions in the commerical property sector following the Brexit vote and the 'reliance of the market...on inflows on foreign capital [or what Mark Carney calls the kindness of strangers]'.[83]

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[78] Laura Dew (2016) Cazenove's Jeffrey - BoE rate cut was 'entirely inappropriate', *Investment Week*, 19 August.
[79] Peter Toogood, investment director at The Adviser Centre, quoted in Victoria McKeever (2016) Three post-Brexit investment scenarios to consider, *Professional Adviser*, 18 August.
[80] Daniel Martin (2016) 'Brexit will actually help the economy thrive' claims former Bank of England governor Lord King as he criticises 'speculative' scare stories as 'insulting to the intelligence of the voter', *Daily Mail*, 29 August.
[81] Andrew Sentance (2016) Let the Bank strike a balance between savers and borrowers, *Daily Telegraph*, 22 October.
[82] Andrew Sentance (2016) The Bank of England should follow US lead on interest rates, *Daily Telegraph*, 17 December.
[83] Jayna Rana (2016) BoE warns post-Brexit commercial property slowdown threatens financial stability, *Investment Week*, 7 December.

The pound fell sharply following the Referendum and the Bank is concerned about the effect of this on inflation. But according to Dr Gerard Lyons, former chief economic advisor to Boris Johnson: 'The weaker pound was inevitable whatever the outcome of the Referendum. Sterling has been seen as one the world's most overvalued currencies for some time….The outcome for the pound now depends on the economic fundamentals, policy and confidence. And having been in dealing rooms for 25 years, confidence is a key factor. Basically, this is not a currency crisis….A weaker pound was moving the economic fundamentals back into shape in an imbalanced economy and makes the UK attractive to invest in'.[84] Roger Bootle and John Mills also agree that a lower exchange rate is good news for the UK. In their view, the pound has been stuck at too high a level for too long and the tendency of the currency to overshoot has trapped Britain in a chronic current account crisis, undermining competitiveness, damaging manufacturing and hitting productivity.[85] Mervyn King also called the fall in sterling a 'welcome change'. It would help the country to grow by making it easier to 'rebalance' the economy away from an excessive reliance on consumer spending in favour of exports: 'The UK economy has to be rebalanced one way or another, Remain or Leave. We need a level of the exchange rate much closer to the level we had in the middle of 2013. We are now in a better position to rebalance the UK economy'.[86] He added: 'During the Referendum campaign, someone said the real danger of Brexit is you'll end up with higher interest rates, lower house prices and a lower exchange rate, and I thought: dream on. Because that's what we've been trying to achieve for the past three years and now we have a chance of getting it. I don't think we should fear Brexit. It's not a bed of roses, but nor is it the end of the world'.[87]

In January 2017, Andrew Haldane, chief economist at the Bank of England, admitted the Bank misjudged the impact of the Brexit vote on the UK economy. He said the Bank had not anticipated the resilience of consumer spending following the Referendum and economic forecasting models were too 'narrow and fragile'.[88] Also in January 2017, Mark Carney, told the Treasury select committee that the Bank no longer considers Brexit to be the largest domestic risk to the UK's financial stability. Instead he was concerned about four domestic issues that could be 'amplified' by Brexit: mounting consumer credit, a weakened commercial real estate market, the current account deficit, and the fall in the value of sterling. He said he had changed his view because of the relatively benign financial environment since the EU Referendum.[89] In February 2017, the Bank raised its GDP growth forecasts for the UK economy from 1.4% to 2% in 2017, from 1.5% to 1.6% for 2018 and

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[84] Ajay Nair (2016) 'We need a clean Brexit' Economist insists weaker pound will attract investors to Britain, *Daily Express*, 11 October.
[85] Roger Bootle and John Mills (2016) *The Real Sterling Crisis: Why the UK needs a policy to keep the exchange rate down*, Civitas, London.
[86] Daniel Martin (2016) 'Brexit will actually help the economy thrive' claims former Bank of England governor Lord King as he criticises 'speculative' scare stories as 'insulting to the intelligence of the voter', *Daily Mail*, 29 August.
[87] Ajay Nair (2016) 'We need a clean Brexit' Economist insists weaker pound will attract investors to Britain, *Daily Express*, 11 October.
[88] Laura Dew (2016) BoE's Haldane admits forecasting errors in run-up to Brexit, *Investment Week*, 6 January.
[89] Chris Giles (2017) Brexit no longer the main risk to UK's stability, says Carney, *Financial Times*, 12 January.

from 1.6% to 1.7% in 2019.[90] In August 2017, the Bank lowered the 2017 forecast to 1.7%, due to slower growth in consumer spending, despite stronger exports and investments and a strengthening global recovery.[91]

9. 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 (EU27) based on a free trade. Typical is the view of Steve Baker MP, a leading Leave campaigner:

> *The UK will leave the EU. We will be an independent country, passing our own laws and governing ourselves. We will be a Global Britain, always the most passionate, most consistent, most convincing advocate for free trade, promoting peace and prosperity around the world. We will seek a unique, reciprocal UK-EU arrangement of open trade in goods and services and cooperation on other matters, like counter-terrorism…. The UK must be willing to rely on existing third-country arrangements with the EU so we can pursue opportunities for better regulation and global growth. Nevertheless, there are strong mutual incentives to agree regulatory equivalence and continued reciprocal market access as a transitional arrangement to a full free trade agreement. That agreement would have a comprehensive services schedule binding both parties to market access and national treatment subject only to each complying with globally-agreed standards…*
>
> *Take asset management. There is strong reciprocal interest here. At our exit date, we will be compliant with the UCITS V directive. While that regulation offers many opportunities for improvement, EU members can allow asset managers to delegate their functions to firms in third countries. Ireland permits delegation to managers in countries outside the EU, including Japan, Hong Kong, Australia and the USA. The bottom line is that it would not be feasible for the EU or its members to cut off delegation to the UK, especially against likely objections from Ireland and Luxembourg: operating as a third-country asset manager would be viable. However, if the UK is deemed equivalent in our withdrawal agreement – the logical consequence of our following EU law until we leave – then there is no reason we cannot continue asset management on the present basis as a transitional measure to a full bilateral free trade agreement.*
>
> *With limited opportunities for growth in Europe, we …have a transformational opportunity to pivot towards providing better-regulated UK products to savers and*

[90] Laura Dew (2017) BoE faces 'tough balancing act' as UK growth forecasts upgraded, *Investment Week*, 2 February.
[91] Szu Ping Chan (2017) Interest rate rise likely within a year, Bank signals, *Daily Telegraph*, 2 August. Exports have risen by 16% since the Referendum, manufacturing order books are at their highest for 30 years and Siemens, BMW and Toyota are increasing investment in the UK.

investors in regions with deep and growing capital pools: that must be our strategic goal. In investment services and market infrastructure, the new MiFID II rules will take affect in January 2018, introducing a new regime for authorisation of third-country firms. That provides a pathway to market access in addition to national and World Trade Organisation (WTO) rules. There will be no legal obstacle to the Commission recognising the UK as equivalent under MiFID II and the alternative would be significant market disruption across the EEA.[92] *Through member-state authorisation, third-country agreements and equivalence recognition, viable options exist for deposit takers and insurers too. In every sector, there are strong reciprocal incentives to conclude bilateral arrangements of equivalence as a transition to a modern free-trade agreement. There is disadvantage to EU firms, for example, in failing to carry forward the preferential risk weightings of assets held in the UK…Once the pragmatism of commercial incentive supplants political grandstanding, we will find we can leave the EU swiftly and successfully into a world of more competitive regulation in which the City flourishes.*[93]

However, Philip Aldrick, writing in *The Times*, says that Europe is in no mood to grant our wish for an amicable divorce: 'Britain just doesn't get it, officials in Brussels say. Westminster expects Brexit negotiations to be driven by logical economic outcomes that will deliver the best deal for all concerned. In Brussels, the sentiment is more abrasive. The negotiation will not be with a single homogenous entity but 27 member states, each with their pet agendas. Any of them can veto a proposal. Even assuming member states rally together, there will be one overriding diktat. "What I hear repeatedly is that the UK is approaching this on a transactional basis, but the EU is approaching it on an existential one", says one foreign apparatchik, "The consensus is you can't make the conditions of leaving too attractive". Brussels is watching the Westminster cycle of leaks and backtracking with slack-jawed astonishment. The prime minister's suggestion that the government would seek a transitional agreement once the two years of post-Article 50 talks conclude was welcomed as a beacon of sense amid the tawdry squabbling. Until she climbed down the following day. Does the UK have a death wish, they are asking'.[94]

The Brexit decision not only affects the UK's future relationship with the EU, other countries have an interest in the outcome. In October 2016, it was announced that US companies were reviewing the future of around $600bn worth of UK investments due to concerns about restrictions on access to the EU single market. The US Chamber of Commerce said the UK would need 'unfettered access' to the single market for US companies to continue expansion plans. It also says that claims that low EU external tariffs mean the cost of leaving the single market will be insignificant are 'nonsense: ultimately, these costs are likely to be borne by British workers and consumers'.[95]

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[92] European Economic Area.

[93] Steve Baker (2016) We need a pragmatic approach to leaving the European Union, *City A.M.*, 31 October.

[94] Philip Aldrick (2016) Europe is in no mood to grant our wish for an amicable divorce, *The Times*, 13 December.

[95] Daniel Flynn (2016) US companies reviewing $600bn UK investment on Brexit fears - Dismiss low costs as 'nonsense'*, Investment Week*, 18 October.

There are issues concerning non-tariff barriers and other forms of discrimination. While this mostly affects products and product standards under the CE — Conformité Européenne — mark, it can also affect the provision of services, e.g., the difficulties British professionals, such as architects, having their qualifications recognised on the continent. More significantly, there is a view developing, especially in the US, that the EU 'is turning into an inward-looking club, using tax and monopoly investigations as form of backdoor protectionism to discriminate against companies from outside the bloc. So systematic has the harassment become that the US is now fighting back, accusing the Europeans or unfairly targeting its corporate giants'. Once outside the EU, it is feared that the UK could be next on the target.[96]

The posturing and grandstanding comments made by the EU's leaders would appear to support this possibility. Here are some examples:

- 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. I see the manoeuvring…It should be obvious that if the United Kingdom wants to have free access to the internal market all the rules and all the liberties... need to be fully respected'. Angela Merkel, the German chancellor, has told German industry leaders that they could not lobby for a sweetheart deal for Britain. François Hollande, then French president, said that Britain must pay a high price for Brexit to discourage others from following suit: 'There must be a threat, there must be a risk, there must be a price, otherwise we will be in negotiations that will not end well and, inevitably, will have economic and human consequences'.[97]

- Speaking at a meeting of EU heads of government in Brussels in October 2016, Angela Merkel said 'As far as the practical terms are concerned, it is going to be rough going', while François Hollande added 'I say very firmly: if Mrs May wants a hard Brexit she will get a hard negotiation… Accepting free movement of people was a condition of securing access to the single market'.[98]

- The then German finance minister, Wolfgang Schäuble, has warned that the UK will be bound by tax rules that would restrict it from granting incentives to keep investors in the country and must continue paying EU contributions after Brexit: 'Until the UK's exit is complete, Britain will certainly have to fulfil its commitments. Possibly there will be some commitments that last beyond the exit … even, in part, to 2030 … Also we cannot grant any generous rebates'. He added that the UK should be prepared for financial services to move to the continent and wants London to lose its

[96] Chris Giles (2016) Post-Brexit trade may hinge on non-tariff barriers, *Financial Times*, 19 December; Matthew Lynn (2016) After US, Brussels could target Britain next, *Daily Telegraph*, 30 August.
[97] Peter Foster and Matthew Day (2016) 'You can't have one foot in and one foot out': Juncker says EU must be firm over UK's Brexit manoeuvring, *Daily Telegraph*, 7 October.
[98] May told to expect tough Brexit talks, *Financial Times*, 21 October 2016.

euro clearing business. Further, the UK would not get special treatment on migration if it wanted to remain in the internal market, since freedom of movement was a core element of the internal market: ‘There is no *à la carte* menu. There is only the whole menu or none. Without membership of the internal market, without acceptance of the four basic freedoms of the internal market there can, of course, be no passporting, no free access for financial products or for financial actors’.[99]

- Robert Fico, the prime minister of Slovakia and the EU’s rotating president at the time, wants to make the UK’s withdrawal from the EU as painful as possible. The main reason for this is that the UK might no longer be willing to absorb Slovakia’s surplus labour force following Brexit.[100] Further, in September 2016, the Visegrad Group (comprising Hungary, Poland, the Czech Republic and Slovakia) announced that it would veto any agreement between the UK with the EU over the single market that did not include free migration of people.[101]

- Jens Weidmann, president of the German central bank said that London’s position as a financial centre would be dealt a severe blow if the UK left the single market because banks would be denied the right to operate across the 27 remaining members of the EU. They would automatically be stripped of their ability to conduct business across the EU: ‘passporting rights are tied to the single market and would automatically cease to apply if Great Britain is long longer at least part of the European Economic Area’.[102]

- Jeroen Dijsselbloem, the Dutch finance minister who also chairs the eurogroup of 19 eurozone finance ministers, has warned that the City of London risks losing its role as the continent’s premier financial centre unless the UK agrees to fully apply EU regulations post-Brexit: ‘Being quite frank, we can’t allow the financial service centre for Europe and the eurozone to be outside Europe and the eurozone, and to go its own way in terms of rules and regulation requirements… We cannot allow a third country to have access, full passporting rights, to financial services markets in Europe, if at the same time we allow them to deviate in terms of capital standards, requirements, consumer protection etc… Even though I’m a great fan of the Brits . . . we have to take a firm stand on this. There is no alternative there’.[103]

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[99] Stefan Wagstyl and Guy Chazan (2016) Wolfgang Schäuble sets out tough line on Brexit, *Financial Times*, 17 November.

[100] ‘Indeed, it is precisely Fico’s failure to create a strong economy … that has led tens of thousands of Slovakia’s best and brightest to leave that country and start anew in Britain’. Further, Mr Fico ‘is a Russophile. He does not fear Putin’s territorial ambitions: indeed, he is opposed to the sanctions imposed on Russia for invading Ukraine’ (Marian L. Tupy (2016) If this is what the EU is like, no wonder Britain is leaving, *CAPX*, 23 September).

[101] BBC News (2016) Visegrad Group of EU states 'could veto Brexit deal', 17 September. There are around 1.2 million Central Europeans working in the UK.

[102] Philip Oltermann (2016) Hard Brexit will cost City of London its hub status, warns Bundesbank boss, *Guardian*, 19 September.

[103] Jim Brunsden (2016) City must apply EU rules to keep lead role, says eurogroup chief: Dijsselbloem says UK must abide by EU rules post Brexit to secure ‘passporting’ rights, *Financial Times*, 29 November.

- Even Enda Kenny, then prime minister of Ireland — a country whose road transport links to the European continent pass through the UK — said that the EU will not give in to British demands for full access to the bloc's single market unless London allows free movement of people: 'Let me tell you that around the European Council table, that is an issue that will not be given in on'.[104] Ireland has also put in a bid to host the European Banking Authority, currently located in London,[105] but this eventually went to Paris.

- Joseph Muscat, the prime minister of Malta and the EU's rotating president when Article 50 was triggered said the UK 'can't have the cake and eat it' and would be offered an inferior deal to full EU membership: 'All of us have been pretty clear in our approach that we want a fair deal for the UK but that kind of fair deal can't translate itself into a superior deal'.[106] Speaking to the BBC's Katya Adler, he said EU leaders are not 'bluffing' when they say the UK will be left without access to the single market when it leaves the bloc if there is no free movement of people: 'This is really and truly our position and I don't see it changing'. He argued that discussions on any 'new relationship' could be delayed until certain key issues had been resolved, such as the bill the UK must pay before leaving, establishing what will happen to the UK-Republic of Ireland border and working out interim arrangements on issues like security and international treaty obligations, such as environmental agreements. He also said that even when a deal is agreed between EU leaders and the UK, the European Parliament may decide to veto it in 2019.[107] He repeated the point that the 'UK will get an inferior deal to full membership of the EU' in the European parliament on the day after Mrs May's Lancaster House speech.[108]

In December 2016, Michel Barnier, the EU's chief Brexit negotiator, made his first public statement on the exit negotiations once Article 50 is triggered – one that had the apparent approval of the remaining 27 EU leaders.[109] He said:

- 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.

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[104] Conor Humphries (2016) No access to EU market without free movement - Irish PM tells Britain, *Reuters*, 12 September.
[105] James Blitz (2016) Brexit Briefing- The battle for London's business, *Financial Times*, 27 October.
[106] Nicholas Cecil (2016) Brexit chief tells UK: You can't have cake and eat it, *Evening Standard*, 21 September.
[107] EU leaders 'not bluffing' over Brexit terms, warns Malta's PM, *BBC News*, 25 November 2016.
[108] BBC News, 18 January 2017. The speech is discussed in section 20.
[109] Mr Barnier was appointed on 1 October 2016 by European Commission President Jean-Claude Juncker and heads a team of 30.

- 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.[110]

This was enough to draw the ire of even the mild-mannered Andrew Tyrie, chair of the Treasury select committee: 'Mr Barnier's latest contribution is of just the type calculated to raise the political temperature at a time when he should be lowering it'.

Downing Street's response to all this rhetoric was to reiterate the desire for a pragmatic outcome: 'This is a negotiation that will take place next year and the government will set out its negotiating strategy in the fullness of time. The aim of that negotiation is to get the best possible deal for Britain, for British companies to access and work with and within the single market and for European businesses to have the same access here'.[111]

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 UK side has already made a number of public concessions: the prime minister has told the Confederation of British Industry (CBI) that it accepts the need for transition arrangements, while David Davis, the Brexit secretary, has said that he would consider continued EU budget contributions in exchange for single market access. This has helped to harden the EU's red lines.[112]

It is clear from the above that the comment made by a senior Bulgarian central banker in 1992 is still true: the Brussels bureaucracy has the same aims and methods as the Comintern, but without the Comintern's sensitivity to local needs.[113]

10. The City's current relationship with the EU

Before assessing how Brexit will affect the City, it is important to look at the City of London's current relationship with the EU.

10.1 Facts and figures

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

[110] Alex Barker (2016) Brussels on Brexit: What Michel Barnier said and what he meant, *Financial Times*, 7 December.

[111] EU leaders 'not bluffing' over Brexit terms, warns Malta's PM, *BBC News*, 25 November 2016.

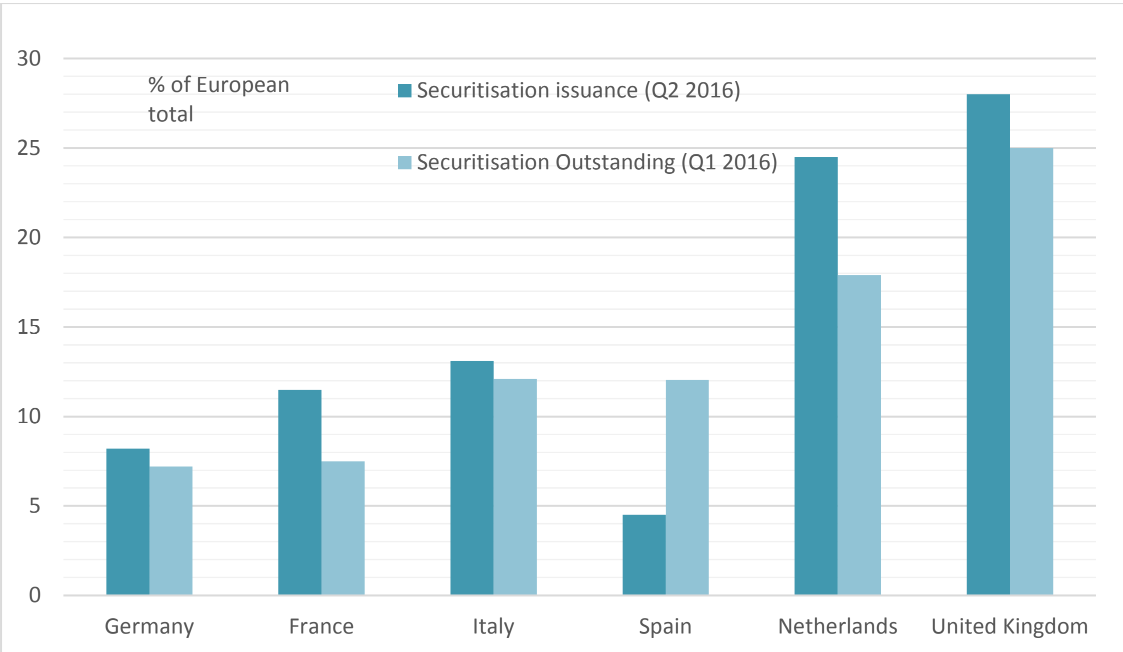
[112] Peter Foster (2016) EU Brexit negotiator Michel Barnier to reiterate 'no cherry picking' mantra, as Europe reveals details of negotiating plans, *Daily Telegraph*, 6 December.

[113] Quoted from Martin Hutchinson (2016) The real danger is staying in, *The Bear's Lair*, 18 January.

to the EU.[114] 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.[115] The UK securities market is the biggest in Europe (Fig. 1), 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 (Fig. 2), and the UK is by far the largest market in Europe for 'alternative finance' (Fig. 3).[116]

Despite this, UK exports of financial and insurance services to the EU have been systematically falling as a share of total exports, from 38% in 2010 to 34% in 2013. And this was during the period when the single market was supposed to becoming more integrated. The rest of the world (ROW) accounts for around 60% of UK net financial services exports: key non-EU markets are the US (receiving 25% of UK net financial services exports), Japan, Switzerland, Russia, Canada, and Australia. The ROW accounts for around 80% of our insurance exports: key non-EU markets are the US, Australia, Canada, Japan, Turkey, China, Singapore, South Korea, South Africa and Mexico.[117]

Figure 1: Securities markets in selected European states



Sources: SIFMA, @joshdigga

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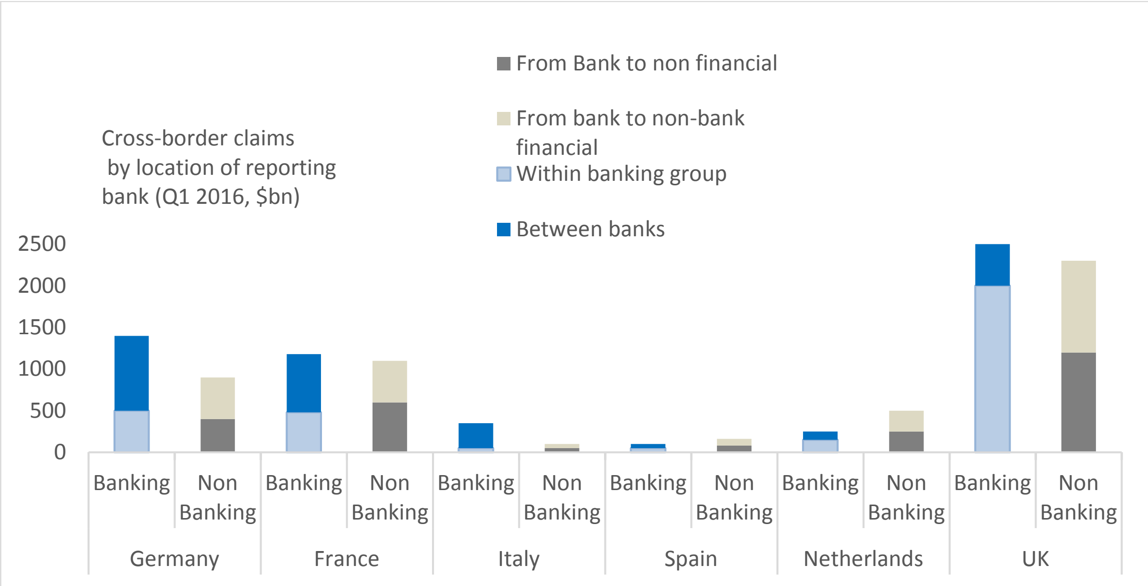
[114] David Wighton (2016) Great Brexit bake-off may produce a much smaller cake than promised, *Financial News*, 3-9 October.

[115] Report for the British Bankers' Association by the lawyers Clifford Chance and the consultants Global Counsel, as reported in Martin Arnold (2016) 'Significant' Brexit risk for 5,500 UK groups using EU passporting, *Financial Times*, 20 September; Robert Colvile (2016) How the world conquered the City, *CAPX*, 27 September.

[116] Lev Borodovsky (2016) Today's Markets in 49 Charts, *Wall Street Journal*, 10 October; http://blogs.wsj.com/dailyshot/2016/10/10/todays-markets-in-49-charts/

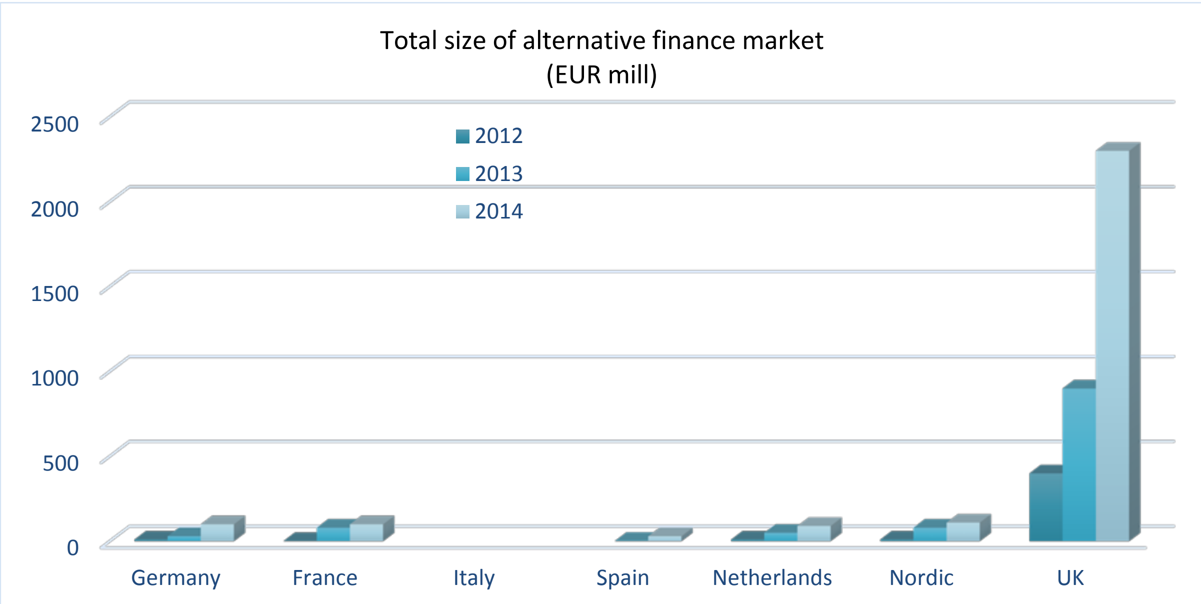
[117] Ruth Lea (2015) *UK exports of insurance and financial services are crucially important, but EU share is falling as growth disappoints*, Economists for Britain, February; http://forbritain.org/EfBFinancialandInsurance.pdf

Figure 2: Cross-border lending to banks and corporates in selected European states



Source: BIS, @joshdigga

Figure 3: The alternative finance market in selected European states



Sources: European Commission, University of Cambridge, @joshdigga

10.2 Passports and equivalence

A brief explanation of 'passporting' and 'equivalence'

Being a member of the EU places the UK inside the coverage of the EU Treaties, conferring single market access rights, 'passports', and the assumption of regulatory 'equivalence':

What are 'passports'?

• Being a member of the EEA and being bound by EU legislation confers the right to 'passport' certain services across the EEA, either on a cross-border basis or through branches, without the need for additional local authorisations

• This legislation limits the extent to which member states can impose additional regulatory requirements on businesses exercising their passport rights

• These passports are not yet available to third-country firms (firms based in countries that are not within the EEA), although there is provision for third-country passports in the Markets in Financial Instruments Directive II (MiFID II) and the Alternative Investment Fund Managers Directive (AIFMD)

What is 'equivalence'?

• Some recent EU legislation has included some 'third-country regimes' which allow non-EEA firms to provide services into the EEA if their home country regulatory regime is 'equivalent' to EU standards. Equivalence sometimes also requires reciprocity (for example, European Market Infrastructure Regulation (EMIR), Central Counterparty (CCP)[118] equivalence)

• These regimes cover a more limited range of services and provide fewer additional rights than the existing passports for EU firms, and may also be subject to additional conditions

• Unlike an EEA 'passport', the rights under these regimes can be withdrawn at any time if a home country deviates materially from EU standards

EU legislation generally requires that the European Commission makes the determination of equivalence, but in some cases this may be left to member states or their national regulators

Becoming a third country with respect to the EEA, means not having to accept the decisions of the European Court of Justice, and has significant regulatory consequence with regards both single market access 'passporting' rights and regulatory 'equivalence':

Single market access 'passporting' rights

• Once a third country, the UK will be outside the coverage of the EU Treaties and the

[118] Clearing houses.

preferential terms conferred on its members with respect to accessing the EU single market

• Businesses trading between the EEA and the UK lose their 'passporting' rights, the freedom of service and freedom of establishment, that are conferred by the EU Treaties and legislation

Regulatory 'equivalence'

• Becoming a third country removes the assumption of regulatory equivalence that is broadly embedded in EU financial services frameworks

• Instead, UK-based entities will need to rely on 'third-country regimes' created under EU law which recognise equivalence for limited purposes

• Equivalence must be requested, tested and affirmed, and is contingent on ongoing proximity to EU standards over time

• Equivalence is not available with respect to the provision of all services, or the servicing of all client types

Note: The basis for 'passporting' is the Treaty for rights for freedom of establishment and freedom of services. The 'Single Market Directives' are specific pieces of legislation which harmonise the approach of such free movement of services and establishment for specific types of firms, products and clients. There are two further freedoms conferred: freedom of movement of capital and freedom of movement of persons. Financial services firms use all four freedoms.

Note: Asset managers can delegate portfolio management of a fund to countries other than that in which it is distributed or fund managed as per global norms. There are existing delegation provisions in key EU financial services legislation (for example, UCITS and AIFMD). Delegation is subject to a number of conditions.

Source: Oliver Wyman (2016, p10) *The Impact of the UK's Exit from the EU on the UK-based Financial Services Sector*, October (commissioned by TheCityUK).

Table 1 shows the total number of passports issued by the Financial Conduct Authority (FCA) in September 2016: 5,500 UK-registered financial services firms have a total of 336,421 passports in order to conduct business in the EEA,[119] while around 8,000 EEA financial services firms have 23,532 passports for business in the UK. So there would appear to be a strong reciprocal interest here. Further, at the time of Brexit, the UK will be fully compliant

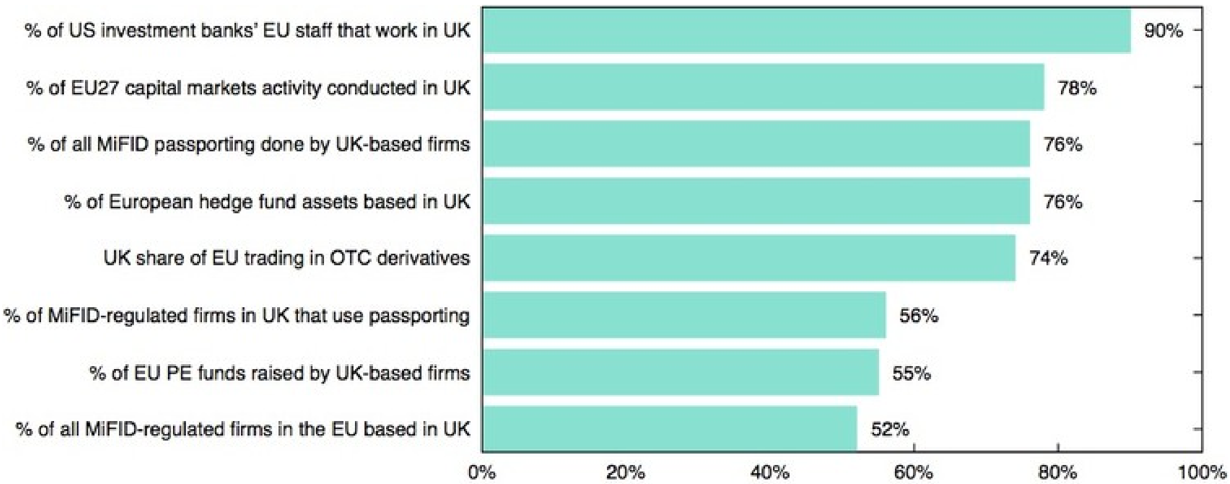
[119] The European Economic Area comprises all the member states of the EU (so covers the single market) plus Iceland, Liechtenstein and Norway. The UK is therefore currently a member of both the EU single market and the EEA.

with the UCITS V directive. Fig. 4, however, shows that UK-based firms dominate passporting activity within the single market – they conduct 76% of it.[120]

Table 1: Number of passports issued by the Financial Conduct Authority, September 2016

Directive	*Activity covered*	*Outbound*	*Inbound*
MiFID	Investment services	2250	988
AIFMD	Alternative funds	212	45
CRD IV	Commercial banking	102	552
Payment Services Directive (PSD)	Wiring services	284	115
Solvency II	Insurance	220	726
Insurance Distribution Directive	Insurance brokers	2758	5727
Total		5476	8008
Source: FCA			

Figure 4: The UK financial services market and passports



*Source: Wright (2016) The potential impact of Brexit on European capital markets.

The following is known about passporting arrangements within the EEA.

Banking

There are 91 UK-incorporated banks that use passporting — 60% of the total, but 95% in terms of assets and staff. UK banks, such as Lloyds, RBS and Barclays, do most of their business in the UK, so do not need a passport. Around 25% of the business of investment

[120] Kim Kaivanto (2016) Why Britain should play the long game with its Brexit strategy, *The Conversation*, 21 September; http://theconversation.com/why-britain-should-play-the-long-game-with-its-brexit-strategy-65507

banks located in the UK relates to the EU in some way or another, according to John McFarlane, chair of both Barclays and The CityUK.[121]

Insurance

Life insurance companies make little use of passporting, because their markets operate around local products, local preferences and local regulations. Life insurers that operate in foreign markets do so using subsidiaries subject to the local regulation. Aviva, for example, has subsidiaries in France, Italy and Spain. Similarly, foreign insurers operating in the UK life market use subsidiaries.

General (i.e, property and casualty) insurance companies operate in what is known as the London market, which is dominated by Lloyds. This market employs 34,000 people and contributes 20% of the City's gross domestic product. The EEA accounts for between 10 and 20% of premium income for some of these insurers and so passports are important. For example, Zurich passports into the UK from Dublin, while AIG passports from London into the rest of the EEA. These insurance companies could equally well use subsidiaries instead of passports: for example, Zurich has a UK-based subsidiary for its life insurance business. The subsidiary would need to be more than just be a post box. It would need to meet all the requirements of Solvency II, such as having local actuaries, underwriters, compliance staff and executives.[122]

The most common passport, however, is for insurance intermediaries and this has been granted to 2,758 UK firms and to 5,727 EEA firms.

Asset management

There are 94 EU firms with asset management passports into the UK, managing 9% of the assets under management, while 32 UK companies passport to the EEA with 6% of assets held by European investors. UK-based asset managers manage £1.2trn of investments for clients based in the rest of the EEA. Around 5% of this is held in UK-domiciled UCITS retail funds and the managers require MiFID passports from the FCA. The passports allow the managers to register these funds in Luxembourg or Dublin, but sell into the rest of the EEA, while most staff – including fund managers, marketing and sales teams – are based in London, although they will also make use of an EEA-based depositary for custodial purposes and need appropriate oversight of fund managers located in the UK. Without such a passport, the asset managers would have to set up a MiFID company in the EEA.

This would be an expensive and time-consuming exercise and apparently would require at a minimum 20-50 personnel experienced in risk, compliance and investment management functions. A MiFID licence can take months or even years to negotiate. However, many UK-based asset managers currently have a UCITS-compliant management company with UCITS-

[121] Laura Noonan, Patrick Jenkins and Harriet Agnew (2016) City's special relationship with EU finance system revealed, *Financial Times*, 25 September. This figure of 25% comes from the Oliver Wyman report discussed below.
[122] Oliver Ralph (2016) London's insurers rush to cover the Brexit bases, *Financial Times*, 29 September.

compliant funds. EEA-based investment managers wanting to sell to UK retail investors could either set up UK funds or apply for their non-UK funds to be 'recognised' by the FCA under existing UK rules and would need to demonstrate equivalent consumer protection to the FCA requirements.

Non-retail funds require a AIFMD[123] passport to market into the EEA. Without this, UK funds could only be marketed in the EEA if country-specific rules (known as 'national private placement regimes') permit. The EU will consider offering an AIFMD third-country passport if it considers the third country's regulatory regime is equivalent in terms of issues such as consumer protection, market disruption, competition, and the monitoring of systemic risk. This would allow third-country firms to market to professional investors across the EEA, subject to them obtaining authorisation in the EEA and fully complying with the AIFMD. The EU is considering offering such passports to Switzerland, Canada, Jersey, Guernsey, and Japan.

Asset managers running institutional mandates also need a MiFID passport to access clients in the EEA. Without this passport, they can only manage individual mandates for EEA investors if this is permitted under country-specific rules. However, under MiFID II, which came into effect in January 2018, there will be an equivalence regime for non-EEA countries. If the UK is regarded by the EU as having equivalent prudential and conduct regulation, UK firms can acquire a third-country passport to provide investment services to professional investors across the EEA without a branch or subsidiary following registration with ESMA. The UK will need to provide an equivalent level of access to the UK for EEA firms. The UK currently allows third-country investment managers to offer certain services to specific types of UK clients under its 'overseas persons exclusion' (as set out in the Financial Services and Markets Acts 2000 (Regulated Activities) Order 2001).

MiFID II does not grant third-country passports for distributing to retail investors. UK-based firms may need to set up EEA branches (if this is permitted in the relevant countries) or an EEA subsidiary (which could access retail clients across the EEA through a MiFID passport).

10.3 The Oliver Wyman report: *The Impact of the UK's Exit from the EU on the UK-based Financial Services Sector*, October 2016

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.[124]

The key information is contained in Table 2 which purports to show that 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

[123] Alternative Investment Fund Managers Directive – see Appendix 5.
[124] Oliver Wyman (2016) *The Impact of the UK's Exit from the EU on the UK-based Financial Services Sector*, October (commissioned by TheCityUK).

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% – see Table 3. The table also shows that, 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.[125]

Table 2: UK financial services sector revenues in 2015 - EU-related business

Sector	*Constituents*	*Revenues (£bn)*	*% of sector total revenues*
Banking	Sales & trading, investment banking, retail & business banking, private banking & wealth management	23-27	22
Insurance & reinsurance	Domestic retail & commercial, corporate & speciality, reinsurance	3-5	10
Asset management		5-6	26
Market infrastructure & other	Exchanges, clearing, inter-dealer broking, securities services, technology, credit rating agencies, payment & data services	9-12	26
Total		40-50	23

Note: International and wholesale business related to the EU includes: all EU client activities with financial services firms based in the UK, UK & Rest of World (ROW) client activity in EU/euro-linked products, UK and ROW activity occurring as a result of EU client activity (for example, portfolio delegation and risk management of trading positions)

Source: Oliver Wyman (2016, Figure 3) *The Impact of the UK's Exit from the EU on the UK-based Financial Services Sector*, October (commissioned by TheCityUK).

[125] To put this into perspective, UK auto manufacturing industry revenue in 2015 was £72bn and 44% of UK manufactured cars were exported to the EU.

Table 3: The impact of passporting on financial services revenue

Sector	Revenue [3]		EU-related revenue				Pass-port cover-age	EU-related revenue at risk due to loss of passporting			Loss of revenue under two passporting loss scenarios			
	£ bn	%	Oliver Wyman [4]		EfB assump			£ bn	% of tot. ind. rev.	Comment	25% at risk revenue lost		50% at risk revenue lost	
			£ bn	%	£ bn	%					£ bn	% of tot. ind. rev.	£ bn	% of tot. ind. rev.
Banking	109	64%	25	23%	12.9			13 (Max)	7.6%	Represents the maximum amount at risk because passporting does not comprehensively cover all sub-sectors of banking	3.2	1.9%	6.4	3.8%
Sales/trading	30				4.5	15%	Yes				1.1		2.3	
Investment banking	11				2.2	20%	Yes				0.6		1.1	
Retail & business banking	62													
Retail (Say, 60%)**	37				0	0%	No			Virtually no EU-related business	0.0		0.0	
Wholesale	25				5.0	20%	Yes				1.2		2.5	

(Say, 40%)**														
Private banking & wealth management	6				1.2	20%	Partial				0.3		0.6	
Insurance	40	23%	4	10%	4.0	10%		0.5	0.3%	Only 13% of EU business is potentially vulnerable because 87% of EU business is conducted via European subsidiaries as a consequence of no single market existing for insurance services[4]. (Possibly none is vulnerable as passporting generally is not employed)	0.13	0.1%	0.26	0.2%
Domestic retail & commercial	28		0				No							
Corporate & speciality	9		3*				No							
Reinsurance	3		1*				No							

Asset management	22	13%	6	25%	5.5	25%	Partial	1.8	1.1%	Two-thirds of EU assets managed in the UK are done so via delegation, in line with international norms, and therefore not directly reliant on the passport [4]	0.45	0.27 %	0.91	0.53 %
Total	171	100%	35	20%	22	13%		15	**9%**		3.8	**2.2%**	7.6	**4.4%**

* Inferred from discussion with Oliver Wyman

** EfB Assumption

Source: *A brief on the City after Brexit*, Written Submission to House of Commons International Trade Committee, Economists for Brexit, 16 December 2016

10.4 The Open Europe report: *How the UK's financial services sector can continue thriving after Brexit*, October 2016

A report by Open Europe was also published in October 2016. It focuses on the issue of passports. Table 4 shows the degree of reliance of different financial services sectors on passports. It suggests, in particular, that CRD IV or UCITS V (covering retail investors) do not allow for equivalence or meaningful third-country access.[126]

Table 4: Importance of EU passport by sector

Industry	Main EU law	Importance of EU passport	Is EU equivalence available?	Does equivalence grant passport-like rights?	Other alternatives and recommendations
Banking	MiFID (MiFID II/MiFIR in 2018)	**High** **Long established, few barriers** (*CRD IV:* deposit-taking, lending, payment services, etc. *MiFID II:* portfolio management, investment advice, etc.)	Yes	Yes	• Bespoke UK-EU deal covering main elements of CRD IV passport • Push for equivalence in CRD V • Set up subsidiaries in EU countries (access to passport) • Operate branches in EU countries (no access to passport)
	CRD IV		No	No	
Asset management	AIFMD (professional clients)	**Medium** **Distribute funds across bloc, manage from single location** (marketing and management of funds across borders)	No	Potentially (via MiFIR)	• Push for swift implementation of third-country AIFMD passport • Push for third-country passport in UCITS VI • Delegation of portfolio management • Private placement • Passive marketing
	UCITS V (retail clients)		No	No	
Insurance	Solvency II	**Low** **Globally diversified, use subsidiaries** (direct insurance and re-insurance, cross-border and via branches)	Yes (re-insurance)	Yes	• Bespoke UK-EU deal covering Lloyd's of London • Expand existing subsidiaries in EU countries and/or set up new ones
			No (direct insurance)	No	

The report concludes:

- *The financial services passport is not a single thing. In reality, there are a series of sector-specific passports built upon dozens of financial regulations and principles. In some sectors, the passport is important to the business, but in other sectors it has much less value. The assertion that the success of the City of London is based on full and complete access to the EU single market in financial services is not borne out by our analysis. However, the loss of the passport could be damaging to some sectors if the government does not negotiate effective alternative arrangements with the EU.*

- *The passport works best in banking (wholesale and investment). Around a fifth of the banking sector's annual revenue is estimated to be tied to the passport. The passport in banking is also a two-way street, with a number of large EU banks making*

[126] CRD is the Capital Requirements Directive and UCITS is the Undertakings for Collective Investments in Transferable Securities Directive – see Appendix 5.

significant proportions of the revenue in London via the passport. Deutsche Bank, for instance, gets 19% of its revenue in the UK.

- *Passporting works less well for asset managers, given that a number of technical barriers remain to marketing funds across the EU (e.g., supervisory and legal fees). Many of the larger funds already choose to operate European subsidiaries, rather than relying on a passport. A large chunk of EU clients' assets are already kept in funds domiciled in Dublin and Luxembourg, with management delegated to the UK. Based on a recent industry survey by the Investment Association, we conclude that a maximum of around 7% of assets managed in the UK would be under direct threat from the loss of the passport.*

- *Insurance is a global industry: 28% of insurance exports went to the EU in 2015, compared to 44% for financial services in general. There is no real single market in insurance in the EU. Up to 87% of insurers operating across borders in the EU do so via subsidiaries rather than branches (reliant on the passport). Lloyd's of London is an important exception to this. The current regulations allow the pool of underwriters based in London to serve clients across the EU. However, even this only accounts for 11% of the market's gross written premium, £2.9 billion – with possibly as little as £800 million (3%) directly reliant on the passport.*

- *If the current passporting system is lost, there are three broad alternatives: 'equivalence', bespoke agreements and local arrangements.*

- *In some cases, equivalence can offer access to the single market when a country is judged by the EU to have a broadly equivalent regulatory and supervisory regime. However, it is a partial solution. While some EU regulations offer passport-like rights for third countries (e.g. MiFIR[127]), others offer no equivalence at all (e.g. CRD IV). Granting equivalence is also a political decision, requiring a judgment from the European Commission, and can take several years. That being said, the UK starts from the basis of having the exact same regulations as the EU – something which should make equivalence easier to achieve.*

- *Negotiating bespoke deals to keep passports based on certain EU regulations will be necessary where equivalence is not available. There is precedent for this, for example the EU has a bespoke agreement with Switzerland on the provision of direct insurance (not including life insurance) via branches.*

- *Where the government does not succeed in negotiating cross-border access, financial firms will still be able set up local branches and subsidiaries if they wish to continue to provide services in certain member states. However, this may require significant investment in terms of capital, staff and infrastructure and may involve moving some of it from the UK.*

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[127] Markets in Financial Instruments Regulation – see Appendix 5.

11. What does the City want?

The City's two key demands for the Brexit negotiations are access both to the single market and to Europe's best labour talent. But differences emerge over other issues such as regulation. According to Alex McDonald, CEO of the Wholesale Markets Brokers' Association: 'The City is pretty aligned when it comes to the main issues. Passporting of permissions [under MiFID, AIFMD and UCITS], of capital and transactions between the two regions, and the work permit issue. They need access to labour. If you speak to the heads of the largest organisations, it's all about talent and the people. As for the balance between passporting and deregulation, it is very one-sided on passporting'.[128]

Anthony Browne added that the crucial point was to 'retain Europe's integrated financial market, not split it in two by building a wall along the channel. The only way to ensure that [outcome] is for banks based in the UK to retain full access to the single market in financial services and for European banks based in Europe to retain full access to the UK's global financial centre and customers based here. In other words, we need to retain some version of 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'.[129]

11.1 Access to the single market via passports is the preferred option

The main way in which UK-based financial services firms currently provide services in the single market is through 'passporting'. As we have seen, this allows firms authorised in one member state to operate in any other member state without additional permission. 'Third-country firms' – from countries such as the US, Switzerland and Japan – with a subsidiary in the UK can also use their UK passports to trade in the EU.

The investment managers were very clear about the desirability of retaining passports. Aberdeen Asset Management's Martin Gilbert said: 'The only thing we want is the continuation of passporting of services. Just as we manage some of our Luxembourg-domiciled funds out of Singapore, and some out of Philadelphia, we manage some out of London. That needs to continue; that's the only thing we really want. It's not so much the passporting of fund sales into Europe, it's the passporting of services out of Europe and into the UK in order to be able to manage EU-domiciled funds. We think it's pretty low-risk that the EU wouldn't allow this; that would also kill US managers being able to manage Luxembourg funds, which they do at the moment, for example'.[130] Insurance is regarded as less vulnerable to passports. Although Europe's insurance industry is heavily concentrated in the UK, this high market share is due mainly to historical relationships, rather than to the UK

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[128] City of London talks tactics on Brexit negotiations, *Financial News*, 1 August 2016. This was the predominant view for the first six months after the Referendum vote.

[129] Tim Burke (2016) BBA chief: 'Banks planning for worst case Brexit scenario', *Financial News*, 20 October.

[130] City of London talks tactics on Brexit negotiations, *Financial News*, 1 August 2016.

being part of the EU. And, as previously mentioned, the insurance industry has traditionally used subsidiaries to access different member states.[131]

The banks' preferred method of accessing the single market is also via passporting. This includes the US and Swiss banks – 90% of the European staff of US banks are based in London. According to Tim Skeet, chairman of Britain for Europe, in the absence of passporting rights: 'People servicing clients – origination and sales people – would have to be relocated within the EU… Clearing of euro transactions might have to move, a long-held hope of the European Central Bank. Traders might stay, although cut off from the primary market teams, the infrastructure of the capital markets would start to look bizarre. Likewise, elements of fund managers' work might equally have to move. There are issues around the workability of the complex and much-delayed MiFID regulations that might render them unworkable with the UK outside the EU'.[132]

In the absence of a deal that gives universal access to the single market, the key City trade groups – such as UK Finance and TheCityUK[133] – have been lobbying for a tailor-made bilateral deal that allows all the different sectors of the City to trade with Europe. Chris Cummings, then CEO of TheCityUK, said it wanted 'a bespoke solution for the UK…that protects our single-market access and makes sure we have supervisory equivalence'. The preferred model is similar to but more comprehensive than Switzerland's current trading arrangement with the EU – the so-called 'Swiss banking' model. These trade groups have rejected the 'Norway model' – whereby Norway has access to the single market via its membership of the EEA, but has no influence on how regulations are set, and must accept both free movement of people and make budgetary contributions – as politically and practically impossible following the Referendum result.

Anthony Browne said: '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'. He says that Swiss insurance companies have full two-way access to the single market via passporting in exchange for Switzerland keeping its insurance regulation at an 'equivalent' level to that of the EU. Swiss banks, however, do not benefit from any such trade deal and so they have to conduct most of their EU capital markets business through London-based subsidiaries. Since the UK is the

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[131] Simeon Djankov (2016) Why London won't lose its crown as Europe's financial capital, *CAPX*, 1 September; http://capx.co/why-london-wont-lose-its-crown-as-europes-financial-capital/

[132] Tim Skeet (2016) Big parts of the City might vote with their feet, *Financial News*, 9 September.

[133] A new umbrella group representing large financial institutions, the European Financial Services Chairman's Advisory Committee, chaired by Baroness Shriti Vadera who also chairs Santander UK, was set up within days of the Referendum. But in September 2016, this group was absorbed into TheCityUK after complaints from smaller institutions who said that their concerns would not be heard if the government dealt separately with the larger banks. One employee of an international bank involved in the talks said: 'It was a complete dog's breakfast. There were a lot of egos involved. The groups weren't connected on content or policy. But it's now been reined in'. (Anjuli Davies, Andrew MacAskill and Huw Jones (2016) Britain's finance sector at odds over Brexit lobbying, *Reuters*, 3 October). Another pressure group, the Financial Services Negotiating Forum, chaired by Daniel Hodson, former CEO of Liffe, and Anthony Belchambers, founder of the Futures and Options Association, was set up in September 2016.

EU's biggest export market, these trade groups believe a 'Swiss-plus' deal that also covers banking activities – such as cross-border lending and corporate deposit-taking – and asset management is feasible.

This view is shared by Xavier Rolet of the London Stock Exchange: 'European companies large and small as well as governments rely heavily on access to the UK financial services sector and [we will] look at the impact of the sector on the real economy. I do think that in a world where financial and business flows are deeply global and interconnected it is critical for passporting to be maintained and that requires some element of regulatory equivalency'.[134]

If, however, there is a loss of passporting and no bi-lateral deal, investment banks are looking at four models to help them continue doing business in the EU after Brexit with as little disruption as possible to their UK operations:

- The dream is the so-called introductory model, under which bank sales teams in the EU 'introduce' clients to the UK entity. But EU local regulators are unlikely to share enthusiasm for this model because it doesn't give them much oversight of the banks.
- A European branch model could see the re-activation of licenses with different European countries. Fully capitalised subsidiaries wouldn't be required, with banks then able to 'branch' into specific countries.
- In a back-to-back model, an EU entity would host a compliance team and a few traders. Deals would move across to a bigger entity in the UK or New York after being booked in the EU.
- Or if all else fails there's the full blown bank model, requiring significant capital, trading infrastructure, compliance and top management. The creation of 'mini-me' versions of their investment banks could be a costly approach for lenders already under pressure to cut costs.[135]

The Open Europe report cited earlier also favours passporting where this is possible:[136]

- *The government's primary objective, with regards to financial services, should be to try and keep the CRD IV passport in place to ensure that London can remain a centre of international banking. CRD IV does not allow for equivalence, or meaningful third party access, so this could be achieved through a specific bilateral agreement (similar to the EU-Swiss deal on insurance) or as a specific chapter of a comprehensive UK-EU free trade agreement. There will need to be deep cooperation on the supervision of the banking sector. The UK should pursue equivalence under MiFIR, which would allow many of the investment banking services provided via the passport (including those by foreign firms) to continue.*

[134] Reported in Martin Arnold and Caroline Binham (2016) UK financial sector targets Swiss-style deal for EU market access, *Financial Times*, 18 August.
[135] Samuel Agini (2016) Banks' blueprints for Brexit, *Financial News*, 28 November.
[136] Open Europe (2016) *How the UK's financial services sector can continue thriving after Brexit*, October.

- *The UK should seek to ensure that EU-domiciled funds can still be managed from the UK after Brexit. This can be done via so-called 'delegation' of portfolio management and may involve firms setting up some additional operations in the EU. Achieving equivalence under MiFIR would also give asset managers a chance to retain passport-like rights for some of the services they offer to professional investors.*

- *The UK should also try and obtain equivalence under Solvency II to help smooth the transition for the insurance industry. A bespoke agreement will be important for Lloyd's of London. Keeping asset managers, insurers and pension funds on board and invested in the UK will be vital. If they (the buy side) stay, the sell side (banks and other businesses) is also more likely maintain the bulk of their operations in London.*

- *Given the fluid nature of the financial services sector, the government should aim to offer the industry maximum certainty about the prospects for future market access and possible transitional arrangements as early on as possible. It is essential to avoid a cliff-edge situation and give the industry enough time to adapt to whatever the new reality is. Based on our background conversations, if banks, for instance, were still unclear about what the future holds one year before the UK formally exits the EU, they would be forced to start making decisions – including over whether to shift part of their business elsewhere. Some firms may well start implementing their contingency plans even earlier than that. A transitional agreement to keep the existing reciprocal passport arrangements in place would allow the industry greater time to plan and the UK government to negotiate alternative arrangements with the EU.*

- *The UK should push for 'pre-emptive equivalence' in areas where it seeks it. This would see the process of judging equivalence starting immediately while the UK is still inside the EU and during the Article 50 negotiations. There is some precedent for this under Solvency II – with equivalence being approved before the directive was fully in force.*

- *The UK needs to convince the EU that keeping cross-Channel financial markets open is a mutual interest. Throughout the negotiating process, the UK should make it clear to its European partners that this is not a 'zero-sum game' and think creatively about how to ensure that the new trade arrangements benefit EU companies and governments. Fragmenting London's financial services ecosystem would lead to higher costs for all concerned. Indeed, if business moves out of London, it is far from obvious that it would relocate in the EU. Financial hubs located outside of the EU would be just as, if not more, likely to reap the benefits. Furthermore, if certain business lines no longer look profitable from the UK they might just be discontinued altogether – a deadweight loss for the UK and EU economy and all consumers of financial services.*

- *The UK should offer reciprocal access to its markets to EU firms, and maintain the current access offered to third countries (granted through EU equivalence at the moment). This will mean the UK would create and establish its own equivalence* *system. The UK should also quickly seek to establish its baseline at the WTO and its commitment to the General Agreement on Trade in Services (GATS).*

- *Domestic reform would help to ensure that London, and the UK more widely, remains an attractive place to for financial services to do business. In particular, the UK government should consider scrapping the bank levy and the corporation tax surcharge for banks. However, at the very least, it should consider faster reductions in the bank levy rate and slower introductions of the corporation tax surcharge.*

Key questions for each sector

Fund management
1. Will UK fund managers be able to get third-country passports under MiFID and AIFMD?
2. Could some bespoke UK deal be struck on UCITS?
3. Will firms still be able to hire EU nationals as easily, and will they want to come here?

Investment banking
1. Will the UK negotiate passporting rights for banks to continue selling services in the EU from a UK subsidiary?
2. Will the UK remain in line with EU financial regulation such as the bankers bonus cap?
3. What might the UK government be prepared to give up to ensure freedom of movement?

Trading and technology
1. What will happen to the implementation of post-crisis market structure regulation such as EMIR,[137] MiFID II and CSDR[138]?
2. Will London-based firms be allowed to clear euro-denominated assets?
3. If the UK ended up outside of the EEA, would its regulation be deemed equivalent?

11.2 Regulation and compliance costs

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 – presumably for reasons not unrelated to those outlined by Daniel Hannan above. 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. Jon Moulton, of private equity company Better Capital, said: ‘creating a good lively and attractive and sensible regulatory regime in London is a big job and it’s an important job’, while Edi Truell, chairman of Disruptive Capital Finance, wants ‘a bonfire of controls throughout the economy’.

[137] European Market Infrastructure Regulation – see Appendix 5.
[138] Central Securities Depositories Regulation – see Appendix 5.

Some commentators believe the UK financial regulators could 'loosen up a little' to compensate for any transfer of business and jobs to the EU and the associated loss of tax revenues: 'Following the post-crisis avalanche of regulation and frenzy of bank-bashing, Chancellor George Osborne promised a "new settlement" with the City after the 2015 general election. The hope is that delivery of the new settlement will now be speeded up… There have been some recent signs of flexibility. Some analysts believe the Bank of England's decision to reduce the banks' countercyclical capital buffers could be followed by other moves to stimulate lending in an effort to soften the economic impact of the Leave vote. The Bank also announced a relaxation of the Solvency II regime for insurers'.[139]

However, there was more common agreement when it came to the issue of compliance costs. A survey of investment bankers published in November 2016 predicted that, while London would remain Europe's financial centre, there would be an increase in compliance costs and both the UK and EU financial markets would be damaged. A particular concern was whether a transition period would be granted between the UK leaving the EU and any new business and regulatory regime being implemented. Without this, some firms may decide sooner rather than later to shift staff and business to another EU state. Others believed that there was a low chance of a transition period being agreed upfront, since it was in the EU's interest to force banks to relocate staff long before the UK's formal exit from the EU.[140]

In anticipation of this, some companies were making contingency plans. For example, in October 2016, M&G revealed plans to launch Luxembourg-based SICAVs[141] and was seeking permission from the local regulator, although it was unlikely to move UK-based staff to Luxembourg. It said that 'a Luxembourg retail SICAV platform will enable us to offer fund strategies to European retail investors if the UK loses financial services passporting rights' and it estimates that 10% of its assets come from European investors.[142] Similarly, Lloyd's of London announced it would seek regulatory clearance for a subsidiary it would establish on the continent in 2017, which will be used to conduct business around the EU using passporting. It said the new subsidiary will cost tens of millions to set up, will need to be fully capitalised and will increase the market's operating costs, notably in compliance and regulation.[143] It later transpired that the subsidiary would be set up with no more than 50 people, despite Lloyds warning in June 2016 that Brexit could lead to 34,000 commercial insurance jobs moving to the continent.[144]

[139] David Wighton (2016) City hopes new order will ease rules to offset EU exit, *Financial News*, 8 July.
[140] Tim Burke (2016) City bankers back London but predict Brexit pain, *Financial News*, 2 November.
[141] A SICAV (Société d'investissement à Capital Variable) is a type of open-ended investment fund in which the amount of capital in the fund varies according to the number of investors. Shares in the fund are bought and sold based on the fund's current net asset value. (http://www.investopedia.com/terms/s/sicav.asp).
[142] Anna Fedorova (2016) M&G reveals plans to create Luxembourg hub post Brexit, *Investment Week*, 10 October.
[143] Jonathan Ford and Caroline Binham (2016) Lloyd's of London to establish EU base in the new year, *Financial Times*, 15 December.
[144] James Burton (2016) So much for an exodus! Lloyd's of London moves just 50 jobs to Europe - after warning 34,000 could go overseas as a result of Brexit, *Daily Mail*, 16 December.

11.3 Access to talent

London is particularly dependent on migrant workers, both skilled and unskilled. Non-UK workers account for 25% of the capital's workforce, compared with just 8% in the rest of the country. In a report for the London Chamber of Commerce and Industry (LCCI), the Centre for Economics and Business Research (CEBR) estimated that there were 771,000 non-UK EU nationals working in London (40,000 work in the City[145]) and 160,000 of these would not be entitled to a visa under the current tier 2 visa rules. According to the CEBR, losing these workers would reduce London's GDP by £7bn by 2020 – with a consequential loss of £2bn in direct tax revenues.[146]

Michaël De Lathauwer, co-CEO of pension scheme fiduciary manager Cardano, reflected the views of many in the City when it came to access to talent: 'I would say that at least the people who have the technical capabilities, who actually are in jobs, Europeans here in London, should be able to maintain [their right to work in the UK]. And secondly the ability to continue to attract people from European countries for very specific roles'. Lisa Rabbe, former EMEA head of public policy at Credit Suisse, said: 'The worst case scenario would be some kind of acrimonious UK/EU negotiations that yielded some kind of tit-for-tat restrictions on EU and UK nationals being able to work in each other's jurisdictions. I think that's unlikely because I think both sides have so much to lose from that and I think that's very clear to both sides'.[147] Paul Manduca, co-head of the Brexit committee of the TheCityUK who also chairs insurance group Prudential, also anticipated that EU hiring would not be curtailed, citing comments from Philip Hammond that there was 'no likelihood' that post-Brexit immigration controls would apply to highly skilled EU workers.[148]

Mahoney et al. (2016) argue that 'in addressing concerns about immigration, the UK government will almost certainly seek to make provisions for skills in the financial services industry within its new so-called "points-based" system'.[149] The government subsequently rejected the points-based system as too slow and hence unworkable.[150] Others prefer a US-style 'green card' system which gives a green card to those offered a job by a company.

Carolyn Fairbairn, Director General of the CBI, has said the government risks hurting businesses if it implements a new immigration system that is too bureaucratic. David Davis, the Brexit secretary, accepts this: 'As we take back control of immigration by ending free movement as it has operated before, let me also say this, we won't do so in a way that it is

[145] Approximately, 40,000 (11%) of the City's 360,000 workers come from the rest of the EU (Harriet Agnew and Patrick Jenkins (2016) Big Bang II: After Brexit, what's next for the City of London?, *Financial Times*, 1 September).
[146] Hayley Kirton (2016) Getting immigration wrong post-Brexit could lose London £7bn by 2020, *City A.M.*, 10 November.
[147] City of London talks tactics on Brexit negotiations, *Financial News*, 1 August 2016.
[148] Patrick Jenkins and Jonathan Ford (2016) City of London lobby group wants 'no change' Brexit deal, *Financial Times*, 8 November.
[149] Daniel Mahoney, Tim Knox and Jon Moulton (2016) The City slickers are here to stay, *Centre for Policy Studies Economic Bulletin Number 83*, 7 September.
[150] Bernard Goyder (2016) The home office is looking into a work permit system, *Financial News*, 12 September.

contrary to the national and economic interest. Because as the chancellor has said, Britain must win the global battle for talent. No-one wants to see labour shortages in key sectors. That wouldn't be in anybody's interest'.[151] This view is supported by Daniel Hannan: 'Philip Hammond is right to oppose restrictions on skilled migrants. As he says, the objections to immigration were never about "computer programmers, brain surgeons, bankers". A poll commissioned by British Future shows that 88 per cent of voters want skilled workers to continue to come here. Indeed, the chancellor should go further, and actively ease restrictions on key industries, such as pharmaceuticals and financial services, thus stealing a march on our rivals'.[152]

The LCCI has proposed that currently employed EU nationals should be issued with a 'London work visa' after Brexit. This would also be used for all other international appointments. Colin Stanbridge, CEO of LCCI, said: 'Immigration has underpinned London's economic, social and cultural development over centuries, making it the great city it is today. CEBR's analysis reveals the significant contribution that migrant workers make to the modern London economy...Given their role and input it is vital to London's future that a degree of flexibility is applied if government amends the UK immigration system'.[153]

Leaders of the UK's fintech industries propose the following:[154]

- *The visas of skilled tech workers from strong tech nations (USA, India, Commonwealth, Eastern Europe) need to be preserved post-Brexit.*
- *It is essential that British universities remain an attractive place to study for non-British and British citizens alike.*
- *To that end we would like the UK government to implement a "STEM[155] Passport."*
- *Ensure the UK is open and welcoming toward skilled workers; is still able to recruit the best skills and entrepreneurial talent across Europe, with minimal barriers to movement; and that existing migrant workers are allowed to stay and continue to work in the UK. The UK professional developer population is currently the largest in Europe, at 745,000 out of 4.7 million (Atomico research) and is the No.1 destination for inbound tech talent (Balderton research).*
- *The No. 1 concern for entrepreneurs post-Brexit is access to talent, in particular technical talent. Hiring through existing visa processes is timely and expensive.*

[151] Joe Watts (2016) Brexit: David Davis says free movement will not be axed in a way that damages the British economy, *Independent*, 2 December 2016.
[152] Daniel Hannan (2016) Brexit must open our economy to the world – not lock it away behind protectionist barriers, *Daily Telegraph*, 26 October.
[153] Hayley Kirton (2016) Getting immigration wrong post-Brexit could lose London £7bn by 2020, *City A.M.*, 10 November.
[154] Letter to Rt Hon Theresa May MP, signed by Bernard Liautaud, Brent Hoberman CBE, Dale Murray CBE, Edward Wray, Niklas Zennström, Richard Reed CBE, Sherry Coutu CBE, Sonali De Rycker and Kathryn Parsons, 12 December 2016.
[155] Science, technology, engineering and mathematics.

Quotas on specific skills could severely limit the ability of new tech companies to grow, as well as limit the ability of British skilled students to learn alongside other global experts.

- *We must give STEM graduates from leading universities an instant qualifying visa to live and work in the UK, and end the uncertainty where they must leave and later re-apply.*
- *This would:*
    - *Ensure that fast-growing tech companies can continue to hire the best talent quickly.*
    - *Continue to make the UK's universities highly attractive to study at for STEM subjects, as students will not fear being forced to instantly leave the country after graduation. The UK already has many of the world's leading computer science institutions, including Oxford, Imperial, UCL, Edinburgh and Cambridge.*
    - *The government should look again at whether linking visa applications with the requirement to attain capital investment is the best way to retain skilled talent.*
    - *Plug a skill gap in STEM present in the UK while more investment is made into education in this space.*
    - *The government could create an 'easy win' with the promotion of a scheme to make awards to young brilliant engineers to relocate to the UK. This would send the right signals to the world and help to avoid any 'brand damage' done by recent government rhetoric around immigration*.

Jersey – with 103,000 residents – is an offshore financial centre that provides an extreme model: migrant workers need to be licensed for their first five years on the island and only those with 10 years' residency can buy a house. Senator Paul Routier argues: 'We use our mechanism of controlling people's access to housing and to work to keep things in balance'.[156]

Whatever solution is found for skilled workers, there remain issues concerning sectors of the economy that have historically relied on unskilled migrant labour. Charles Ind, managing partner at UK private equity firm Bowmark Capital, has the following concerns: 'If the ultimate outcome is a less flexible and less fluid market for unskilled labour, that would obviously have an adverse impact on companies in many sectors of private equity investment – and in particular healthcare, especially social care, and the hospitality industry,

[156] Gren Manuel (2016) Searching for an immigration model, UK officials look at Jersey, *Financial News*, 17 November.

such as casual dining'. These sectors employ unskilled migrant workers and remain core targets for private equity investment.[157]

William Hague, the former foreign secretary, proposes a system of work permits for any EU national who is offered a job in the UK, unless they have a criminal record or are on a terror watch list. In addition, 'we will not help them look for work, we will not pay them out-of-work benefits, we will not give them social housing and they will have to earn the right to any in-work benefits over time, but if they find work here they can come…That way, our economy will still be supported by the Europeans who help keep our restaurants, financial services and agriculture running, but we will have control over who comes here and what we give them. If the numbers in any one year were impossibly large, we could stop issuing such permits, but in practice this system would be one significant step short of the freedom of movement we have today, and we would expect the EU to give the same rights to British citizens in return'.[158]

11.4 Supporting support services

A particularly important support service to the UK financial services industry is the legal services sector. In December 2016, TheCityUK published a report called *The Impact of Brexit on the UK-based Legal Services Sector*. The lobby group wants the government to safeguard legal services as a 'vital asset for the UK' in view of the widespread use of English law in commercial contracts and international dispute resolutions. The report states that approximately 25% of the 320 legal jurisdictions worldwide are founded on English common law principles and 4% of governing law in global corporate arbitrations is English law. It also states that the UK legal services industry contributed £25.7 billion to the UK economy in 2015, employing 370,000 people, of whom around 20% work in the City. Miles Celic, the CEO of TheCityUK, said: 'It is vital that the key challenges and opportunities for the sector are addressed in the Brexit negotiations and that its competitiveness is maintained and enhanced'. The report presents four recommendations that will help safeguard the sector's competitiveness: promoting the 'ongoing value and validity of… English law in its Brexit messaging'; articulating how cross-border civil litigation will be handled once the UK leaves the EU; maintaining the sector's access to the free movement of professionals practising legal services; and engaging with industry bodies to assess and understand knock-on impacts of Brexit on the legal sector.[159]

12. What do Remain politicians want?

Andrew Tyrie MP, former chair of the Treasury select committee and a prominent Remain supporter, argues that the Brexit negotiations will present a 'formidable challenge' for the

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157 Jessica Davies (2016) Brexit visa regime a threat to private equity favourites, *Financial News*, 20 October.
158 William Hague (2016) How Theresa May can deliver the Goldilocks solution to Brexit: neither soft nor hard but the one that serves the country best, *Daily Telegraph*, 3 October.
159 Lucy McNulty (2016) City lobby wants clear post-Brexit plans for legal sector, *Financial News*, 20 December.

UK, especially over the issues of freedom of movement and bank passporting. He believes that 'In practice, the government is likely to conclude that it will need a negotiated settlement involving complex trade-offs between these various objectives'. At the same time, he believes that 'A reality check is in order for the EU. The four freedoms of the single market are not inviolable and inextricably interdependent. Far from being "completed", the single market in services remains, in places, an aspiration. Nor is freedom of movement for people as complete as it appears. Purism by EU negotiators on this point would not only be inconsistent with reality; it would also clash with other member states' economic interests'. 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'. He is opposed to the WTO option:

> *One proposal should probably be set aside from the start. This is that the government should rely entirely on its rights as a member of WTO, thereby avoiding protracted and difficult negotiations with the EU. Pursuing this option would leave goods exporters facing, on average, a tariff of 5.3%. But this average conceals much higher rates on a number of areas of importance for the UK, such as the 9.8% tariff levied by the EU on imported motor vehicles. Perhaps more important, many UK exporters would face the requirement not only to conform to EU standards, as they do currently, but to prove that conformity, in some cases by sending samples to the EU for independent testing. For pharmaceuticals and medical devices, another key area of interest for the UK, the conformity assessment requirements, and restrictions on marketing, could be particularly onerous.*
>
> *… For services, the deficiencies of the WTO option are greater still. Reliance on WTO rules would substantially curtail the UK's ability to conduct cross-border trade, and the rights of UK firms to establish a physical presence in the rest of the EU, with the level of access varying between member states. These barriers are significant and would be highly disruptive to the business of selling services into the EU, now and in the future. Many such businesses – including Vodafone, AXA, Centrica, EasyJet, Goldman Sachs, Lloyd's of London, the London Stock Exchange and Santander – warned of this disruption before the Referendum…[and] chose to highlight the importance of 'unrestricted access' to the single market because they were worried about the effects on their businesses*.

Mr Tyrie's preferred solution is to maintain passporting:

> *Securing continued market access for services is perhaps the biggest priority for the negotiations. The UK has a £17.1 billion trade surplus with the EU in this sector. But negotiations will not be straightforward. For financial services, which account for a third of the UK's services exports to the EU, the only 'off-the-shelf' arrangements to preserve the access currently enjoyed under the passporting regime would be through EEA membership. This would require the UK to conform to EU financial services regulation now and in the future, but with no formal say over its content or development.*

On services, particularly financial services, the UK needs a deal that gives it both access and influence, possibly by building on the current approach used by the EEA, through the establishment of standing regulatory committees. Its size – preponderance in financial services – and pre-existing levels of integration with the EU, mean that it is much better equipped to obtain something than any other country to negotiate this. Nonetheless, maintaining passporting arrangements, while preserving the control necessary to run the world's leading financial centre, will be one of the most challenging aspects of the negotiations.[160]

13. What does the UK financial regulator want?

Andrew Bailey, CEO of the Financial Conduct Authority, explained what the UK financial regulator wanted in a letter to Andrew Tyrie as chair of the Treasury Select Committee, dated 28 October 2016:

In arriving at what is, at this stage, necessarily initial FCA thinking on an 'optimal framework', we are mindful of our statutory objectives and therefore seek 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. The points I outline below are motivated with regard to those objectives.

Given the scope, scale and nature of the UK's financial services sector, a framework based upon five broad principles would help achieve this:

1. Cross-border market access. As is clear from the 'passporting' figures set out in my letter of 17 August,[161] *in particular with regard to wholesale and insurance business, UK and other EU firms operate cross-border into European and global markets as a matter of course. Open markets are an important enabler of healthy competition, supporting FCA objectives.*

2. Support for the principle of consistent global standards where markets are also global. With so many sectors of financial markets truly international in their cross-border activity, it is important that – where relevant – regulatory standards are globally consistent. This means in certain areas, particularly wholesale financial markets, having standards that are consistent across regions and jurisdictions in order to minimise the risks of regulatory arbitrage and fragmented markets. It also means regulators working effectively together through international standard setting organisations as well as regionally.

[160] Andrew Tyrie (2016*) Giving meaning to Brexit*, Open Europe, Briefing 09/2016, September; http://openeurope.org.uk/wp-content/uploads/2016/09/Giving_meaning_to_Brexit_Andrew_Tyrie.pdf
[161] See Table 1 above.

3. Cooperation between regulatory authorities. Where business is being done involving firms, customers and markets across different jurisdictions, close contact and collaboration between competent authorities is essential to ensure that regulatory standards and outcomes are met and enforced. The FCA benefits greatly from cooperation with regulators in Europe and more widely – we can share information, intelligence and best practice, and our interactions provide a platform for consistent and effective supervision. A robust framework which provides for continued cooperation will be fundamental in enabling us to meet our objectives.

4. Influence over standards. Where UK firms and consumers have access to cross-border markets, they are affected by the common standards governing these markets. In order to ensure that consumers are protected and markets are competitive and well-functioning, the UK authorities should have influence over the standards that structure these markets.

5. Opportunity to recruit and maintain a skilled workforce. The health of the UK's financial sector relies, in part upon it being able to recruit and maintain the right people with the right mix of skills. A diverse workforce with varied experience and the requisite expertise is a key ingredient in ensuring the UK's markets and firms are well run and remain competitive, protecting consumers.

Mr Bailey also explained the 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. EU rules instead are by their very nature the product of a negotiation between member states and as such imply some degree of compromise between actors. Of course, even within the EU, individual member states are afforded some flexibility to tailor legislative implementation to their markets, for example where they are implementing directives, or where they benefit from specific derogations.

This potential flexibility in the regulatory environment outside the EU is, for certain countries and certain products or services, also tempered by their need to adhere to shared international standards (for example those set by the Basel Committee on Banking Supervision). In addition, for those countries wishing to be determined as equivalent with the EU, their ability to set their own standards and diverge from elements of the EU framework can be limited yet further.

Improving Global Standards

Given the UK's status as a world-leading financial centre, the FCA considers participating in global-level regulatory dialogue as in important responsibility. We have a strong voice at a range of international authorities including the International Organisation of Securities Commissions (IOSCO), the Financial Stability Board (FSB), and the International Association of Insurance Supervisors (IAIS), among others. The

UK, like many other jurisdictions, is also subject to periodic assessments and peer reviews by global-level bodies including the International Monetary Fund and Financial Action Task Force, which use accepted international standards as the benchmark for their assessments. Our desire to remain actively involved in discussions to develop regulatory standards at global level is therefore not in question.

Through our participation in various global level organisations, such as IOSCO, we are able to shape and develop global standards and contribute to efforts to promote global consistency and cooperation between regulatory authorities. Whilst the UK has a strong presence in these fora, the practicalities of developing and improving global standards are affected by the need for the various global bodies to build consensus among their memberships and ensure standard are applicable across a breadth of legal and regulatory regimes.

Global standards are also not legally binding and can lack consequences in the form of sanctions or penalties for non-compliance. Therefore building strong relationships with our overseas counterparts on a bilateral basis is also seen as an important component of the FCA's ability to improve global standards and cooperation between regulatory regimes.

In September 2017, Mr Bailey gave a speech on the benefits of free trade in financial services:[162]

I strongly believe in free trade and open markets in financial services, particularly wholesale services. …

The post-crisis reforms put us in a much better position to support open financial markets in which we can deal with the harm arising from externalities and spillovers. …

Almost since Bretton-Woods there has been a debate on whether regional trade blocs stimulate or restrict trade, and likewise whether or not they are consistent with Most Favoured Nation provisions. …

Today in the UK, we stand at a point where we have the basis for effective open financial markets and free trade supported by the regulatory reforms post-crisis, but a threat to achieving that outcome in the form of reactions to Brexit….

We know that EU withdrawal has potential risks for disruption to financial services for the UK, EU and even globally. Some of these financial stability effects arise due to so-called cliff edge risks. But by working closely together as authorities we can

[162] Andrew Bailey (2017) Free Trade in Financial Services matters, 29 September; https://www.fca.org.uk/news/speeches/andrew-bailey-speech-free-trade-financial-services-matters

minimise these risks and support a transition to a new relationship between the UK and the EU….

We all begin with the same shared objectives. The overall objective of regulatory standards in financial services is to support the delivery of financial stability, consumer protection and open, innovative financial markets which enable growth and prosperity.

However, in my view there should be a strong preference to preserve cross-border operating where it is consistent with the overall standards. So what principles might we turn to when considering such an arrangement?

Any agreement on market access must be clear and sustainable to provide confidence in its long term operation. Trade in financial services can only flourish when built on a stable base that firms and regulators can understand and rely upon.

The Most Favoured Nation principle of non-discrimination should be at the core of any agreement. It should provide for equal treatment under its terms. It should not allow jurisdictions or firms to be discriminated against because of where they are based.

And where market access is predicated on commonality of rules, this should be determined by taking a proportionate and outcomes-based approach, focusing on whether rules address the same risks while seeking to avoid market distortion or regulatory arbitrage. It should also take into account the extent to which rules are aligned with international standards. …[C]urrently international standards remain somewhat patchwork, but as they develop – and I hope they will – then they can increasingly be relied upon for the purposes of cross border trade.

To help achieve this, we need to have cooperation. Regulators must work together to protect market functioning and integrity. Given the high degree of integration in financial markets, regulatory authorities should be able to share information without obstruction.

14. The UK financial services industry's advantages, vulnerabilities, threats and opportunities

14.1 Advantages

The UK has a number of very powerful advantages:

- London is the most competitive city in the world for financial services, according to the Z/Yen Global Financial Centres Index, while its closest EU rivals – Zurich and

Frankfurt – rank 16th and 20th.[163] London is also the world's most global city, 'resilient, agile and great at adapting', according to PricewaterhouseCoopers' *Cities of Opportunity* report.[164] In 2017, London pulled further ahead of New York in second place over concerns about increasing US protectionism, although the lead fell back in 2018.[165]

- 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.[166]

- 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.[167] In 2018, Forbes voted the UK the best country to do business.[168]

- 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.[169]

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163 http://www.cityam.com/282918/london-remains-top-world-global-financial-services-says; Paris is 24th, Dublin 31st, Munich 35th, Madrid 41st, Warsaw 45th, Amsterdam 50th, and Milan 61st; http://www.longfinance.net/Publications/GFCI23.pdf

164 http://www.pwc.com/us/en/cities-of-opportunity/2016/cities-of-opportunity-7-report.pdf

165 Gemma Acton (2017) London wins top financial center title once again as gap with New York widens, *CNBC.com*, 11 September.

166 Grant Thornton (2016) *The impact of 'Brexit' on the financial services sector*, April. This helps to limit the effect of Brexit on financial service firms based in the UK: 'Global financial services firms are adept at dealing with local market variations and hidden barriers to trade, such as competing regulatory and tax regimes, offering reassurance that UK financial service firms will be relatively unaffected by Brexit in the medium to long term'. Mark Carney is the current chair of the FSB.

167 https://home.kpmg.com/content/dam/kpmg/pdf/2016/03/uk-competitiveness-report-2016.pdf

168 Kurt Badenhausen (2018) The UK tops Forbes' Best countries for business 2018, *Forbes Business*, 19 December.

169 http://www.doingbusiness.org/reports/global-reports/doing-business-2016

- 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.[170] 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'.[171]

- 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:[172]
    - London is a leading centre for Islamic finance and the premier western offshore centre for Renminbi trading[173]
    - EY rates the UK as the world's leading fintech centre and the digitisation of banking represents a huge opportunity.[174] A report by Gerard Lyons – a former economic adviser to Boris Johnson when he was Mayor of London – predicted that London will remain a market leader in fintech after Brexit and found that:
        - Investment into the City's fintech sector rose 37% in the first half of 2017 compared to the previous year
        - 31 out of Europe's top 50 fintech businesses are headquartered in London
        - London employs 71,000 software developers, more than any other European city and more than San Francisco. This figure is set to grow by a further 22% by 2025
        - Tech giants such as Amazon and Google are making investments in London.[175]

- The UK ranks second behind the US in the Portland 30 Index of Global Soft Power.[176]

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[170] Simeon Djankov (2016) Why London won't lose its crown as Europe's financial capital, *CAPX*, 1 September; http://capx.co/why-london-wont-lose-its-crown-as-europes-financial-capital/

[171] Gren Manuel (2016) Hammond: skilled financial execs will still be able to come*, Financial News*, 9 September.

[172] https://www.globalinnovationindex.org/gii-2016-report.

[173] Anthony Browne (2016) Why the Chancellor needs to cut banking taxes – and fast, *CAPX*, 20 October.

[174] Anna Irrera (2016) London still 'top spot' for fintech after Brexit, *Financial News*, 29 September. According to Ophelia Brown, a general partner at venture capital fund LocalGlobe: 'None of the fundamentals changed overnight and all the positives of starting a fintech company in London have not changed', while 'London is here to stay', added Nigel Verdon, a serial fintech entrepreneur and founder of Digital Change Partners. John Barrass, deputy CEO of the Wealth Management Association, argues that the significance of the digitalisation of the financial services sector cannot be underestimated: 'Nearly all our clients are private and the way in which they access the system is altering very dramatically over time because the younger generation of course is using mobile electronic access in a way that the older one didn't. This is absolutely transforming a whole lot of things which are unconnected with borders and unconnected with Brexit, unconnected indeed with the way in which the single market works, and one of the problems for the European Commission has been how do you actually get common standards and how do you regulate activities that are brand new' (Keynote debate: Could Brexit positively impact UK financial services?, Misys Connect Forum, 20 September 2016; http://misys.kulu.net/view/XG1zcTzFEDU).

[175] Rebecca Byrne (2017) City Could 'Benefit' From Brexit - Report Claims, *WSJ City*, 12 October.

- 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).[177]

- 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.[178]

Another key advantage is that 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:[179]

- 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,[180] 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.[181]

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[176] Graeme Leach (2016) Five reasons the Anglosphere has real geopolitical teeth, *City A.M.*, 15 December.
[177] http://www.shanghairanking.com/SubjectEcoBus2015.html. Universities UK, representing university vice-chancellors, said they would continue to succeed after Brexit as long as they had the right government support (Neil Woolcock (2016) We'll thrive after Brexit, say university chiefs, *The Times*, 9 December).
[178] British Council.
[179] James Quinn (2016) Four reasons why banks won't leave the City of London after Brexit, *Daily Telegraph*, 24 October.
[180] The cost of moving ultra-high speed fibre-optic cables – which link London and New York's foreign exchange centres – would simply be too expensive (Mark Boleat (2016) City firms are preparing for the worst from Brexit – but hoping for the best, *City A.M.*, 19 December).
[181] Courtney Goldsmith (2016) London won't lose its status as leading finance and legal centre after Brexit, professionals say, *City A.M.*, 21 December.

- 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', according to Deutsche Bank analyst Jochen Moebert.[182] It is also recognised by entrepreneurs like Jim Mellon: 'Clearly the finance sector is very important to the British economy, but I don't think it's going to go away because the infrastructure in the City of London is just so great, it's unparalleled'.[183]

14.2 Vulnerabilities

There are a number of areas in which the UK is vulnerable.

The main vulnerability is over passporting which is currently linked to the single market and membership of at least the EEA. According to Mahoney et al. (2016): 'While unlikely, it is not impossible that the loss of the passport system for UK financial institutions may trigger some migration of global firms' EU headquarters. For example, it has been claimed that loss of passporting rights could see UK exports of financial services to the EU halve to around £10bn.[184] This could be problematic in the short-term by exacerbating the UK's record current account deficit. A rapid solution to continued passporting arrangements between the UK and the single market should therefore be a high priority in Brexit negotiations'.

The Treasury is certainly aware of the importance of access: 'We are actively engaged with the financial services sector and welcome its input as we prepare for the negotiations to exit the EU. Our position is absolutely clear, Britain remains open for business and we will work hard to get the best deal possible deal'.[185] Philip Hammond said, following a meeting with City representatives in September 2016, that he 'understands the scale of the potential impact leaving the EU could have for parts of the financial services industry. That is why I am determined to listen to what the industry has to say on key issues, like access to the single market…It is important Britain maintains its status as a great place for financial services and that is why the government stands ready to help the sector maximise the opportunities that leaving the EU presents'.[186] There have even been suggestions that the government would be prepared to pay into the EU budget to get continued access to passporting.[187]

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[182] Jack Sidders (2016) Brexit: German bank shelves plan to open UK office until Theresa May provides clear plan, *Independent*, 29 November.

[183] Courtney Goldsmith (2016) London won't lose its status as leading finance and legal centre after Brexit, professionals say, *City A.M.*, 21 December.

[184] http://www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/brexit-impact-financial-services.pdf

[185] Reported in Martin Arnold and Caroline Binham (2016) UK financial sector targets Swiss-style deal for EU market access, *Financial Times*, 18 August.

[186] Martin Arnold, George Parker and Caroline Binham (2016) City of London steps up lobbying for finance-friendly Brexit, *Financial Times*, 7 September.

[187] George Parker and Martin Arnold in London and Alex Barker (2016) UK looks at paying billions into EU budget after Brexit: Plan would let finance sector keep single-market access, *Financial Times*, 16 October.

Another concern, as previously mentioned by a number of people and organisations, 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'.

The Treasury select committee's former chair, Andrew Tyrie, is concerned that: 'None of the current off-the-shelf arrangements can preserve existing passporting arrangements, while giving the UK the influence and control it needs over financial services regulation as it develops'.[188]

The City is vulnerable to fragmentation in the asset management industry. A Bank of England Financial Stability Report warns that: 'If asset management were to fragment between the UK and Europe, material economies of scale and scope that are currently achieved by pooling of funds and their management would be reduced. Together, these effects could increase the reliance of both the UK and EU economies on their banking systems and reduce the diversification and resilience of finance. …There is no generally applicable institutional framework for cross-border provision of financial services outside the European Union. Globally, liberalisation of trade in services lags far behind liberalisation of trade in goods. So without a new bespoke agreement, UK firms could no longer provide services to EEA clients (and vice versa) in the same manner as they do today, or in some cases not at all. This creates two broad risks. First, services could be dislocated as clients and providers adjust. Second, the fragmentation of service provision could increase costs and risks'.[189]

Euro trading is another potentially vulnerable area. This is a US$2 trillion-a-day market with London having a 70% market share compared with 11% in Paris and 7% in Frankfurt. The European Central Bank has tried to ban euro trading outside the eurozone, although the European Court of Justice has so far blocked this.[190] A similar issue relates to euro clearing, i.e., the clearing of euro-denominated derivatives trades. Brussels wants to move euro clearing from London to the continent following Brexit and also wants the ECB to have 'legal competence' over 'systematically important' clearing houses located outside the EU.[191] S&P Global Ratings said that such a move would impose a 'massive extra burden of margin collateral' on market participants and harm the chance of the euro becoming a global reserve currency.[192] This concern is shared by Simon Kirby, former economic secretary to the Treasury, who argues that if clearing is 'dismantled and redistributed' across the EU, everyone would be worse off. Clearing contracts in one location offers significant capital

[188] Reported in Martin Arnold (2016) 'Significant' Brexit risk for 5,500 UK groups using EU passporting, *Financial Times*, 20 September.
[189] Mike Sheen (2017) BoE warns asset management 'fragmentation' could harm UK's financial resilience post-Brexit, *Investment Week*, 27 June.
[190] Simeon Djankov (2016) Why London won't lose its crown as Europe's financial capital, *CAPX*, 1 September; http://capx.co/why-london-wont-lose-its-crown-as-europes-financial-capital/
[191] Fareed Sahloul (2017) ECB seeks greater powers to regulate clearing houses, *Financial News*, 23 June.
[192] Mehreen Khan (2016) Euro clearing shift to EU after Brexit 'unlikely', says S&P, *Financial Times*, 17 November.

efficiencies by allowing similar positions to be offset against each other and lowering collateral costs.[193] Xavier Rolet, CEO of the London Stock Exchange, in giving evidence to the Treasury select committee, went even further and warned of the 'potentially systemic' impact of moving clearing functions out of London if there is continued uncertainty over the final shape of Brexit after the Article 50 process is complete. He said it was essential 'to find a way to buy ourselves a period of time of stability, of grandfathering, that needs to extend into several years'.[194] The US is also opposed to the move. Christopher Giancarlo of the US Commodities Futures Trading Commission warns against the Balkanisation of European financial markets.[195]

A further vulnerability, according to Mahoney et al. (2016), is that the 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 concern is summed up by the members of Tech City UK's Future Fifty tech programme, which helps some of the UK's fastest growing digital companies to scale up: 'We want to build businesses in an economy that is outward-looking and dynamic. With Brexit, must come great opportunities, but we must be careful to avoid potential pitfalls. As tech company founders we want to work with government to find solutions to the digital industries' need for international talent. Only with a steady flow of international and home-grown talent, British tech can continue to compete on the world's stage'.[196]

14.3 Threats

European financial centres have used the opportunity of Brexit to compete for London's financial services business. Immediately after the Referendum, the French prime minister, Manuel Valls, said: 'We know that groups based in the City are planning to leave for Dublin, Amsterdam, Frankfurt and Paris. We are working on measures that could help strengthen our attractiveness. I think notably about taxation or the status of expatriates. To major international companies I say, 'Welcome to Paris! Come invest in France!''.[197] Edouard-François de Lencquesaing, CEO of the European Institute of Financial Regulation and an adviser to Paris Europlace – which lobbies for Paris as a financial centre – said Paris could support up to 25,000 additional personnel if firms had to move staff out of the City of London because of Brexit.[198]

Frankfurt also believes it is well placed to benefit from a hard Brexit fallout, which could see a fifth of London's finance jobs shifted from the UK capital, according to a survey by the

[193] Samuel Agini (2016) City Minister warns against post-Brexit derivatives clearing shift to NY, *Financial News*, 19 October.
[194] Rolet warns of Brexit 'systemic risks', *WSJ City*, 10 January 2017.
[195] Philip Stafford and Jim Brunsden (2017) Washington warns against EU location policy, *Financial Times*, 10 May.
[196] Lynsey Barber (2016) Britain's tech stars rally against Brexit immigration curbs in open letter, *City A.M.*, 18 October.
[197] Sybille de La Hamaide and Michel Rose (2016) French PM tells London financial firms 'Welcome to Paris', *Reuters*, 2 July.
[198] Reported in Lucy Burton and Samuel Agini (2016) Europe's Brexit havens urged not to 'waste a good crisis', *Financial News*, 28 July.

Boston Consulting Group. Corporate banking and investment banking were the businesses found to be most likely to relocate staff, according to the survey, but securities services, transaction banking as well as asset management and wealth management were also expected to be affected. Hubertus Väth, managing director of Frankfurt Main Finance which promotes the city as a financial centre, has estimated that at least 10,000 employees from across the financial services sector could move from London to the German city over five years.[199]

The *Financial Times* has reported that Germany is considering changing its labour laws to make Frankfurt a more attractive location for banks forced to move staff from London after Brexit. Currently, laying off staff is difficult and costly, with minimum statutory redundancy terms being twice as generous in Germany as in the UK. A redundancy payout for a banker earning $1.5m could typically be $150,000 in London, but up to $2.25m in Frankfurt. Given that banks hire and fire at short notice, this makes Frankfurt a much less attractive location. The proposed reform would place an upper salary limit on employee protections of €100,000 or €150,000, making redundancy terms less generous.[200] Similarly, when Jamie Dimon, CEO of JP Morgan, warned the French president that France is unlikely to lure banking jobs away from London post-Brexit unless the nation overhauls its employment legislation, François Hollande assured Dimon that the next president would make the necessary changes.[201]

Many commentators believe the threats from Paris and Frankfurt to take London's business lack credibility. For example, the City of London corporation's Jeremy Browne said: 'One of the problems the French have, is that it's quite hard to make a pitch saying we want to be the home of financial services when you have spent 20 years making a virtue of being rhetorically hostile to financial services'.[202] Similarly, Paris has been making a big bid to attract UK fintech companies, but the red tape of just doing business there pushes up the costs, while the problem for Berlin, another contender, is that 'people don't start speaking German overnight'. [203]

Similarly, the *Financial Times* story about Germany was dismissed by Simon English writing in the *Evening Standard*:

> *The Germans are coming. From yesterday's FT, this headline: Frankfurt steps up bid to woo London banks after Brexit….Frankfurt is only the fifth-largest city in Germany with a population of less than 750,000. Compared with London, it is Toytown.*[204]

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[199] Stefanie Eschenbacher (2016) Brexit could see one in five banking jobs leave London – study, Financial News, 4 July.
[200] Patrick Jenkins and Laura Noonan (2016) Frankfurt vies for UK banking jobs post-Brexit, *Financial Times*, 9 October.
[201] JP Morgan warns French over tough labour laws, Telegraph Business, 6 January 2017.
[202] Courtney Goldsmith (2016) London won't lose its status as leading finance and legal centre after Brexit, professionals say*, City A.M.*, 21 December.
[203] Anna Irrera (2016) London still 'top spot' for fintech after Brexit, *Financial News*, 29 September.
[204] According to Savills, Frankfurt does not have much spare office space – in contrast with Dublin (*Financial News*, 10 November 2016).

There's a book fair. A motor show. Otherwise, think of tumbleweed floating down streets made for bicycles.[205] *Every banker imagining that he is going to steal trade and take it to Frankfurt has got a rival scheming to keep it here and do it better. And moreover, to do it in English. The advantage of our language shouldn't be underestimated.*

The City has spent 70 years building an infrastructure that is dedicated to banking. London is better at financial services than anywhere else in the world, and will remain so. We'll forgive the few bankers who call this wrongly and end up taking what turns out to be a two-year holiday in Frankfurt before they return to find that promotion has passed them by.

Some argue that the real beneficiary of the Brexit confusion will be New York, but you note that those saying so are all American. Folk who think the City of London will win this battle with Europe have one strong piece of evidence in their favour: they have always been right before.

So here's my prediction: in five years' time, German and French banks will still be sending more people here than we are sending there. Bank on it.[206]

Mahoney et al. (2016) also conclude that: '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'. And as Bernard Jenkin MP points out 'the UK financial services sector dwarfs that of the rest of the EU — Canary Wharf on its own is bigger than Frankfurt'.[207] This view is confirmed by John Cryan, then CEO of Deutsche Bank, who said that the UK will retain the status of being Europe's top financial hub over the next ten years.[208]

According to the *Financial Times*: 'No city in the future EU27 comes close to providing the scale and infrastructure required of a top-10 global financial centre. The European cities aspiring to absorb some of London's business are fairly small. No less important, their inhabitants enjoy a way of life that many do not wish to see disturbed by having their city transformed into a teeming, expensive financial hub. Dublin is one example. In a joke that alludes to London's Canary Wharf financial district, a docklands development in Dublin is labelled "Canary Dwarf". …The arrival of thousands of investment bankers, asset managers and insurers fleeing London after Brexit would place intolerable strain on the city's housing, education and other resources… Obstacles to turning some other European city into a financial centre equivalent to London look, for the foreseeable future, insurmountable'.[209]

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[205] Graeme Leach in a private communication said 'Last time I was in Frankfurt and walked through the financial district, there was a tyre repair centre ... imagine a Kwik Fit on Threadneedle Street!', 1 September 2016.

[206] Simon English (2016) Bankers heading off to Frankfurt? It's just a fantasy, *Evening Standard*, 11 October.

[207] Bernard Jenkin (2016) There is no such thing as hard or soft Brexit - Britain should look to leave the EU as swiftly and simply as possible, *Financial Times*, 31 July.

[208] Cryan expects London to remain top financial hub post 'Brexit', *Daily Telegraph*, 1 September 2016.

[209] James Blitz (2016) Brexit Briefing: The battle for London's business, *Financial Times*, 27 October.

Further, as Jes Staley, CEO of Barclays, says: 'The users of capital find the providers of capital, not the other way around, and the providers of capital, by and large, are resident in London and New York. I don't think London will lose its gravitational pull in terms of management of capital in any reasonable timeframe'.[210]

On top of all this as Jim Mellon points out: 'No one wants to go to Paris or Frankfurt or indeed to Dublin'.[211] This view is confirmed by Christoph Rieche, who came from Switzerland in 2003 and started an alternative lender that supplies financing to small and medium-sized businesses: 'London is probably the only place in the world where you can run a global operation because of the unique talent pool'. Another European financier said of Frankfurt: 'It's not a place where non-Germans could live very happily', while his views of Paris are: 'It's a much more beautiful city than London but it's a bloody hard place to do business'. He also warned against rash relocations: 'I have some friends who moved [from London] to Geneva for tax reasons and now either they regret it or some are thinking of moving elsewhere'.[212]

In July 2017, Morgan Stanley and Citigroup said they would move some staff to Frankfurt, following similar moves by Standard Chartered, Goldman Sachs, JP Morgan, Nomura and Daiwa Securities.[213] However, the Bank of England governor, Mark Carney, still predicted that the City would continue to thrive in a post-Brexit world doubling in size over the next quarter century as 'we will keep our market share of cross-border capital flows'.[214]

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'.[215] To illustrate the potential costs of this, it was reported in November 2016 that Goldman Sachs was considering relocating some of its businesses from the City to Frankfurt in order to gain access to the single market after Brexit. This, in turn, would require European Central Bank supervision and to qualify for this, GS was told it would have to increase the assets of its eurozone operations to €30bn.[216]

A not unrelated issue is a potential retaliatory protectionist war between the US and the EU in which the UK could be caught up. The EU has plans to mirror the 2014 US 'intermediate holding company' rules that ringfence foreign bank capital. If adopted, US investment banks, such as Goldman Sachs, would have to put additional capital and liquidity into their EU subsidiaries to protect against another financial crisis and be separately wound up if required by the European regulator. Banks regard separately capitalised holding companies

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[210] Ben Martin (2016) Barclays boss: London's 'gravitational pull' on finance will not wane after Brexit, *Daily Telegraph*, 16 November.
[211] Courtney Goldsmith (2016) London won't lose its status as leading finance and legal centre after Brexit, professionals say, *City A.M.*, 21 December.
[212] Joshua Chaffin (2016) London's allure for European expats survives Brexit vote, *Financial Times*, 30 November.
[213] Lucy McNulty and Samual Agini (2017) Willkommen in Frankfurt, *Financial News*, 31 July.
[214] Szu Ping Chan (2017) Interest rate rise likely within a year, Bank signals, *Daily Telegraph*, 2 August.
[215] David Wighton (2016) Dr Fox prescribes the wrong medicine for UK economy, *Financial News*, 15 September.
[216] Goldman mulls relocating from London to Frankfurt post 'Brexit', *Financial News*, 10 November 2016.

and multiple pools of capital in different financial centres and overseen by different regulators as inefficient compared with a single pool set and monitored by their home regulator. The need for a separately capitalised holding company in Frankfurt, for instance, would make London less attractive as a headquarters for European operations. The proposed rule changes from Brussels would potentially affect London, once it was no longer an EU financial centre.[217]

EU regulators are also trying to exercise influence over organisations that remain in London after Brexit. For example, the European Commission has proposed granting the European Securities and Markets Authority (ESMA) regulatory powers over both central counterparties or CCPs (i.e., clearing houses) and credit rating agencies based outside of the EU, which would include London-based organisations after March 2019.[218]

Delegation is another issue over which ESMA is seeking to exercise more control. In July 2017, ESMA issued guidance to EU national regulators on how to deal with fund manager relocations from the UK after Brexit. It said that national regulators dealing with 'authorisation' requests should satisfy themselves that firms do not 'perform substantially more portfolio management and/or risk management functions for the relevant funds in their original member states or third country on a delegation basis'. Under the 1985 Ucits Directive, fund managers are allowed to delegate certain functions for their EU funds – such as portfolio management and risk management – to organisations outside the EU. Peter Astleford at lawyer firm Dechert said: 'US managers in particular will have a wary eye on this new manifestation of "Fortress Europe". The implied and overt requirements for local substance, taken literally, show a new and potentially worrying sign for … managers'. Dan Waters, managing director of ICI Global – the trade body representing fund managers globally – said 'any restrictions on delegation could impact fund managers globally… The language about delegation of portfolio management – and to third countries – is of huge concern. Ucits would not exist in South America or Asia if portfolio management could not be delegated. Where is the evidence it is not working?'.[219] Stephen Barclay, then City minister, said the government 'strongly supports the global delegation model for portfolio management, in partnership with other countries that share our views on this issue. [It allowed UK asset managers] to sit at the heart of global investment allocation [and also benefitted Europe]. A restricted delegation model would cause fragmentation and prompt funds located in Europe [to] leave the continent for other financial centres, such as New York or Hong Kong'.[220]

A final threat comes from another aspect of EU rules on 'authorisation' which it is claimed could lead to trillions of pounds worth of derivatives contracts between UK and EU

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[217] Alex Barker, Jim Brunsden and Martin Arnold (2016) EU to retaliate against US bank capital rules, *Financial Times*, 21 November.

[218] Lucy McNulty (2017) Rating agencies plan Brexit moves as watchdog ups demands, *Financial News*, 9 October; Nick Reeve (2017) ESMA: Hard Brexit would pose 'significant stability risks', *IPE*, 10 October. The issue of CCPs is discussed later in the report.

[219] David Ricketts (2017) US fund managers jittery over post-Brexit delegation, *Financial News*, 21 August.

[220] Susanna Rust (2017) UK sets up asset management taskforce in Brexit-fuelled action plan, *IPE*, 2 October.

counterparties suddenly becoming illegal if there is 'no deal' in March 2019. However, this has been dismissed as scaremongering, since it 'fails to reflect the true position in law. It fails to recognise the operation of public international law, the European Convention on Human Rights and the EU Charter of Fundamental Rights. Each of these, in its own way, provides for the protection and continuation of contractual rights at the point of Brexit, deal or no deal'.[221]

14.4 Opportunities

Mahoney et al. (2016) argue that 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 80% of the UK's), they only account for 20% of intra-EU trade.[222] 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.[223]

Mahoney et al. (2016) argue that 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'. The urgency for beginning these negotiations as soon as possible is demonstrated by the EU's complete inability to negotiate trade deals of its own, apart from some very small ones mostly with its former colonies. This was shown most starkly by the difficulties facing the EU in trying to conclude the €6bn a year Comprehensive Economic and Trade Agreement (CETA) with Canada, as a result of Wallonia's refusal to ratify the agreement in October 2016. CETA removes 99% of customs duties between Canada and the EU, and Wallonia's heavily subsidised farmers did not like the idea of cheaper Canadian imports. Chrystia Freeland, Canada's trade minister, said: 'it's become evident for me…that the European Union isn't capable now to have an international treaty even with a country that has very European values like Canada… I've worked very, very hard, but I think it's impossible. We have decided to return home… it is emotional for me'.[224] But this is not a one-off, it is standard behaviour on the EU side in trade negotiations. In April 2016, France asked the EU Commission to delay the restart of trade talks with Mercosur, the Latin American trading bloc which includes Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay and Venezuela. Again, it was (French) farmers who did not want competition from cheaper Latin American producers.[225]

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221 Barnabas Reynolds (2017) Deal or no deal, the City can still prosper after Brexit, *Daily Telegraph*, 12 October.

222 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/448444/BIS-15-436-deepening-the-single-market-in-goods-and-services.pdf

223 http://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/compendium/unitedkingdombalanceofpaymentsthepinkbook/2015-10-30/unitedkingdombalanceofpaymentsthepinkbook

224 Peter Dominiczak and Peter Foster (2016) The EU is 'impossible'; Canada walks out of trade talks, *Daily Telegraph*, 22 October.

225 http://internacional.elpais.com/internacional/2016/04/25/actualidad/1461597521_725644.html

As James Skinner writes: 'As an independent nation free from the EU, the UK can finalise its own trade deals across the world with countries that are already eager to do business, such as Australia, New Zealand and India. Canada has already expressed tremendous interest in beginning trade negotiations with the UK and, acting independently, we would not need to worry about small regions in the EU causing delays. There would be no need to rely on 27 other member states agreeing to a deal that will provide significant economic benefits to businesses and its consumers, and most importantly, we would not have to wait multiple years for parliaments to debate and assess disputes from small populations on the continent who only serve their own self-interests'.[226] In November 2016, Liam Fox, the international trade secretary, announced that the countries that have a free trade agreement (FTA) with the EU are willing to continue to deal with the UK on the same terms after Brexit.[227]

Brexit also opens up the opportunity for the City to escape from the clutches of both the European Court of Justice (ECJ)[228] and EU regulators and hence enhance its competitive position relative to continental financial centres. Mahoney et al. (2016) offer the following examples:

- 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 0.01% on derivatives which will reduce GDP by more than the tax revenue raised.

- The Market Abuse Regulation,[229] 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, but according to Jon Moulton: 'I have never yet met an investor who thought it useful – let alone needed it'.

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[226] James Skinner (2016) Canada has shown us we were right to leave the EU*, BrexitCentral*, 23 October; http://brexitcentral.com/james-skinner-canada-shown-us-right-leave-eu/?utm_source=BrexitCentral+Mailing+List&utm_campaign=c616615b0c-Mailchimp+bulletin&utm_medium=email&utm_term=0_23a30e67d9-c616615b0c-18935675/

[227] Marcus Leroux (2016) Trading partners want to keep EU deal terms after Brexit, says Fox, *The Times*, 4 November.

[228] Like free movement, the ECJ is a totemic component of the single market (Simon Nixon (2016) A hard Brexit is inevitable if Britain rejects rules set by European courts, *The Times*, 22 September).

[229] See Appendix 5.

- 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'.[230] Valdis Dombrovskis, the European Commissioner for Financial Stability, Financial Services and the Capital Markets Union, wants to accelerate the EU's move to capital market integration. He said that the 'possibility of Britain exiting the single market just makes the case for Capital Markets Union CMU) stronger and more urgent'. He wants a second wave of capital market integration, in areas such as insolvency rules, retail banking and infrastructure investment. In particular, he is looking at easing up the Solvency II rules for insurers to make it easier for them to invest in infrastructure and wants to encourage institutional investors to make greener investments.[231] In September 2017, the European Commission recommended that ESMA becomes an 'investigatory hub' for market abuse cases across the EU. Mr Dombrovskis said: 'The EU needs to act as one player so that we can stay ahead of the curve. More integrated financial supervision will make the Economic and Monetary Union more resilient'.[232]

Another example relates to pension funds. They use over-the-counter swaps bought from investment banks to hedge their interest rate and inflation risks. Under the European Market Infrastructure Regulation, which comes into effect in August 2018, these swaps will have to pass through clearing houses which require daily collateral payments to be made in the form of variation margin payments. It has been estimated that the cumulative cost of these collateral payments will reduce EU pensioners' retirement income every year by €3bn or by 3.1% in the Netherlands and 2.3% in the UK, the two countries with the largest pension funds in Europe. Brussels wants to give an exemption to pension funds from EMIR, but is being blocked by France which has no pension funds but which wants to use EMIR to target overseas clearing houses which are active in the EU as a way of forcing the clearing of euro-denominated securities to take place within the eurozone.[233] Local government pension funds have also been caught up in MiFID II: they will lose their status as professional investors and be downgraded to retail investors by default, unless they can be 'opted up' to professional status again – but this will be a costly and complex exercise.[234] Pension funds currently come under the IORP II Directive[235] – which does not require them to hold costly

[230] Caroline Binham (2016) EU's financial watchdogs signal post-Brexit clampdown, *Financial Times*, 9 September.
[231] Bernard Goyder (2016) Capital Markets Union: we'll go on without UK says commissioner, *Financial News*, 9 September.
[232] Lucy McNulty (2017) EU wants to supercharge its top financial regulator, *Financial News*, 25 September.
[233] Jim Brunsden and Philip Stafford (2017) Brussels races to amend rules that sting pension industry: EU derivatives rules scheduled for 2018 set to strain occupational schemes, *Financial Times*, 19 January.
[234] Stephanie Baxter (2017) MiFID II: An EU curveball for LGPS pooling and infrastructure drive, *Professional Pensions*, 19 January.
[235] Institutions for Occupational Retirement Provision.

capital buffers – but the EU wants pension funds to come under the Solvency II Directive – which would require them to have capital buffers, since they would effectively become insurance companies. This is opposed by the UK and Holland, but is supported by French and German insurance companies which argue that pension funds have an unfair advantage in competing for pension business.

Nigel Lawson, chancellor of the exchequer between 1983 and 1989, argues that the economic gains from leaving the EU will be substantial:

> *If you chart the course of the EU economy as a whole, both before and after the advent of the so-called single market, it is clear that it has brought no discernible benefit.*[236]
>
> *Our starting point needs to be that we seek the best possible relationship with the peoples and governments of Europe, against whom we have no grievance and a multiplicity of mutual interests. So far as the single market is concerned, we must respect the EU doctrine that to remain a member in any shape or form we would have to accept the freedom of EU citizens, beyond those already here, to come and live and work in the UK. That is something the British people have, understandably, made clear is not on, so we must accept that we will be outside the so-called single market.*
>
> *That is scarcely a disaster. The rest of the world is outside the single market, and trades happily and profitably with the member nations of the EU. You do not need a trade agreement in order to trade. Unsurprisingly, even now, our trade with the rest of the world, with most of whom we have no trade agreement, is greater than, and growing faster than, our trade with the EU. We have always been, and remain, a full member of the World Trade Organisation in our own right.*
>
> *The banks may be concerned about exit from the single market, and there may indeed be some complications for them. But the position of London as one of the only two truly global financial centres in the world, and the only one in the European timezone, is unassailable. And they have far more to fear from being inside it, particularly from further European legislation on banking union and the financial transactions tax.*

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[236] As Ryan Ryan Bourne argues: 'The European Commission itself (who have no incentive to underestimate) believes this common regulatory zone has raised EU-wide GDP by just 2.1 per cent overall. That figure was calculated for 2008, at the height of the boom. As the economist Andrew Lilico has outlined, for the UK we can imagine this would be less significant still: the UK trades less with other EU member states than the EU average and specialises in services where the single market is less complete. Added to that, we were already fairly liberal in regulatory terms during this period (meaning the benefits from any harmonisation measures would be less pronounced for us)' (Ryan Bourne (2016) The 'Single Market' battle is the Remainers last stand in the Brexit war, *City A.M.*, 10 October).

….Instead of wasting time on a futile and wholly misguided attempt to secure a trade agreement with the EU, the government needs to focus on how we propose to conduct ourselves as a self-governing nation outside the bloc. A whole range of issues need to be addressed, from the precise nature of our immigration controls (which need to be a single system applying to Europeans and non-Europeans alike) to how we will support our farmers following our exit from the Common Agricultural Policy.

There are also some issues that will involve bilateral agreements with individual European countries, such as over security cooperation and (with the Irish Republic) over our land border with the EU.

Above all, on the economic front, a study needs to be undertaken of the vast corpus of EU regulation to which we are presently subject, to decide which we wish to retain, which to amend (and how), and which to scrap altogether.

There are other economic gains to be secured from Brexit, from not having to pay our net annual subscription of some £10bn and rising to our newfound ability to strike trade deals with the faster-growing countries of the world. But it is the benefit of intelligent deregulation, something that cannot be captured in any theoretical economic model but which we demonstrated in the 1980s, that offers the prospect of the greatest economic gain. And this is entirely in our own hands, and not a matter of negotiations with others. That is what we need to be focused on now.[237]

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. For example, TheCityUK, says that: ‘Deepening ties with European companies, old friends like the United States and Japan, and new markets like China and India would help Britain preserve its global role in finance after leaving the EU’. Chris Cummings said the UK must make more of how much companies across Europe rely on Britain's financial services and allied professions like accounting and law to do business. The backing of these companies would be important in upcoming UK-EU trade talks to ensure continued access to the single market: ‘What I hear from major European corporates is they like to do business through London due to the depth of the talent pool and capital markets here. As major “buyers” of financial services still want to come to London, the “sellers” such as banks are staying put’. He called on the Treasury to strengthen its Financial Services Trade and Investment Board. Britain's new trading terms with the EU may not be known for several years. John McFarlane, TheCityUK’s chairman said: ‘We must now speak confidently and with one voice to policymakers to help inform them about the deal we want to see from the upcoming negotiations’.[238]

Lord Howard Flight, co-founder of Guinness Flight Global Asset Management and former shadow chief secretary to the Treasury, goes further: ‘It is time people woke up in London to the opportunities outside of the EU. We’ve been lazy. Particularly the large investment banks have been satisfied with the business they could get out of Europe, and making plenty

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[237] Nigel Lawson (2016) Brexit gives us a chance to finish the Thatcher revolution, *Financial Times*, 2 September.

[238] Huw Jones (2016) UK finance body urges courting 'old' friends like U.S., Japan post Brexit, *Reuters*, 3 August.

of money out of it. Leaving the EU could wake up this country to the opportunities elsewhere where it's had a lot of historic involvement [such as the Commonwealth countries]'.[239]

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

The City's wish was to preserve passporting, but Barney Reynolds, a partner at lawyer Shearman & Sterling, 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'.[240]

Mr Reynolds identifies three main concerns in maintaining passports in a report entitled *A Blueprint for Brexit*:[241]

- 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.

Mr Reynolds pointed out that the prime minister has ruled out arrangements which do not involve controls over EU immigration and a return of sovereignty: 'Let me be clear — we are not leaving the EU only to give up control of immigration again. And we are not leaving only to return to the jurisdiction of the European Court of Justice'. In any event, given the vote,

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[239] Lucy Burton (2016) Cheer up! London could be the new 'Super Singapore', *Financial News*, 15 September.
[240] Keynote debate: Could Brexit positively impact UK financial services?, Misys Connect Forum, 20 September 2016; http://misys.kulu.net/view/XG1zcTzFEDU
[241] Barnabas Reynolds (2016) *A Blueprint for Brexit: The Future of Global Financial Services and Markets in the UK*, Politeia, November.

the UK should ensure it is able to regulate its own markets taking into account local conditions and needs, based on its traditionally key values of free and clean markets, systemic risk protection and consumer protection. The UK will face difficulty achieving these important goals if it maintains the passport.

A whole range of individuals and organisations have said passports are unnecessary:

- Barney Reynolds: 'When I started in the City in the 1991, I was doing a lot of work around cross-border business. We didn't have a passport and there was a very limited passport introduced in 1995. The proper passport was rolled out in 2007 [when MiFID I came into force]. The idea that [the future of the City] is dependent on this new-fangled thing that's only been in existence properly since 2007 is utterly absurd'.[242]

- Angela Knight argues that there are two big mistakes the City could make now: 'The first is try and recreate being part of the single market. That isn't what was voted for. The people in the country are now much more gung-ho about Brexit actually than they were before the vote; [also] there is still very little sympathy for financial services industry….The second very big mistake [would be] if each part of the financial services industry [proposes] what it would like, runs off and tries to sell it both to the UK government and on into the European arena – because all that will [indicate is that] the Brits don't know what the hell they want…So if ever there was a time for coherency, it's now'.[243]

- *Financial News* assembled a panel of entrepreneurs in September 2016. None of the entrepreneurs thought that their businesses would suffer if the UK were to lose passporting rights. Michael Spencer, CEO of Icap, said 'Today, we can't think of any business that we currently do that would be adversely impacted at the moment'. David Harding, CEO of asset manager Winton, agreed: 'It won't have any impact, as far as I can see, on my business from the raising funds end in Europe, or the investor end in Europe'. Anne Glover, CEO of Amadeus Capital Partners, while accepting this, had some concerns about private equity: 'Frankly, I am not totally convinced that it makes a huge difference, as long as they don't abolish the existing private placement regimes. We don't want to go AIFMD simply because we don't need custodians, we don't need depositaries – that is just overkill for what we do. I think the private equity industry will be in more difficulty, because they will need to be approved as a third-country player and approvals under AIFMD [which would allow non-EU players to operate freely inside the EU] have been slow'.[244]

[242] Keynote debate: Could Brexit positively impact UK financial services?, Misys Connect Forum, 20 September 2016; http://misys.kulu.net/view/XG1zcTzFEDU
[243] Keynote debate: Could Brexit positively impact UK financial services?, Misys Connect Forum, 20 September 2016; http://misys.kulu.net/view/XG1zcTzFEDU/
[244] Margareta Pagano (2016) City entrepreneurs say Brexit can work – for the bold, *Financial News*, 20 September.

- Moody's Investors Services accepts that the loss of passports would be 'manageable' for most banks and financial services firms: 'The direct impact is likely to be modest. The greater impact would be felt through higher costs and diversion of management attention, as the companies concerned restructure, reducing profitability for a time. This is credit negative but manageable. And other critical factors such as capital and liquidity, which are largely determined by global standards, are unlikely to face material changes due to Brexit per se'.[245]

- The Tax Incentivised Savings Association (TISA) told the Treasury that it would like the government to seek equivalence rather than full membership of the single market, since passporting, as well as the free movement of people, are not essential for its member firms, which include asset managers. TISA director general David Dalton-Brown says equivalence would be a 'win-win opportunity': 'Many of the EU directives, like AIFMD and MiFID II, already embody the concept and through enabling legislation it can be added to others, such as UCITS'. Equivalence would 'facilitate the continuation of existing business' and minimise impact on the financial services sector's 113,000 UK jobs dependent on European Union trade. The government should task the FCA to start work immediately on a domestic-only version of the regulatory rulebook: 'This should focus on cutting away most of the paperwork that consumers are expected to wade through to open a savings and investments account'. While freedom of movement is not essential for the industry, the government needs to streamline the visa process in order to get the best financial services professionals from Europe and around the globe 'without delays or hindrance'.[246]

- The Association of Investment Companies also told the Treasury that it does not want the government to pursue passporting if it means ending access on a country-by-country basis. Instead, it wants a tailored UK regime which sheds 'unhelpful' EU regulation for products that are not actively marketed to European investors. Around 95% of investment company investors are from the UK. Ian Sayers, CEO of the AIC, says: 'We are cautious about seeking a full passport for EU-wide access "at all costs"'. Unlike UCITS funds, investment companies currently do not have access to the full EU passport and instead access investors there on a country-by-country basis (via the national private placement regimes). This allows alternative investment fund managers to market products that cannot otherwise do so under the AIFMD domestic marketing or passporting regimes.[247]

- David Wighton of *Financial News* also accepts that 'Even the most diehard supporters of the current system admit that in many cases it would not be a big deal. Passports are convenient but many firms could without too much bother go back to

[245] Ben Martin (2016) Banks can cope with loss of EU passports after Brexit, says Moody's, *Daily Telegraph*, 19 September.
[246] Jessica Tasman-Jones (2016) TISA: Passporting isn't essential in Brexit negotiations, *Money Marketing*, 5 October.
[247] Jessica Tasman-Jones (2016) AIC warns Treasury passporting is not a dealbreaker, *Fund Strategy*, 4 October.

the way they did business in the 1990s, before passports were introduced, [although] some firms have structured their businesses entirely around passports,….[and] fear (rightly or wrongly) that without passports (or something like them) they will have to shift a fair chunk of their operations into other EU countries'.[248]

- Even TheCityUK has given up hope of retaining passporting, in the light of the government showing little interest in the idea. Instead, Miles Celic is looking for a 'bespoke deal', based on equivalence, which is tailored to the needs of the UK: 'It would protect London as a market and those European customers using it. That's an advantage not only for the UK, but for the EU too'.[249]

Another problem with the UK retaining passporting as part of a FTA with the EU post-Brexit is that it could have implications for the other FTAs that the EU has signed' such as the EU-Canada Comprehensive Economic and Trade Agreement. Chris Bryant from lawyers Berwin Leighton Paisner says that if the EU offers better terms to another country, such as the UK, it will then have to offer the same terms to Canada (with some exceptions). The EU might be unwilling to do this.[250]

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. At least the quest for the Holy Grail, an equally impossible mission, raised the moral tone of knighthood in the early Middle Ages. 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 EU is a customs union, but] a customs union does not stop non-members from accessing it. It only stops its members from forging trade ties with third countries. The US exports more to the EU than does the UK, and Japan is not far behind.*
>
> *And despite the fact that the expression "single market" is the most utilised in every discussion, the EU is only partially a single market. None exists in services – now the*

[248] David Wighton (2016) Brexit's passporting debate stamped through with confusion, *Financial News*, 23 September.
[249] Jonathan Ford (2017) City of London lobbying group drops demand for EU 'passport', Financial Times, 12 January.
[250] David Wighton (2016) Brexit's passporting debate stamped through with confusion, *Financial News*, 23 September.

largest sector of the British economy. 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.

The only way the EU could stop its institutions from accessing the City's wholesale markets post-Brexit would be by imposing exchange controls. And financial retailers have a relatively low cost option for marketing to continental savers/investors through Luxembourg subsidiaries – as do American asset managers. Under General Agreement on Trade in Services rules against non-tariff barriers, they can't be blocked. So financial services are a non-issue.

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.

Does anyone really think that EU leaders are bluffing when they say absolutely no concessions on free movement? Can one imagine the implications for the highly restive eastern European members, if it gave in on this sacred principle? Forget the EU's trade balance. Politics will always trump economics in Brussels. There can be no separation between practical proposals on trade issues and the simple and fundamental principle of free movement of people within the EU, regardless of how they achieved entrance in the first place. The issues are inextricably linked in the minds of Eurocrats now desperate to keep 'le grand projet' alive in the face of a hundred unkind economic and political cuts.

The apparent concession for temporary suspension of uncontrolled immigration won by David Cameron was still entirely subject to EU discretion on its duration and conditions of implementation. It in no way returned border control to British jurisdiction. And in this context, there was never any reason to believe the UK would abandon its centuries-old tradition of importing needed skills from anywhere in the world.

Now, by seeking to secure an impossible and relatively economically immaterial "deal" on so-called single market access, we are jeopardising the bespoke trade deals we could do in certain sectors once the UK becomes a fully independent country. The balance of economic and political advantage is overwhelmingly in favour of a clean break with the EU's dilution of national sovereignty and its protectionist and limited single market.

The Leave campaign successfully identified a national, gut feeling that "something was wrong" about a sacrifice of sovereignty on such matters as border control and the judicial system. Now the public's resolve must be strengthened by an educational blitz on the true nature and limited scope of the much vaunted "single market", on *the benefits of leaving it and its restrictions, and by a slaying of the false dragons being kept alive by Remainer misrepresentations.*[251]

Mr Yassukovich develops his ideas in a subsequent *Financial Times* article:

There is confusion over the fate of the UK service economy after Brexit, particularly where the City of London is concerned. Misunderstandings threaten a proper discussion and, worse still, run the risk of wasting diplomatic capital in the Brexit negotiations.

Commentators and even Treasury officials keep repeating the mantra that "the City must have access to the single market". But there is effectively no single market in services in the EU, and certainly not in financial services. For example, a qualified German hairdresser must requalify to practice in France (and there are two different qualifications, domicile and shop), and an English solicitor cannot provide conveyance for a residential property sale in most EU countries.

As there is no banking union, no unified capital market and no European stock exchange, the regulation of financial services, focused largely on investor protection, is at national not EU level. Every industrialised nation, including the US, has investor protection legislation which requires overseas providers to undergo some form of registration and authorisation. And these requirements are exempted from the restrictions on non-tariff barriers in the General Agreement on Trade in Services.

The concept of "passporting" was designed to allow a financial institution authorised in one EU member state to apply for passports to market financial products in other member states without the need of further authorisation. It is open to firms in non-member states to establish a presence in one EU state and apply for passports from there. Luxembourg tends to be the location of choice for obvious tax reasons. After Brexit, UK firms, which have shown little interest in penetrating retail markets on the continent, will remain free to set up subsidiaries in the EU to acquire relevant passports.

In the absence of a single market, strongly resisted by EU members highly protective of their own regulatory regimes (including the UK), an attempt was made to introduce a single standard for retail products, resulting in the Markets in Financial Instruments Directive, roundly ignored by France and other EU countries, but strictly observed by the UK. It was hoped the passport system would introduce competition within the EU. But this has not happened and the core retail financial activities — residential mortgages, deposit and savings products and so on — remain almost entirely national, and highly protected.

So the concern about "access" must refer to the City's wholesale business, by far the most important component of its position as the world's premier financial centre. But

[251] Stanislas Yassukovich *(2016)* Abandon all ideas about a so-called "soft Brexit" – we need a clean break from the EU, *BrexitCentral*, 12 November.

wholesale financial services are purchased at source by professional clients, even those who do not maintain a presence themselves in the City, as so many do. EU institutions also buy wholesale services in the other financial centres of the world, such as New York, Dubai, Hong Kong and Tokyo.

There is no passport requirement to have orders executed on the City's exchanges, any more than for orders on those in New York, Chicago or Tokyo. The world's banks do not need a passport to access London's interbank market, which is global, or to buy or sell foreign currency, or to participate in capital market syndicates. Nor do companies need one to buy reinsurance at Lloyd's, engage corporate finance and M&A advisers or procure a host of other City services delivered at source.

So now a new threat is perceived by Brexit sceptics: that the EU may deny its institutions access to the City. Although, the EU cuts itself off from the world in many ways, it has yet to ban its citizens from contracting services outside its borders.

…Access to the EU single market in financial services is not an issue — simply because, effectively, there isn't one. As it did when the UK did not adopt the euro, the City should just get on with business as usual.[252]

It took until January 2017 before the City abandoned the idea of passporting as being unworkable after Brexit.[253]

16. What are the alternatives to what the City wants?

In this section, we look at a number of alternatives to passporting that have been proposed.

16.1 Enhanced equivalence model

An alternative is the 'third-country equivalence regime' under the EU's MiFID II legislation which came into force in January 2018. This covers the entirety of investment businesses, including banks doing their investment business.[254]

Barney Reynolds proposes an 'enhanced equivalence' model which does not import the 'four freedoms' or other concessions on sovereignty. This would involve the UK:[255]

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[252] Stanislas Yassukovich (2017) The City has nothing to fear from Brexit, *Financial Times*, 12 January.
[253] Jonathan Ford (2017) The City sets plausible goals for life after Brexit: The UK should pursue a deal based on equivalence but not at all costs, *Financial Times*, 14 January; International Regulatory Strategy Group (2017) *The EU's Third-Country Regimes and Alternatives to Passporting*, January (commissioned by TheCityUK and the City of London Corporation).
[254] Andrew Tyrie (op. cit., p. 5) states that banking services have not been included in the equivalence arrangements so far agreed with non-EU countries.
[255] Barnabas Reynolds (2016) *A Blueprint for Brexit: The Future of Global Financial Services and Markets in the UK,* Politeia, November; Barnabas Reynolds (2016) The UK's natural advantages mean the City can continue its dominance post-Brexit, *Daily Telegraph*, 23 November; Barnabas Reynolds (2017) *A Template for Enhanced Equivalence: Creating a Lasting Relationship in Financial Services between the EU and the UK,*

- Removing the most unnecessarily onerous requirements of EU legislation, 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.

If the UK had equivalence-based access on this basis, then Mr Reynolds argues that this ‘would allow for reciprocity and mutual benefit between the UK and the EU. Mutual access between the EU and UK would be premised on equivalence between the two jurisdictions, providing for strong, open relations between the EU and the UK and delivering the

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Politeia, July; Barnabas Reynolds (2018) *Enhanced Equivalence – A Win-Win Proposition*, New Direction and Politeia, February.

advantages of access from the EU to the City, the main financial market in its time zones. Although a satisfactory resolution to the two issues… would deliver broad equivalence-based access to the EU, the UK and EU could go further than this to reflect the historical, geographical and cultural importance of the relationship between the two. An additional agreement could be sought between the UK and EU on a procedural framework for establishing, maintaining and withdrawing equivalence for the future. That would give certainty to both parties and to financial markets participants across Europe….Institutions from a number of other countries enjoy this status under various pieces of existing EU legislation, including companies incorporated in the US, Japan, Singapore, Switzerland, Canada, Mexico and others. Given the UK's close political, geographical and economic ties to the EU, it is likely that an equivalence regime will be even more successful and mutually beneficial than it is in other jurisdictions'.

The EU, despite its protectionist inclinations: has signed the Maastricht Treaty with its commitment to free capital movement; participates in the Bank for International Settlements, the central bankers club, which aims to ensure that financial markets remain open and non-discriminatory by requiring the same rules to be applied everywhere; and should recognise that companies in the EU will not be able to raise the capital they need without being able to access the City. On top of this, the US government is adamant that equivalence should mean what it says.[256]

Mr Reynolds is therefore reasonably confident that the EU will accept the enhanced equivalence model if they are being rational: 'All the existing equivalence based laws are invoked by the UK and we have basically a coverage of maybe 80%-85% of the financial markets…I think they're going to give it to us because … if they don't, it hurts them more than it hurt us. There are all sorts of reasons behind that, it hurts their branches in London, it hurts their access to liquidity, it hurts their access to capital funding, it just basically imposes costs on them. … I think it is even more likely [that] they'll plug the gaps in the equivalence regimes, most of them historical anomalies. The fact that Capital Requirements Directive IV hasn't got an equivalence regime is not some deliberate measure in my view. I think it's because MiFID II had it and this was introduced subsequently, so that's unfinished business with CRD IV. [Similarly] with various of the other holes. The one question mark is over primary insurance. I think that wasn't considered in Solvency II because there's no one in our time zone capable of offering retail insurance or primary insurance to the EU markets. It wasn't really relevant, it is relevant now. I don't see why the EU wouldn't wish to have access to cheap products subject to equivalent standards… [Nevertheless], equivalence is not a "must" at any cost. The UK needs to have flexibility in redrafting its laws to be in line with international standards while still being deemed "equivalent"'.[257]

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[256] Economists for Brexit (2016) A BRIEF ON THE CITY AFTER BREXIT: Written Submission to House of Commons International Trade Committee, 16 December; Patrick Minford (2016): *Trading Places: Consumers versus Producers in the new Brexit Economy*, Politeia.

[257] Barnabas Reynolds (2016) The UK's natural advantages mean the City can continue its dominance post-Brexit, *Daily Telegraph*, 23 November; Barnabas Reynolds (2016) *Brexit: Continuity of current arrangements for banks and investment banks*, Shearman & Sterling LLP, 27 June;

Some in the EU show signs of not being rational. For example, the French Finance Minister, Bruno Le Maire, says that the EU will not enter into a financial services deal with the UK because it will conflict with the EU's requirements for financial stability and effective supervision. But, as Barney Reynolds argues:

> *This ignores the fact that the EU already has negotiated equivalence-based arrangements with the US for the most systemically risky portion of the market, clearing houses, and has similar arrangements in place with many financial sectors across the world covering a whole patchwork of financial services provision. It has not previously been suggested that financial stability is at risk, and indeed several US clearing houses operated with EU customers throughout the 2007-8 crisis without hiccup.*
>
> *As for supervision after Brexit, under the equivalence concept this would be, as is current practice, conducted in the recognised country, in this case the UK. Given the UK has some of the best regulators in the world, with decades of proven experience and expertise (and upon whom the entire EU system already places huge reliance), raising that topic in the context of whether to rely on equivalence is clearly spurious. In fact Enhanced Equivalence allows the markets to be run far more safely, avoiding the tensions between the global markets located in the UK and the more specific markets across the EU27.*
>
> *Indeed it was partly the EU's passport regime operating in the run-up to the 2007-8 crisis, through the attempted harmonisation of rules across the EU, which led to dangerous regulatory arbitrage and then the credit crisis. The UK was, as a result of belonging to that system, held back in its supervision by having to operate within a structure in which some EU member state regulators were openly offering not to apply certain key (and expensive) rules in return for business being located there.*
>
> *After the financial crisis the EU has sought to address this problem by federalising control over supervision, but largely through prescriptive rulemaking, which has introduced new risk into regulation. The fact is that one size cannot fit all in regulation or supervision, particularly between the UK's global financial markets and the very different markets in the EU27.*
>
> *A new arrangement of Enhanced Equivalence, where the UK achieves the same internationally recognised outcomes through its world-class regulatory system is intrinsically a far safer way of proceeding and reflects the approach the EU is already rightly comfortable with for the US and elsewhere.*

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http://www.shearman.com/~/media/Files/NewsInsights/Publications/2016/06/Brexit_Continuity-of-current-arrangements-for-banks-and-investment-banks_B-Reynolds_FIA062716.pdf

The EU maintains that it will not outsource the writing, interpretation or enforcement of its regulations to an outside party. Maybe so, but in fact no such outsourcing would be required under the Enhanced Equivalence arrangements proposed here. The EU would continue to set its own requirements and could change them when it likes. Where the UK standards meet the same high level outcomes, by whatever means, there would be mutual recognition. Where those outcomes are not met, there would be a proportionate forfeiture of access after the point has been properly checked procedurally, if necessary by an independent arbitral body.

Brussels is also concerned to ensure the UK is not overly competitive. But this politics of punishment would never be accepted by the UK. More importantly, it would damage the prosperity of the EU27's citizens and could not for that reason be put forward in good faith by those who are democratically accountable. The whole world is competitive. The EU27 cannot reject that or seek to cushion competition within the EU timezones with the UK alone. You don't win a race by tugging at the shorts of the next runner – at least not over any sustainable period. A competitive City of London is essential to provide low-cost growth capital to EU businesses and to finance consumers' lives.

Some work is needed to achieve the best arrangements under Enhanced Equivalence. The EU's existing equivalence regime would need some tweaks. The current regime, with its one-way, unilateral equivalence determinations, does not go far enough to avoid uncertainty and therefore potential harm. Many institutions have made clear that on that basis they would feel forced to establish infrastructure in the EU27, which is where the costs charged back to EU citizens start escalating. The markets and commentators have made clear that the global markets will remain in the City of London, so the fragmentation merely leads to significant cost being pushed onto EU27 citizens….

This is a pivotal moment for the EU. The efficacy and accountability of its core institutions is being tested before the curious eyes of the world, wondering what the true nature of the emerging EU will be. If this test is failed, EU citizens are likely to wonder why their aspirations for economic growth and opportunity have been dashed to satisfy a bureaucratic ideal. In order to minimise the risk of such an outcome, UK citizens will want to see that their leaders have reached out to the EU27 publics in some way and have not blindly persevered in negotiating with institutions which might be structurally incapable of reaching a win-win outcome.[258]

[258] Barnabas Reynolds (2018) Can the EU step up to a win-win Brexit outcome in financial services?, *BrexitCentral*, 21 March.

Others have also proposed the third-country route. For example, Mahoney et al. (2016) argue that in a post-Brexit world, the UK could establish third-country status in many areas: 'A recent measure by ESMA, for example, could provide a blueprint for UK financial service firms. ESMA's passporting rules now mean that asset managers in some countries outside the EU can continue offering services to investors across Europe, replacing the previous system of country-by-country private placement authorisation. It should be noted, however, that third-country arrangements do not exist in some areas such as payment systems providers, which could prove to be more problematic'.

Similarly, Simon Currie, private investment funds partner at lawyers Morgan Lewis, also agrees that the third-country regimes legislation provides a route for firms located in non-member states – in particular, in asset management – to access the single market:

> *Third-country regimes are a feature of a number of EU legislative acts, most notably the Alternative Investment Fund Managers Directive and the Markets in Financial Instruments Regulation and could serve to substantially mitigate the effect on UK fund managers and investment firms of a UK withdrawal from the EU. In broad terms, these regimes permit access to the EU market on the basis of an assessment of the suitability or equivalence of the regulatory regime in the country where the third-country firm is based.*
>
> *Subject to this assessment, in the case of the AIFMD, a fund manager from outside the EU could opt into the regulatory regime under the directive in order to market its funds (whether or not established in the EU) to EU investors and to manage EU funds, either on a cross-border basis or via the establishment of branches in the EU.*
>
> *The application of the AIFMD third-country regime to a particular country is dependent upon ESMA advising the EU Commission that there are no significant obstacles to doing so. Thus, the manager would benefit from passporting rights and would not need to establish a presence in the EU in order to do so. This extended passport is a hybrid in the sense that, unlike passporting for EU firms, the regulatory authorisation of the third-country firm in its home territory would not be sufficient, and it would be necessary for the firm to be authorised and supervised in relation to activities undertaken within the EU by an EU regulator.*
>
> *So a UK fund manager, following a UK exit from the EU and an extension of the AIFMD third-country regime to the UK, would need to be authorised in an EU country as well as being authorised in the UK by the Financial Conduct Authority in order to conduct cross-border business. This dual regulation would inevitably impose an additional burden, but should otherwise enable UK firms to market and manage funds across the EU in a very similar way to that presently applying. It ought to be an attractive alternative to establishing a separate affiliate in the EU.*
>
> *Similarly MiFIR, [which came] into effect in January 2018, entitles third-country investment firms to provide investment services to professional clients across the EU upon registration with ESMA. Although somewhat more limited in its scope, this also*

has the potential to ameliorate, at least in part, the adverse impact of a UK exit from the EU on the ability of UK investment firms to conduct cross-border business.

The application of the AIFMD third-country regime to a particular country is dependent upon ESMA advising the EU Commission that there are no significant obstacles to doing so. No acceptance by the country in question of free movement of people is required. ESMA has already advised the Commission that the AIFMD passport can be extended to fund managers in Guernsey, Jersey and Switzerland (although the Commission has not yet acted upon this advice).

An extension of the MiFIR regime to a country requires the Commission first to have determined that the legal and supervisory regime in the relevant country is equivalent to that under applicable European standards but, again, does not impose any acceptance of free movement principles.

Since the UK has implemented the AIFMD and will have implemented the recast MiFIR regime prior to any Brexit taking effect, it should be technically straightforward for the Commission to permit UK fund managers and investment firms to take advantage of these third-country rights following a Brexit.

No doubt political issues will complicate the process, but ensuring that UK firms are able to use these rights ought to be an important component of any exit negotiations.[259]

In December 2017, the Bank of England's Prudential Regulatory Authority proposed permitting EEA branches to convert to third-country branches.[260] There are 77 branches of 'incoming' EU and other European Economic Area (EEA) banks operating in the UK that are authorised to take deposits and they lend more than £1trn (or 15 per cent of all loans) to UK residents. The PRA argues that a third-country regime is permissible where there is good regulatory cooperation with the host country. This is particularly useful for systemically important wholesale banks, since the PRA can influence supervisory outcomes for the whole group, including the UK branch, via the existing college system or by bilateral engagement combined with prompt information exchange. It still allows the PRA to impose extra governance requirements under the senior managers' regime, restrict the branch's business model or impose additional liquidity requirements.

[259] Simon Currie (2016) How could the 'third-country regime' potentially work for UK asset managers post-Brexit?, *Investment Week*, 27 July.

[260] *The Bank of England's approach to the authorisation and supervision of international banks, insurers and central counterparties*, 20 December 2017; https://www.bankofengland.co.uk/news/2017/december/approach-to-authorisation-and-supervision-of-international-banks-insurers-central-counterparties

The proposal has been described as sensible and pragmatic by Simon Hills, Director of Prudential Policy at UK Finance.[261] He suggests it would be helpful if the EU adopted a similar approach to UK banks, since these 'outgoing' banks are important for EU-based buyers of financial services: for every €1 spent by a UK buyer with an EU-based financial services company, EU-based buyers spend more than €6 purchasing financial services from UK-based companies. UK Finance supports an ambitious EU-UK free trade agreement for financial services which would involve 'a variable approach depending on the likely levels of supervisory concern, a symmetrical approach based on mutual acceptance of regulatory and supervisory cooperation and reciprocity, and the need for an adaptable cross-border financial services framework that can respond to technological developments or other changes. Its application to the supply of outgoing financial services would ensure that EU companies could continue to use London's international financial services centre to meet their financing and risk management needs'. UK Finance believes the same approach could be applied to all regulatory cooperation in global financial services, not just with the EU. This is because it is important that international standards, such as the Basel framework for prudential banking regulation, are applied in a harmonised way based on transparent implementation and mutual trust between supervisors around the world.[262]

16.2 Mutual recognition

Another option which would achieve a similar result as enhanced equivalence is 'mutual recognition' through 'mutual market access', a new concept proposed by the International Regulatory Strategy Group (IRSG) which is affiliated to TheCityUK.[263] This assumes that financial services regulation and supervision in the UK and EU would remain aligned in the future. This would be achieved by having post-Brexit rule setting in the two jurisdictions jointly monitored by a Forum for Regulatory Alignment.

However, Barney Reynolds is concerned 'with inventing a new concept [on account of] its potential to open a Pandora's box of new negotiating points. That could ultimately lead to a weaker solution or an attempt by the EU to restrict the UK's approach to tax, competition and other areas of policy, which has long been a concern for the French'.[264] Nevertheless, this option appears to be gathering increasing support in the UK, including from the prime minister in her Mansion House speech on 2 March 2018,[265] the chancellor Philip Hammond,

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[261] Simon Hills (2017) Pragmatic approach to oversight of EU banks paves way for Brexit progress, UK Finance, 21 December; https://www.ukfinance.org.uk/pragmatic-approach-to-oversight-of-eu-banks-paves-way-for-brexit-progress. UK Finance was formerly known at the British Bankers Association.

[262] UK Finance (2017) *Supporting Europe's Economies and Citizens: a modern approach to financial services in an EU-UK Trade Agreement*, September; https://www.ukfinance.org.uk/wp-content/uploads/2017/11/EU-UK-Trade-Agreement-report-ONLINE-UPDATED.pdf

[263] Lucy McNulty (2017) Brexit blueprint proposes market lock-outs, *Financial News*, 2 October.

[264] Barnabas Reynolds (2017) Deal or no deal, the City can still prosper after Brexit, *Daily Telegraph*, 12 October.

[265] The prime minister spoke of her need for a 'comprehensive system of mutual recognition. The UK will need to make a strong commitment that its regulatory standards will remain as high as the EU's', https://www.gov.uk/government/speeches/pm-speech-on-our-future-economic-partnership-with-the-european-union. See also: Funds Congress backs mutual regulatory recognition post-Brexit, *Investment Week*,

the secretary of state for leaving the EU David Davis, and the Bank of England governor Mark Carney.

On the other hand, Lord John Kerr, the former British Ambassador to the EU who drafted Article 50, didn't see this option working all, believing instead that only the equivalence option will be offered on the grounds that 'the City needed to prepare for a deal that would ultimately hurt London's standing as a global financial centre', since equivalence can be withdrawn at short notice and is open to manipulation for political purposes. The rationale for this view is the EU's negotiating guidelines for the UK's withdrawal from the EU which referenced an aim to use improved equivalence mechanisms for future financial services trade between the EU and UK.[266]

16.3 Special hybrid (Swiss insurance model)

The former 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.[267] 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'.[268]

Two variations on this model have been proposed by the International Capital Market Association (ICMA) in a working paper entitled *European Capital Market Integration Post-Brexit* released in October 2016. The first would be a 'bespoke bilateral agreement' with the EU that gives it access to the single market through a recognition of equivalence between UK and EU financial services regulation. But the paper recognises that gaining equivalence could be a drawn-out task and could be revoked later by the EU: 'It is not clear to what extent a bilateral agreement between the UK and the EU27 would preserve capital market integration between London and financial centres in the EU27: for example, whether banks would have to maintain two separate balance sheets, one for the UK and one for the EU27, which would be more expensive – in terms of capital and liquidity – than the single balance sheet they need within the EU at present'.

The second would be a 'separate sectoral agreement' with the result that 'the City of London – as a European financial asset – would in practice remain "in", while the UK as a whole would come "out" of the EU'. However, the report recognises that there are 'few precedents for the bilateral negotiation of financial services', so if the agreement takes

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16 February 2018; Tim Wallace (2018) Hopes grow of a bespoke Brexit deal for the City, *Daily Telegraph*, 17 February.

[266] Lucy McNulty (2018) Article 50 Author tells the City to forget about planning for a bespoke Brexit, *Financial News*, 9 April.

[267] Alex Barker and Jim Brunsden (2016) EU reconsiders financial market access rules, *Financial Times*, 6 November.

[268] Timothy Ross (2016) Banks likely to lose passporting with Brexit, official says, *Bloomberg News*, 26 October.

longer than two years to negotiate, an interim agreement would need to be put in place to avoid a cliff edge whereby the regulatory regime changes overnight.[269]

A similar proposal has been made by Geoff Raby and Andrew Stoler who argue that the UK should just participate in the Capital Markets Union. The CMU project aims to reduce fragmentation in financial markets, diversify financing services, strengthen cross-border capital flows, and improve access to finance for business. It is particularly concerned about the removal of regulatory barriers, rather than an attempt to promote further integration among member states under a single market supervisor. The UK has traditionally been the EU's strongest supporter of CMU.[270]

Another suggestion for limited participation is for the UK to participate in the Trade in Services Agreement (TiSA). TiSA is currently being negotiated between the EU and key WTO members, which together account for 70% of total world trade in services. The UK is a member of the WTO and the EU has services schedules which are specific to member states. For example, some member states are unwilling to allow foreign competition in some service sectors and have corresponding TiSA carve outs; by contrast the UK places no restrictions on foreign providers of services to the UK.[271]

16.4 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. Dominic Johnson, CEO of Somerset Capital Management and chair of lobby group New City Initiative, said: 'It would be ideal to have a dual funds regime in the same way as Jersey; this would be perfect. This would allow companies to participate in the EU market if they wanted to'.[272]

The dual regulatory system 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.

[269] Tim Burke (2016) ICMA: Brexit threatens capital markets integration, *Financial News*, 5 October.
[270] Geoff Raby and Andrew Stoler (2016) Britain's services trade can flourish outside the EU Single Market, *City A.M.,* 15 December.
[271] Geoff Raby and Andrew Stoler (2016) Britain's services trade can flourish outside the EU Single Market, *City A.M.,* 15 December.
[272] Reported in Mark Cobley and Jessica Davies (2016) Americans vs Brits: City splitting over post-Brexit strategy, *Financial News*, 26 June.

- UK and ROW – the UK would then establish a regulatory framework that is best suited for UK companies operating outside the EU.

16.5 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 basis, 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.

CEO Ian Sayers supports the layered approach because: 'It would maintain strong regulatory standards for investors but also reduce unnecessary compliance burdens. It would maximise the UK's ability to reduce costs, enhance competition and support investment in the UK economy. Where funds actively seek EU investors, EU rules would be overlaid. The rules allowing investment companies to market into individual EU countries work well and can be used to target additional demand effectively. It is unlikely that the additional compliance costs that come with a full passport would outweigh the benefits of any extra marginal demand. Even UCITS, which have had a full EU passport for many years, have limited cross-border distribution in practice'.[273]

16.6 Establish a fully capitalised subsidiary (Swiss banking model)

In this 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.[274] Swiss banks run their European investment banking businesses, via London subsidiaries, which is why this is also known as the 'Swiss banking' model.

While this is a fail-safe solution guaranteeing access, it is expensive. As Simon Gleeson, a regulatory partner at Clifford Chance, points out: 'If there is no compromise between the UK and the EU on financial services, both global and EU banks will have a choice between committing more capital to new subsidiaries to retain existing business, thereby reducing return on equity, or simply forgoing those revenue streams, thereby also reducing profits. In an environment where low levels of bank returns are acknowledged as a key threat to stability, that is not good'.[275] Further, there will be certain business areas that are unprofitable, such as retail banking business (deposit-taking and lending) in other EU states:

[273] Tom Eckett (2016) AIC advises 'layered' approach to fund regulation in post-Brexit UK, *Investment Week*, 4 October.
[274] Grant Thornton (2016) The impact of 'Brexit' on the financial services sector, April.
[275] Caroline Binham (2016) EU's financial watchdogs signal post-Brexit clampdown, *Financial Times*, 9 September.

the markets are very competitive and the City's share in these markets is negligible, so this model will not be appropriate in this case.[276]

16.7 The World Financial Centre model

Barney Reynolds recognises that the enhanced 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'.[277]

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 enhanced equivalence model:[278]

- Removing not only those particularly burdensome rules that could not be removed under the enhanced 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

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[276] Martin Hutchinson (2016) Quit backsliding on Brexit!, *The Bear's Lair*, 12 September.
[277] Barnabas Reynolds (2016) The UK's natural advantages mean the City can continue its dominance post-Brexit, *Daily Telegraph*, 23 November.
[278] Barnabas Reynolds (2016) *A Blueprint for Brexit: The Future of Global Financial Services and Markets in the UK,* Politeia, November.

- 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.

According to Mr Reynolds:

> *The effect would be the development of an attractive, market-friendly regulatory framework, allowing banks and financial institutions to improve returns on equity, free from unnecessarily burdensome EU regulation. This world is not to be feared. It allows the UK to regain the prominence it enjoyed under the global regulatory framework of the early 1990s and before, reinforced with a modern understanding of the importance of systemic risk mitigation and consumer protection and enhanced by a more radical re-think for which Brexit provides an opportunity. Systemic risk regulation is an area in which the UK has rightly taken the lead in formulating at an international level and which must find a place in post-Brexit laws.*
>
> *The [World] Financial Centre model recognises that it is not only that EU regulation goes beyond global standards and best practices (which it does), but that it does so in untargeted and inappropriate ways, driven by social policy and other extraneous interests. This has led not simply to more regulation, but to worse regulation. It has also created an incentive for some member states to disregard important regulatory requirements, creating informal regulatory arbitrage within the EU (which was one of the main underlying causes of the 2008 financial crisis). In rebalancing the UK's regulatory framework, it must be recognised that it is not simply a matter of "more" or "less" regulation, but rather better regulation to which the UK should aspire.*
>
> *By building on the UK's reputation as an attractive, market-friendly, well-respected place to do business, the incentive (far from moving business from the UK to the EU) would be for banks to continue to be established in the UK, and have their most significant customers come to the City to transact business. This should be welcomed, and the UK should facilitate customer access wherever possible, for example, by structuring its tax laws to allow UK affiliates of EU companies to be established with tax transparency. This would allow businesses that currently are cross-border to be conducted through UK affiliates of EU counterparties and up-streamed to the EU parent without incurring an undue tax burden.*
>
> *This more radical solution may prove better than the enhanced equivalence model, depending on what the EU seeks for equivalence and how protectionist EU laws become going forward. Further, in some existing areas of law, such as AIFMD or*

Solvency II, it could well be that the [World] Financial Centre model is preferable for the UK regardless of any equivalence offer.

…Unburdened from the shackles of European social policy, the UK could rethink its regulatory framework entirely and move to better, more targeted regulation. This approach is not entirely new. In some ways, it winds the clock back to the situation before the passport came in partially in 1995 and more fully in 2007….[We could] revive an obligation by regulators to consider the competitiveness of the UK's financial sector. This was killed off after the crisis, when the light-touch approach of the old City regulator, the Financial Services Authority, was widely criticised. Instead, [we] would strip the watchdog of its newly inherited antitrust powers, which were part of the post-crisis reforms of tackling "too-big-to-fail" institutions and improving competition among financial firms.

Mr Reynolds proposes a number of ways that financial services firms would be able to continue doing business in the EU even without single market access via passporting or an enhanced equivalence regime, by making maximum use of international law protections from any cliff edge:

- Making use of 'reverse solicitation exemptions' or 'overseas persons exemptions'[279] which allow financial institutions to provide certain cross-border services to a client (such as securities trading, advising on or managing investments, or taking deposits from non-retail customers) without being registered or authorised in that client's member state, provided that the services are provided on the initiative of the client.

- Making use of the existing EU laws that allowed cross-border dealings — 'including multiple on-the-ground visits' — without a local branch or licence. If needed, firms could set up an EU subsidiary to do business with clients in the bloc, while shifting the business back to the UK headquarters via 'back-to-back' trading arrangements.[280]

- Making use of human rights legislation. The right to property protects rights under contracts between UK and EU27 businesses that exist prior to Brexit. It arises both in the European Convention on Human Rights, to which the UK and every EU27 state will remain a party and in the EU's own Charter of Fundamental Rights. These property rights protect contracts which have an economic value on Brexit.[281]

A particular attraction of the go-it-alone model is that the 'legal options for future UK-EU relations…are secondary to political considerations, which will determine the depth of cooperation permitted at EU level and between regulators, as well as the regulatory

[279] Under AIFMD and MiFID II.
[280] See Barnabas Reynolds (2017) The Art of the No Deal: How Best to Navigate Brexit for Financial Services, *Politeia*, November. Other ways of allowing business moves to be minimised include indirect clearing, agency arrangements, give-up agreements, delegation, outsourcings, branching back and reinsuring back into the UK from the EU27.
[281] See *Continuity of Contracts and Business on a "Hard" Brexit: Human Rights and Reverse Solicitation to the Rescue!,* Shearman & Sterling, 31 October 2017.

benchmarks for market access. Berlin, Paris and Brussels are determined to ensure Britain does not receive a better deal outside the bloc. As a result, senior EU officials say it is almost impossible to imagine Britain retaining similar access privileges in different legal form after Brexit'.[282]

Others, such as Edi Truell, go even further than Mr Reynolds and argue that the City was so economically important to the EU that it could negotiate 'equivalence' status for new lighter touch UK regulations: 'London is the pre-eminent financial centre in Europe. We need to be more self-confident. We should say, if you want to trade with us, these are our rules – instead of worrying about access to the EU market'.[283]

These views are echoed by Richard Tice – co-chair of Leave Means Leaves, which was launched in September 2016 – who believes that the City will get a £12bn a year windfall once it is liberated from 'burdensome' and 'highly expensive' EU regulations, equivalent to 2-3% of the financial sector's annual costs. According to Mr Tice, 'being able to cut unnecessary regulation and bring back legal jurisdiction to the UK opens up a whole host of opportunity. The EU, on the other hand, faces a very difficult struggle ahead. It is essential that they secure a deal with the UK on financial reciprocity or they will see capital move from Frankfurt, Paris, Madrid to London'.[284]

The long-term projections of Professor Patrick Minford, chair of Economists for Free Trade, suggest even bigger benefits from leaving the EU. According to Professor Minford's model, UK financial services will grow by an additional 10% in the next decade if there's a clean break from the EU. He said: 'City bosses appear to be on a relentless and misguided campaign to try and pressure government into staying in the single market, in spite of there not being a true single market in financial services. That seems astonishing to us when our projections show how much better off over the long-term the industry will be out of the EU and outside the single market, as the UK exploits its natural strengths in the service sector. London is the financial capital of the world and free from the shackles of this regime, it will undoubtedly thrive, growing by £20bn over the next ten years'.[285]

In May 2018, the Institute of Economic Affairs issued a report on the financial services regulations that would be needed to support the World Financial Centre model.[286] The report argues that financial services regulations must: not restrict growth in financial services, not encourage regulatory arbitrage, not prevent sections of the economy from

[282] Martin Arnold and Caroline Binham in London and Alex Barker in Brussels (2016) City should welcome escape from burden of EU rules, says report, *Financial Times*, 3 November.
[283] Reported in Mark Cobley and Jessica Davies (2016) Americans vs Brits: City splitting over post-Brexit strategy, *Financial News*, 26 June.
[284] Mark Sands (2016) The City is set for a £12bn windfall after liberation from EU red tape, according to these Brexiteers, *City A.M.*, 30 October.
[285] Ryan Sabey (2016) BIG BUSINESS BOOST: Britain's financial services will receive £20bn Brexit bounce OUTSIDE the EU single market, *Sun on Sunday*, 23 October.
[286] Shanker Singham and Catherine McBride (2018) *Improving Global Financial Services Regulation*, Institute of Economic Affairs, May.

accessing capital or other financial products, help to develop safe but competitive markets, and facilitate the growth of new and small businesses.

With these aims in mind, the report makes the following proposals:

- Develop a strong domestic regime in line with global standards and best practices. The UK should reshape its own regime by removing any unnecessary processes and focusing instead on proportionality of the regulatory outcomes in a transparent and cooperative manner.

- Pursue WTO disciplines with renewed urgency. The WTO understanding on financial services should be developed with the goal of liberalisation of market access. The WTO Most Favoured Nation (MFN) principle of non-discrimination should be at the core of any agreement on international financial services.

- Form an alliance with other major financial markets, such as Switzerland, Hong Kong and Singapore to enable further and deeper integration opportunities. A UK regime of multilateral mutual recognition (MMR) would allow the UK to strengthen its involvement in global regulation formation and dispute resolution.

- Form an alliance with UK-linked international financial centres. The UK should make comprehensive bilateral agreements based on mutual recognition with the Crown Dependencies and the Overseas Territories that have established adequate regulatory standards in key financial service sectors such as banking, asset management, insurance and reinsurance.

- Introduce regulation to encourage innovation. Domestic SMEs and fintech companies should have proportionate regimes of regulation and taxation to ensure good conditions for new entrants and dynamic high growth firms.

- Establish regulatory coherence agreement between the UK and the EU27. Such cooperation should include shared cost benefit analyses in regulatory promulgation with regard to a range of factors, including impacts on trade and competition.

- Allow EU27 headquartered banks with UK branches to continue post-Brexit provided that their home regulators continue to cooperate with the UK authorities, and expedite conversion from branches to subsidiaries if desired. This provides certainty for EU banks trading in the UK, ensures market stability and would be a show of good faith that the UK will not restrict EU27 access to financial services.

Commenting on the report, Shanker Singham, Director of the International Trade and Competition Unit at the IEA and a co-author of the report, said: ‘Now is the time for the UK to promote more competitive regulation in global standard setting organisations and to challenge global rules with anticompetitive effects. Financial regulation is already based on international standards in many key areas. Outside the EU, the UK will have the advantage of greater agility in decision making, entering into regulatory recognition arrangements with third countries and implementing appropriate regulations. If these tracks are initiated, the future for UK financial services should be very bright'.

17. 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: 'From the UK's perspective, any such deal is likely to involve significant concessions on sovereignty issues, free movement of persons and budget contributions, which are politically undesirable. From the EU's perspective, there is no appetite to "reward" the UK for leaving the EU by granting it special privileges and the EU is keen not to set an attractive precedent, which might incentivise other member states to consider their position'.[287]

Instead Mr Reynolds wants a solution that focuses on the UK, because 'what used to happen and will happen if they're protectionist …. is the customers come to us. When I started, CEOs used to fly in from Europe to do business here during the day to work out what they wanted to do with their customers and so on, and deal through affiliates here. We'll move back to that. It imposes an additional cost on them if they wish to go down that route, we just make ourselves very attractive, but the centre of gravity, the magnetic pull is here. The dog is here, as it were, with the tails, little wisps, into Europe. You can't pull on those wisps and pull the whole bulldog over the Channel. It doesn't work, it's not possible'.[288]

He likes the equivalence regime:[289] '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. [You] can take whole buckets of EU law out of our system on the basis that they're not relevant to equivalency. An awful lot of the laws are not relevant'. In addition, 'enhanced equivalence, being based on existing EU legal concepts, is fully compatible with EU values and its red lines. It takes the existing EU equivalence concept, fills in the gaps and makes it mutual and binding. It supports a sovereign-to-sovereign relationship already in existence in EU law and in application with numerous countries around the world, including the US, Canada, Mexico and Singapore'.[290]

However, a number of commentators have argued that equivalence will be a poor substitute for passporting. For example, Anthony Browne says: 'Passporting has underpinned the growth of London as Europe's financial centre, and helped financial services become our biggest export market by far. The UK exports over £20bn of financial services a year to the EU27, much of it underpinned by passporting rights. The nine different

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[287] Barnabas Reynolds (2016) *A Blueprint for Brexit: The Future of Global Financial Services and Markets in the UK,* Politeia, November.
[288] Keynote debate: Could Brexit positively impact UK financial services?, Misys Connect Forum, 20 September 2016; http://misys.kulu.net/view/XG1zcTzFEDU/
[289] If safeguards can be built in to stop the EU summarily and suddenly changing rules.
[290] Barnabas Reynolds (2018) Can the EU step up to a win-win Brexit outcome in financial services?, *BrexitCentral*, 21 March.

passporting regimes in EU law allow financial services companies in one country to establish a branch in another country without having to be separately authorised or regulated. It also allows financial service companies to sell directly to customers across other EU countries. The alternatives such as equivalence are poor shadows of genuine passports. They only allow a much narrower range of services, offer more limited rights at greater cost and, crucially, can be withdrawn at short notice. The equivalence regime also takes many years to secure and put in place and is subject to political whim… Downplaying the importance of passporting goes against the golden rule of negotiations. We should aim high at the outset rather than narrowing our horizons… We want to retain Europe's integrated financial market, not split it in two by building a wall along the channel'.[291]

Other potential problems with equivalence are:

- It only applies to specific activities, mainly in wholesale rather than retail finance
- It could also constrain the UK's ability to alter 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.[292] For example, would the EU make equivalence conditional on the UK abiding by EU rules on banker bonuses? And what if the EU decided to tighten those rules further? Would the UK follow?[293]
- Banks are unlikely to rely on equivalence for long-term business planning. According to Simon Gleeson, a partner at Clifford Chance, 'the difference between a passport and equivalence is similar to the difference between offering someone citizenship or a temporary right to remain: one allows a person to build a life in a country; the other encourages them to seek long-term security elsewhere'. [294]
- 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.

According to the *Financial Times*:

> *'Any move to tighten the access regime would signal that Brussels will let Britain take nothing for granted in negotiations to leave the EU. It would also be a blow to the US and*

[291] Anthony Browne (2016) There's no room for complacency about the value of passporting rights to UK financial services, City A.M., 19 October.; Tim Burke (2016) BBA chief- 'Banks planning for worst case Brexit scenario', *Financial News*, 20 October.
[292] Stephen Fidler (2016) London's City Faces a Post-Brexit Dilemma, *Wall Street Journal*, 27 October.
[293] Simon Nixon (2016) No Quick Fix to City of London's Brexit Conundrum, *Wall Street Journal*, 28 September.
[294] Simon Nixon (2016) No Quick Fix to City of London's Brexit Conundrum, *Wall Street Journal*, 28 September.

more than a dozen jurisdictions, who fear approval for their pending applications will be waylaid by Brexit politics. One senior EU official said equivalence "is not automatic and is not a right" and was bound to be reconsidered in light of Brexit. Another official noted that the patchy criteria needed to be clarified. The aim would be to create a more transparent process and recognise that deep financial interaction, such as with the US or UK, requires deeper equivalence checks.

…British ministers have admitted that the uncertainty around equivalence — and the fact that rights can be abruptly withdrawn — means it "wouldn't necessarily work" for international banks in London.

...However, EU officials note any permanent "hybrid" arrangement would only be possible in a full trade deal, completed years after the UK has left the union. For this reason the existing equivalence regime would be an important basis for any transition arrangements, which banks see as vital for an orderly exit. Mark Carney, Bank of England governor, has described equivalence as the "way forward" in global financial regulation.

….EU officials recently cited Brexit when telling a number of jurisdictions not to expect an imminent equivalence decision from AIFMD, the EU law to regulate hedge funds and private equity groups. Around a dozen jurisdictions — including the US and Switzerland — have already been cleared by ESMA as meeting EU standards but the commission has delayed signing off the access rights.

…Cross-border rights secured through equivalence are typically better than those granted by a national regulator, but weaker than a full "passport" to offer services across the EU. Existing rules open gateways for EU firms to use market infrastructure in a non-EU country, reduce restrictions on data transfers, or ease regulatory requirements for branches of non-EU firms.

However a wide range of financial activities and regulations include no "equivalence" provisions. These include banking activities such as lending and deposit taking, payments, custody, and private wealth management.

Richard Reid, a research fellow in finance, banking and regulation at the University of Dundee, said he doubted there would be any appetite in Brussels to make the equivalence regime "less strict".

"Even before the Brexit vote, the last financial crisis had fostered an environment of more intrusive regulation," he said. "Now, with some in the UK arguing that perhaps one way forward for its financial services industry is to benefit from being freed from unwarranted EU legislation, it may be unrealistic to think that gaining EU equivalence recognition will be straightforward"'.[295]

[295] Alex Barker and Jim Brunsden (2016) EU reconsiders financial market access rules, *Financial Times*, 6 November.

Some lawyers have also pointed out that there could be practical difficulties with Barney Reynold's proposal to use 'reverse solicitation exemptions' to retain staff in London, a proposal that also has the support of Jacob Rees-Mogg MP, a former member of the Treasury select committee: 'It is in everybody's interest if we maintain as open as possible financial markets with essentially widespread equivalence regimes … what I was trying to get at in this session was if that turns out not to be possible, there are ways of working around it to ensure that the disadvantages are not in fact that great. …At the moment the City is quite understandably lobbying as hard as possible to get the least change and has a strong interest in not admitting that there are alternative solutions ... and therefore to say there are reasonably straightforward options is not in their interest because they want to try and persuade the government to prioritise them in negotiations against other important parts of the negotiation'.

However, Andrew Procter, a financial services regulation partner at Herbert Smith Freehills, said reverse solicitation was 'a shaky basis on which to build a business model. The approach would raise questions about how clients become aware of new products and services, and warned that EU countries also take different views on whether it is a permissible way of providing services to their citizens. Many of them have not said clearly, one way or another, whether they would permit it, in what circumstances and for what products and services. Even where it is clearly accepted, the other country could change its mind, with little warning, and prohibit the practice'.

Barney Reynolds's response was that 'there are [legal] workarounds for many points. There are innovative uses of reverse solicitation which haven't been fully explored so far. There are also US business models that rely in part on this exemption, which provides additional cover for particular interpretations. I think there are innovative answers which cushion the transition and minimise, further than has been identified hitherto, the amount of stuff that one might consider moving'. However, he conceded: 'What is true to say is that reverse solicitation doesn't get you to exactly the same place as the passport. [But] it is one of the points that assists in reducing the amount needing to be considered for relocation'.[296]

However, whatever model is chosen, Mr Reynolds is clear that 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: 'There is no need to make any adjustments in this regard. The importance of maintaining full trading and clearing in euros in the City and the reasons why the EU does not have the power to take control of this business', since the European Central Bank does not 'own' the euro.[297]

[296] Lucy McNulty (2017) City lawyers dismiss MP's post-Brexit job retention strategy, *Financial News*, 12 January.

[297] Barnabas Reynolds (2016) *A Blueprint for Brexit: The Future of Global Financial Services and Markets in the UK,* Politeia, November.

18. Transitional arrangements

18.1 Is a transitional arrangement needed?

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. They have agreed a transitional or implementation period between 30 March 2019 and 31 December 2020.

According to Pascal Lamy, the former EU trade commissioner and director-general World Trade Organisation: 'A transition is unavoidable. It is a practical necessity. But it is impossible to imagine a transition without knowing where you are heading, the landing zone'.[298] Another EU diplomat said it is not possible to have clarity before the end of the Article 50 process. This is because there will be hundreds of billions of euros in joint UK-EU liabilities to unwind as well as negotiations over the EU's budget contributions in terms of amount and duration.[299] Gideon Rachman argues that 'the negotiations are too complicated to complete in the allotted time'.[300]

However, the idea that 'negotiations are too complicated to complete in the allotted time' is simply not true according to Lawyers for Britain.[301] 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. For example, when Czechoslovakia split into the separate states of the Czech Republic and Slovakia on 31 December 1992, both new states agreed to assume and continue to honour the treaty obligations of the former State of Czechoslovakia, and other States and international bodies accepted the succession as being effective, where necessary agreeing new machinery for the separate representation of the two new states…… [I]nternational counterparties to the existing EU FTAs will almost certainly follow general state practice in state succession cases and accept the rolling over of FTA arrangements so that they continue to apply to the UK after Brexit'. So that leaves trading arrangements with the EU. As Lawyers for Britain argue there ought to be 'mutual interest in preserving the continuity of existing treaty arrangements, particularly those which affect day-to-day existing trade, unless there is some good and concrete reason for changing those arrangements'.

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).

[298] Alex Barker and Stefan Wagstyl (2016) Brexit: How to avoid a cliffhanger, *Financial Times*, 11 October.
[299] Alex Barker and Stefan Wagstyl (2016) Brexit: How to avoid a cliffhanger, *Financial Times*, 11 October.
[300] Gideon Rachman (2016) The chaotic route to train-crash Brexit, *Financial Times*, 20 December.
[301] Brexit and International Trade; http://www.lawyersforbritain.org/int-trade.shtml

The City would like certainty of any transitional agreements as soon as possible. TheCityUK's Miles Celic said: 'What firms in the financial and related professional services industry will want to see as early as possible is an agreed and secured transitional period to help ensure financial stability and minimise disruption to their ability to provide products and services to customers'.[302]

18.2 Types of transitional arrangements

The *Financial Times* and BBC suggested five possible transitional models.[303]

The accident: an almost immediate exit

This would be an immediate hard Brexit with standard tariff rates set under WTO rules. In extremis, the position of cross-border companies and residents could be unclear. The UK would no longer be subject to more than 30 EU regulatory agencies and would have to introduce some of these itself, such as those dealing with chemical and medicine regulation. New customs arrangements would need to be put in place. EU officials believe this would be impossible to achieve in two years. Supporters of unilateral free trade, on the other hand, argue that the UK's position could be considerably simplified if, when it exited the EU, it unilaterally removed all tariffs and non-tariff barriers on imports into the UK from both the EU and the rest of the world, even if these regions imposed tariffs or continued to maintain tariffs on exports from the UK.

The status quo prolonged: lasting one to three years

The UK retains access to the EU single market for between one and three years after formal exit from the EU. While this would provide increased certainty for businesses, there appears to be little appetite for this arrangement in Brussels, it being seen as too politically and legally cumbersome for a temporary deal. Also the European Parliament would want a firm cut-off date in order to force UK businesses to relocate to the EU. The idea is also not attractive to Whitehall as it would mean at the time of the next election in 2020, the government would have to explain to voters why the UK had left the EU but was still subject to its laws and making budget contributions. A particular problem would be financial services regulation. As Sam Woods of the Bank of England has said: 'Running a leading global financial centre and a massive banking system with a set of rules over which you have no influence is not something you would easily choose to do'.

The glide path: lasting into the mid-2020s

This would involve an arrangement in which the UK and EU gradually diverge. Some access rights to the single market would be tapered, while others would be prolonged through bespoke agreements. This model is attractive to Mark Boleat of the City of London Corporation: 'Moving locations takes a long time, so businesses are having to take decisions

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[302] Bernard Goyder (2016) City asks for a bit more time, *Financial News*, 3 October.

[303] Alex Barker and Stefan Wagstyl (2016) Brexit: How to avoid a cliffhanger, *Financial Times*, October 11, 2016; James Landale (2016) Brexit: Legal battle over UK's single market membership, *BBC News,* 28 November.

[now]. Without a transition, in three years' time they may say we did not need to do it'. The City would, however, need to rely on equivalence arrangements holding and any move by the to deviate from EU law could put market access at risk during the transition.

The basics: lasting into the mid-2020s

This would involve the UK remaining in the customs union under a zero-tariff agreement until the final deal is signed. Any new trade deals negotiated with other countries would begin on the day the UK leaves the customs union.

Remaining in the European Economic Area: lasting into the mid-2020s

All EU member states are in the European Economic Area and it had been assumed that when the UK leaves the EU it would automatically leave the EEA as well. But some lawyers argue that leaving the EEA would not be automatic and would happen only if the UK formally withdraws by triggering Article 127 of the EEA agreement. The legal question is focused on whether the UK is a member of the EEA in its own right or because it is a member of the EU. If its negotiations with the EU went badly, and no deal looked likely, the UK could threaten to stay inside the EEA after Brexit. This would be politically hard for the government to sell as it would still involve EU workers moving freely within the UK. But it might be economically better than having to rely on WTO rules which could involve tariffs and barriers to trade. The ability to stay on in the single market means Britain could force the EU into accepting a transitional period for the UK to avoid an economic cliff edge. This would be a useful stick for UK negotiators to have up as there appears to be no mechanism for the EEA to force out one of its members. Professor George Yarrow, chairman of the Regulatory Policy Institute and emeritus professor at Hertford College, Oxford, said: 'There is no provision in the EEA Agreement for UK membership to lapse if the UK withdraws from the EU. The only exit mechanism specified is Article 127, which would need to be triggered'.[304]

18.3 How long should transitional arrangements last?

Some commentators have argued that: 'Two years clearly isn't enough. American banks would need more than that to set up subsidiaries in the EU should that be needed, according to one senior investment banker. It will also take much longer than two years to devise a "third-country" equivalence regime that can replace the automatic right to operate in the EU, which Britain currently enjoys thanks to [the] financial services passport. It took three years for US and EU regulators to agree on such a regime for central clearing counterparties. The European Central Bank could be swamped with requests for regulatory approval'.[305] Some diplomats believe a full deal might take up to 10 years to complete.

A more immediate problem with a transition is that it adds to uncertainty and provides an opportunity for 'international banks to get cold feet over losing "passporting" rights and start shifting operations from London to the eurozone… Senior EU diplomats admit the

[304] James Landale (2016) Brexit: Legal battle over UK's single market membership, *BBC News*, 28 November.
[305] George Hay (2016) Banks ask for Brexit clarity they can't have, *Reuters Breaking Views*, 8 September.

timetable also reflects a cold calculation of interests: delaying agreement on a transition would spur companies to move some of their business to the EU to cope with the danger of a hard exit… Speaking at an EU summit in Brussels, Mario Draghi, European Central Bank president, repeated his assessment that Britain would "first and foremost" bear the economic pain of Brexit'.[306]

However, John Mills, chair of the Labour Leave campaign, argues that 'Brexit need not take more than 2 years, and when we joined the common market in 1973, it took less than two years. This was a result of political establishment wanting it to be a success and it is clear that the faster Brexit is concluded, the better. A permanent deal covering most aspects of Brexit is possible in 2 years, with smaller issues to be resolved later. When Norway didn't join the EU in 1972, it negotiated a trade deal within 8 months'.[307]

Leaving the EU is 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'. He continues: 'There are two crucial legal components of Brexit. The first is Article 50, the procedure laid down by the EU treaties by which we disapply these treaties to the UK in international law. This is implemented by an act of parliament, which is the second component. This need be no more than a few clauses, including one to repeal the European Communities Act of 1972, which currently implements EU law into our domestic law, and another to incorporate all the EU laws that apply directly in UK law into UK statute. That is what Brexit is; there is no "hard" or "soft" option'…Nor is it attractive to spend as long as six years in [an] invidious state of uncertainty, waiting for the EU to decide the outcome of triggering Article 50 while also remaining subject to all the obligations of EU membership. It would take only one of the other 27 member states to say *non* at the end of the process to wreck the whole agreement'.[308]

David Davis, the Brexit secretary, supports this view: negotiations between the UK and the EU on their future relationship 'will be unlike any before, since both sides will start from a point of exact equivalence' and he added that 'we should steer clear of protectionist measures that would damage both the UK and Europe. Because it's in all of our interests to avoid barriers to trade'.[309]

Nevertheless, some believe that a long transition period might be necessary because of the complexity of the regulatory arrangements in financial services that need to be agreed. Two years seems to be the minimum time it takes to agree such deals, as in the case of the

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[306] George Parker (2016) Fears EU Brexit delays will spur bank exodus to eurozone, *Financial Times*, 19 December.

[307] John Mills (2016) Britain can Brexit in just two years if our politicians adopt the right can-do attitude, *City A.M.*, 15 December.

[308] Bernard Jenkin (2016) There is no such thing as hard or soft Brexit - Britain should look to leave the EU as swiftly and simply as possible, *Financial Times*, 31 July.

[309] Joe Watts (2016) Brexit: David Davis says free movement will not be axed in a way that damages the British economy, *Independent,* 2 December.

Swiss-EU insurance deal. Mark Carney, the governor of the Bank of England, says that typically it takes much longer: 'When there is a financial reform it takes a period of time: the Basel reforms phased in over eight years. The Vickers reforms phased in over four to six years … Normally, it is in the range of four to seven years'. Enda Kenny, then Irish prime minister, has said that it would be impossible to agree everything in two years: 'There's a growing feeling in Europe that there should be a transition period, and that the transition period will be longer than those two years — I think it will be'.[310] The City itself is looking at a transitional period involving three phases: the two-year Article 50 withdrawal phase, a two-year sequential period for discussing the new arrangements, and an implementation phase of three years.[311]

The problem, of course, with a transition is that it can end up being indefinite. The EU's deals with Norway and Switzerland were intended to be temporary measures. Leave Means Leave and other pro-Brexit groups oppose a long transition, arguing that 'many vested interests seeking to water down or even halt the UK government's commitment to deliver Brexit for the people'. The European Commission says it would consider a transitional arrangement, but would expect freedom of movement of people, the powers of the ECJ and budget contributions to be maintained during this period.[312] It also said it wanted the power to raid financial firms in the City under plans to closely police enforcement and regulation of the City.[313]

In early December 2016, Philip Hammond and David Davis had their first joint meeting with City leaders, including those from Lloyd's of London, the London Stock Exchange, Barclays, Santander, BlackRock, Goldman Sachs and the Association of British Insurers, to discuss the UK's 'smooth and orderly transition' from the EU. The discussions included a deal that would allow current trading rules to continue for a limited period. Previously, Mr Davis had been sceptical of any transition arrangements. One participant said that 'a transitional deal would be in the interests of Britain and the EU and necessary for the financial stability of both'. The meeting also discussed options for how the City would access to the single market after Brexit, including one based on regulatory equivalence between Britain and the rest of the EU.[314]

19. Recommendations, challenges and bargaining chips

19.1 Recommendations

We have five recommendations.

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[310] Chris Giles (2016) Mark Carney urges transitional Brexit deal, *Financial Times*, 28 November.
[311] Private communication from Daniel Corrigan.
[312] Chris Giles (2016) Mark Carney urges transitional Brexit deal, *Financial Times*, 28 November.
[313] James Crisp (2018) EU wants power to raid financial firms in Britain after Brexit, *Daily Telegraph*, 14 February. For a recent example, see Christopher Williams (2018) European Commission raids Murdoch's Fox offices in London over sports rights 'cartel', *Daily Telegraph*, 10 April.
[314] George Parker and Martin Arnold (2106) Hammond and Davis promise City 'smooth and orderly' Brexit, *Financial Times*, 6 December.

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 cooperate, then we recommend:
    - either a third-country enhanced equivalence model 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. 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-country access through a specific chapter of a comprehensive UK-EU free trade agreement;[315]
    - or mutual recognition of financial regulations with mutual market access.

- 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 cooperate, we recommend that the UK adopts a World Financial Centre model where the City 'goes it alone'.[316]

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.[317] A different system would be offered to entrepreneurs who wanted to set up a company in the UK.

3. Transitional arrangements

The City should make the most of the transitional or implementation period between 30 March 2019 and 31 December 2020 to secure existing commercial relationships and initiate new ones, now that it will no longer be a rule taker from Brussels.

The principal benefit of this is that having a fixed date for exit is necessary to prevent what the Remainers (on both sides of the English Channel) really want which is a 'transitional' deal of indefinite duration that keeps the UK inside the customs union, the single market

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315 As proposed by Open Europe (2016) *How the UK's financial services sector can continue thriving after Brexit*, October.

316 As proposed by Barney Reynolds.

317 Schemes similar to the Seasonal Agricultural Workers Scheme would operate for unskilled workers.

and subject to ECJ jurisdiction. Further, such a transitional deal would simply prolong business uncertainty since it would be unclear when it ends and what would happen when it ends. It would be much better for business certainty to have exit on a defined day, even if there is no deal, since that can be planned for.

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.[318]

There has been far too much tendentious political interference in the setting of financial regulations in the EU, dressed up as a concern about systemic risk, whereas the real purpose is to protect national markets. The LSE's Xavier Rolet has pointed out that political judgments in the EU may overwhelm any possible economic consequences to itself and that the EU has various ways of 'effectively creating a disabling environment' to London.[319] On the other hand, the global principles established by the G20 in 2009 after the Global Financial Crisis to reduce the risk of another crisis recognised that the free flow of capital was the 'oxygen of commerce', according to Jes Staley, CEO of Barclays, and that this will 'keep London a major financial centre after Brexit.'[320]

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

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[318] Andrew Bailey has also called for the introduction of a set of global regulatory standards, since current systems do not support free trade and capital mobility (Victoria McKeever (2017) FCA chief Andrew Bailey calls for global regulatory standards, Professional Adviser, 26 January).
[319] Rolet warns of Brexit 'systemic risks', *WSJ City*, 10 January 2017.
[320] Ben Wright (2017) 'Global rules will keep London a major finance centre after Brexit', *Daily Telegraph*, 21 January.

outside Europe's borders.[321] The UK's share of exports to the EU has fallen from 54% in 2006 to 44% in 2015;[322] 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.[323] The total value of UK exports to the EU was £134bn in 2015 (compared with imports of £223bn), but US exports were £203bn[324] – and the US is outside the single market and the customs union.

The UK, outside the shackles of the EU, can be part of this growth area, but it needs government support. This is the view of the Association of British Insurers which is urging the government to help the UK insurance sector gain access to overseas markets, particularly China and India, as part of overall efforts to boost global trade in financial services. The AIB's members – who manage investments totalling £1.9trn – are keen to expand in the Asian tiger markets of Hong Kong, Indonesia, Japan, Malaysia, Singapore and South Korea. They are seeking the UK government's support in reducing barriers including collateral requirements and the bureaucracy related to moving staff to these countries.[325]

19.2 Challenges

Andrew Tyrie cautions against unrealistic expectations concerning the UK's ability to discard all EU regulations: 'some Leave campaigners appeared to treat all EU regulation as if it were all a tangle of unnecessary red tape that could be burned at the point of Brexit. Much EU law has sought to facilitate trade by establishing common standards and procedures: it has been permissive, rather than restrictive. Far from liberating businesses, amending or repealing many such rules would inhibit trade and put UK exporters at a commercial disadvantage to their EU competitors. Brexit should enable beneficial alterations of the UK's regulatory framework, such as the EU's counterproductive "bonus cap", and capital rules that disadvantage smaller challenger banks in favour of large incumbents (although even these may compromise single market access). There will also certainly be greater opportunities to influence standard-setting at an international level. But there will be no bonfire'.[326]

However, this is not a real problem. As previously mentioned, many global standards in finance are set internationally, rather than in the EU. Further, it is what happens at the margin that matters and helps to tilt the balance in favour of one jurisdiction against another when it comes to firms deciding their location. As we have seen, the EU has an

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[321] European Commission (2015) *Trade for all - Towards a more responsible trade and investment policy*, October; http://trade.ec.europa.eu/doclib/docs/2015/october/tradoc_153846.pdf/

[322] It could actually be as low as 40% due to the 'Rotterdam effect', UK goods passing through the port of Rotterdam on the way to global markets, but being counted as exports to the EU (Liam Halligan (2017) Clean Brexit can avoid the cliff-edge chaos, *Sunday Telegraph,* 15 January).

[323] Alan Beattie (2016) Brexit risks 60% drop in service sector exports, *Financial Times*, 14 October.

[324] It could actually be as low as 40% due to the 'Rotterdam effect', UK goods passing through the port of Rotterdam on the way to global markets, but being counted as exports to the EU (Liam Halligan (2017) Clean Brexit can avoid the cliff-edge chaos, *Sunday Telegraph,* 15 January).

[325] *Daily Telegraph* (2016) AIB urges UK government to support overseas expansion, 21 November.

[326] Andrew Tyrie (2016) *Giving meaning to Brexit*, Open Europe, Briefing 09/2016, September; http://openeurope.org.uk/wp-content/uploads/2016/09/Giving_meaning_to_Brexit_Andrew_Tyrie.pdf

inbuilt hostility to financial markets. This is especially true of France. In 2012, when François Hollande became president of France, he promised to fight against 'financial speculation'.[327]

Another challenge is that many in the City, as Danial Hannan has pointed out, actually like the protectionism and burdensome regulation that the EU offers – and indeed have lobbied in Brussels over the years to increase the level of protectionism – and accordingly want to torpedo the implementation of Brexit through its special pleading. This is amply illustrated by the comments above from the City institutions and trade associations.[328] The City lobby is so powerful and well-funded it may also influence the position taken in other areas outside the financial markets. At the same time, it is important to recognise that the City is not united. The debate has moved on from Remain vs Leave and is now between those who want access to EU financial markets, with attendant regulation (EMIR, AIFMD, MiFID II) and those with little interest in access to EU financial markets especially because of the attendant regulation. Big international banks want access, hedge funds want appropriate regulation and dislike AIFMD, asset managers have options already in place and the larger ones can live with regulation as is.

A further challenge concerns ratification procedures in the EU. The ECJ has ruled that national parliaments should ratify EU trade deals. The European Commission had assumed that it could agree a trade deal which would then only need to be approved by QMV. But the ECJ has determined that the current trade deal with Singapore must be signed off on by each member state. This, as previously mentioned, could make it more difficult for any deal with the UK to be approved.[329]

The EU might, however, take a much stronger view on the freedom of movement of people and might demand this in exchange for access to the single market. Both Switzerland and Norway have, by joining the Schengen passport-free travel area, accepted free movement. Yet control of immigration was a red line for many Brexit supporters. Further, an agreement reached between the UK and Brussels could be voided if just one of the other 27 member states rejects it.[330]

Nevertheless, free movement is not just an issue in the UK. There is a lively debate in Germany over whether the EU should back down on free movement to prevent any emerging barriers to lucrative cross-border trade.[331] The debate centres on whether there should be free movement of people (the original form of one of the free movements) or free movement of workers, which would exclude those going to another member state in order to look for work and claiming welfare benefits in the meantime. Another issue that

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[327] http://www.telegraph.co.uk/news/worldnews/europe/france/9266993/Francois-Hollande-inaugurated-as-French-president.html

[328] Recently reinforced by the City's support for the CBI's assertion that businesses 'generally perceive EU regulation to be good regulation' (CBI (2018, p.7) *Smooth Operations: an A-Z of the EU rules that matter for the Economy*, April).

[329] Jim Brunsden (2016) EU court judge questions Brussels' trade deal powers, *Financial Times*, 22 December; Marcus Leroux (2016) New blow for Brexit trade deal, *The Times*, 22 December.

[330] David Wighton (2016) Strictly Brexit- A two-step is better than a quickstep, *Financial News*, 1 August.

[331] Simon Nixon (2016) Free-Movement Conundrum Isn't U.K.'s Simon Only Hurdle to Accessing EU Market, *Wall Street Journal*, 21 September.

has been raised is the language skills of migrants and whether free movement should exclude those with inadequate skills in the language of the host country.

19.3 Bargaining chips

A number of commentators pointed out that the UK had a very strong hand at the beginning of the EU negotiations. For example, Alex Barker writing in the *Financial Times* says: 'It is facing a 27-country bloc that remains economically fragile, worried about security, under populist assault and divided over the crisis of legitimacy facing its central EU institutions. Britain is the *demander*, but in its favour are the fruits of decades of economic integration and near-irreplaceable contributions to common European interests. It has leverage'.[332] Similarly, James Forsyth writing in the *Spectator* believes the UK holds the aces in Brexit talks: 'London is the de facto financial and banking capital of the eurozone. The more trouble the single currency gets into, the more dangerous it would be to erect barriers between the two. These could threaten the finances of some eurozone states by making it legally complicated for them to sell their sovereign debt on the London market. One of those intimately involved in preparing the UK's negotiating strategy tells me that only the French appear oblivious to this. However, the UK does not want to publicly highlight so explosive an issue. It is often said that politics will trump economics in the Brexit negotiations. But the single currency's stability is not just an economic issue — the euro is the ultimate expression of the European political project. So the financial services sector may get a significantly better Brexit deal than expected'.[333] The euro has also come under attack from Peter Navarro, head of president Trump's new National Trade Council, who claims that the currency is an 'implicit Deutsche Mark' that is 'grossly undervalued' and that, as a result, Germany has an unfair trade advantage and 'continues to exploit other countries in the EU as well as the US'.[334] Even Holland, one of the inner core members of the EU and the euro project, has announced a parliamentary inquiry into Dutch membership of the euro 'amid a growing chorus of scepticism about the single currency'.[335]

Here are the principal areas in which the UK had significant leverage if it chose to exercise it.

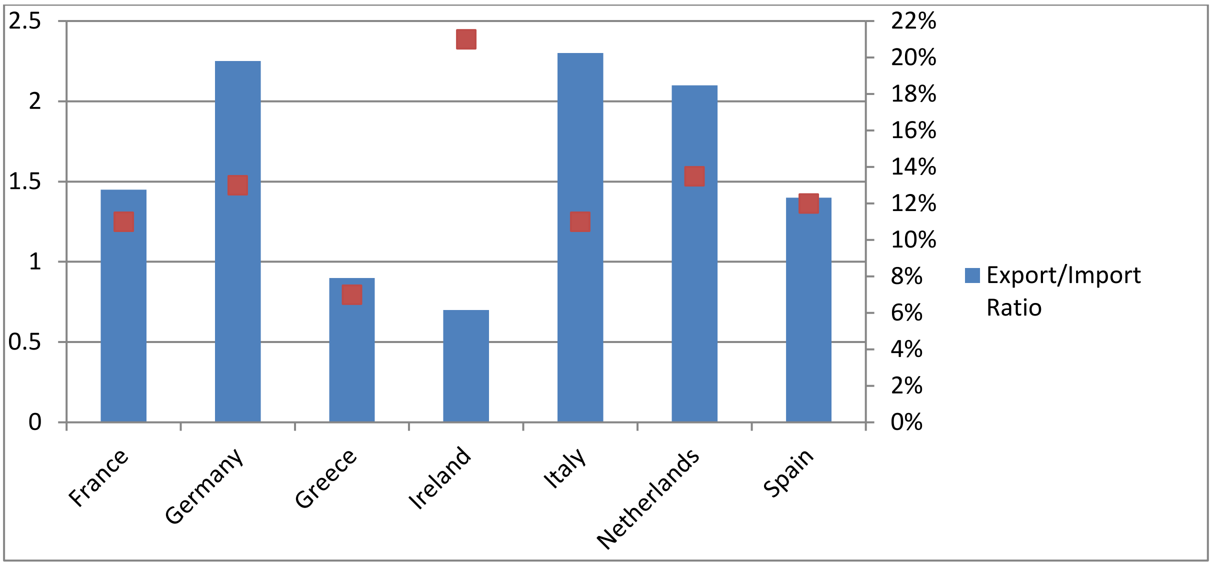
Economic self-interest and future trading relationships

The UK's strongest bargaining chip is its trade deficit with the EU as a whole and with key countries in particular. In Fig. 5, the blue bars show each country's export/import ratio with the UK, with values above (below) 1 indicating that the country is a net exporter to (importer from) the UK. The red squares show each country's exports to the UK as a % of their total exports to EU28 countries. Germany, for example, sells to the UK more than €2 in goods for each €1 it buys from us, and more than 13% of its EU exports go to the UK.[336]

[332] Alex Barker (2016) Brexit negotiators identify UK's trump cards, *Financial Times*, 28 November.
[333] James Forsyth (2016) Britain holds the aces in Brexit talks, *Spectator*, 26 November.
[334] Nick Fletcher (2017) Trump's trade adviser says Germany uses euro to 'exploit' US and EU, *Guardian*, 31 January.
[335] Peter Foster (2017) Netherlands holds inquiry on whether it shoukd ditch the euro, *Daily Telegraph*, 25 February.
[336] Economic Research Council (2016) EU Nations' Reliance on UK Trade, 13 October; http://ymlp.com/z48rdJ/

Germany is also a net exporter of services (including finance) to the UK with sales of €41bn, compared with purchases of €24bn in 2015.

Figure 5: EU states' reliance on trade with the UK (2015 data)



Sources: Economic Research Council, European Commission, Eurostat

The UK could offer the choice between continuing a zero-tariff preferential trade arrangement and accepting WTO MFN terms. Pro-Brexit MPs Peter Lilley and John Redwood have said that 'the UK would recommend the former, but could live with the latter'. The UK's trade deficit with the EU and the cost of unwinding the deep cross-border supply chains in industries such as car making suggest it would be 'insane' for countries such as Germany to impose tariffs on the UK which buys 20% of all its cars, according to Boris Johnson, the foreign secretary. Dominic Raab, another pro-Brexit MP, said: 'The strength of our position is our economic weight. If we end up with a worst-case scenario, on WTO terms, it hits continental exports disproportionately hard, costing European companies profits and jobs. Their rational self-interest is to avoid that'.[337]

A study by Civitas has concluded that if the UK leaves the EU without a free trade deal and trade is instead conducted under WTO 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.'.[338]

Wolfgang Münchau writing in the *Financial Times* argues:

> *If a hard Brexit were to force the UK and the EU to impose quotas on traded goods and to suspend trade in most services, Germany would be harder hit than the UK…. The Germans have an interest in maintaining free trade in both goods and services.*

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[337] Alex Barker (2016) Brexit negotiators identify UK's trump cards, *Financial Times*, 28 November.
[338] Ben Martin (2016) EU exporters have more to lose than the UK from tariffs after Brexit, *Daily Telegraph*, 24 October.

Most other EU countries would come to a similar conclusion once they calculate the implications a hard Brexit would have for them. We just cannot get around the fact that the UK had a current account deficit of more than 5 per cent of gross domestic product last year. Having an unsustainable external position is a rare benefit when you want to negotiate a trade deal.

It would be different if the EU had leaders who put the common interest before their own. The eurozone crisis taught us they do not. That is also true of Angela Merkel. The German chancellor vetoed debt relief for Greece, joint eurozone debt instruments and common deposit insurance for the eurozone. She may pretend that she wants to be tough on Britain — but once German jobs are at risk, I would expect her principled position to crumble.

If the Brexit negotiations get stuck — as they undoubtedly will at some point — we may find that macroeconomic considerations become more important. A hard Brexit may knock a couple of percentage points off UK gross domestic product but would presage a crisis in the EU. The total effect on GDP in the eurozone would be smaller but the dynamics may be worse. Brexit, for example, would risk pushing Italy into a recession, and that could trigger another financial crisis.

My conclusion is that both sides have an interest in a fair and square deal. The purpose of UK diplomacy in the next three years will be to remind the Europeans that the risks are more symmetrical than they think.[339]

The Bavarian economy minister, Ilse Aigner, has come out strongly in support of a 'comprehensive' trade deal with the UK after Brexit. She acknowledges that the UK is one of the 'most important trading partners for Bavaria' – 20% of all German cars, with most of them made in Bavaria, are sold to the UK – and she wants to avoid the 'high risk' to the economy of not getting a good deal with the UK: 'We have to do everything to address the uncertainties that have arisen…we have to find ways to put economic relations with the UK on a new foundation without fractures'.[340] This comes a month after the IW Cologne Institute for Economic Research predicted that the UK's exit from the European Union would reduce German GDP by 0.25 percentage points and, that as a result of the weaker pound, German exports would fall by 9% in 2017.[341]

The Bavarian economy minister's concerns are recognised by Germany's minister of European affairs, Michael Roth, who said: 'Given Britain's size, significance, and its long membership of the European Union, there will probably be a special status which only bears limited comparison to that of countries that have never belonged to the European Union'. They are also echoed by Germany's vice-chancellor, Sigmar Gabriel, who said: 'My personal

[339] Wolfgang Münchau (2016) Britain and Europe share an interest in an amicable split, *Financial Times*, 22 October.
[340] Laura Hughes (2016) Germany needs post-Brexit EU trade deal with Britain to minimise own economy fallout, minister warns, *Daily Telegraph*, 25 November.
[341] Brexit to eat into German GDP: study, DW, 25 October; http://www.dw.com/en/brexit-to-eat-into-german-gdp-study/a-36146322

view is that we should do everything, as far as it is politically justifiable, to keep the British as close as possible to Europe. This will not be easy. But above all, it must be done quickly. The uncertainty is the biggest problem. In our estimation, the process is taking far too long'. The official line from Mrs Merkel is that the UK will not be allowed to 'cherry pick' in the negotiations, especially over accepting the EU's four basic freedoms. However, supporters of a soft Brexit hope that Germany's own economic interests will change Mrs Merkel's mind and will be prepared to offer Britain a deal.[342] Angela Merkel has even started to suggest that the EU needs to 'discuss further' the rules around freedom of movement of people and that the UK might be able to regain full control of its borders while still retaining access to the single market. Both she and Jean-Claude Juncker had previously said this would be impossible.[343]

German Lawyer Gunnar Beck puts it much more starkly at the time:

> *The passage of time is revealing how weak Germany's and the EU's negotiating position actually is. Politically, Mrs. Merkel is committed to "ever closer" integration within the EU and wants to transform Germany into a "moral superpower". But these goals, which have manifested partly in a willingness to bail out bankrupt eurozone member states and partly in controversial policies, such as welcoming more than 1.5 million migrants over the past 18 months, carry spiraling economic and social costs that German voters might not be prepared to bear.*
>
> *So Mrs. Merkel has sought to disguise the true costs of European union by shifting the book value of Germany's total euro rescue loans and guarantee exposure to the Bundesbank, the European Central Bank and the European Stability Mechanism. But this strategy has turned those three institutions into "bad banks" holding nonperforming assets such as Greek sovereign debt. With taxpayers on the hook in the event of losses at those institutions, Berlin can't afford many more financial shocks.*
>
> *Meanwhile, Germany has stood by while, for the sake of holding the euro together, the ECB has pursued policies that hurt Germans. German savers lost interest income worth €125 billion ($140 billion) between 2011 and 2015 as a result of the ECB's ultralow rates and quantitative easing, according to a study from Germany's Postbank. And the open door to migrants will cost €50 billion in 2016 and 2017 alone and nearly €400 billion over the next 20 years, assuming optimistically that most of these refugees eventually find work. If integration fails or many more refugees arrive, the costs will be significantly higher.*
>
> *Due to continuing euro crisis measures and the increasing costs of its refugee policy, Germany's economy and public finances are likely to weaken, while German unemployment should start rising again beginning next year. With economic growth*

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342 Justin Huggler, (2016) EU should aim to keep 'close relationship' with post-Brexit Britain, says German economy minister, *Daily Telegraph*, Harry Winston9 December.

343 Gren Manuel (2016) Merkel's nuance on 'free movement of people': She's not wobbling — but she is looking at definitions, *Financial News*, 16 November.

chronically sputtering, Berlin (and the EU overall) will have to depend on trade-induced moderate growth to minimize the future costs of these various policies to taxpayers.

Trade with the UK will be a crucial component. Nine EU member states send at least 5% of their total exports to Britain, and in Germany that percentage is around 7.5. Germany's trade surplus with the U.K. was €51 billion in 2015, around 20.5% of Germany's entire trade surplus.

Yet even these figures understate Germany's economic dependence on Britain. Around 36% of Germany's total exports in 2015 went to countries within the eurozone. However, under the so-called Target 2 payments system operated by the ECB, Germany's balance-of-payments surplus with the eurozone is financed not by the transfer of foreign-currency reserves, gold or other near-liquid assets, but by an open-ended overdraft facility granted by the Bundesbank.

Under this peculiar system, the exporter is paid not by the importing country but by Germany's central bank, which itself never receives payment. Rather, a credit note is issued by the importing country's central bank, which it has no obligation ever to pay.

The Bundesbank's Target 2 balance stood at more than €660 billion as of July. If Germany's eurozone exports were paid for in the same way as its other exports, it would be a much richer country.

That Germany is moderately prosperous at all under this system is owed in large measure to its trade surplus with partners outside the eurozone. This surplus is paid for in the traditional way, by transferring actual money to Germany. Germany and other export-driven eurozone economies thus depend on trade with Britain as a key partner outside the dysfunctional eurozone much more than is commonly realized.[344]

The cost of not reaching a trade agreement will be high for both sides. When the UK leaves the EU, EU law requires EU member states to impose the Common External Tariff on the UK and this is also required by Article XXIV of GATT. The imposition by the EU of tariffs on its imports from the UK would cause major problems for EU manufacturers dependent on existing EU-UK supply chains, as supply chains are highly sensitive to tariffs.[345] A case in point is the German car industry, which is already lobbying the EU for existing trade arrangements to continue. The only permissible ways out under Article XXIV would be for there to be an EU-UK customs union agreement or a free trade agreement (FTA). This suggests that the appropriate UK negotiating strategy is to offer a zero-tariff trade deal with the EU.

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[344] Gunnar Beck (2016) Germany Discovers Some Home Truths About Brexit, *Wall Street Journal*, 14 September.

[345] Peter Wells (2016) Written Evidence (FTG0013) – HOUSE OF LORDS: FUTURE TRADE EVIDENCE, AUTOMOTIVE SECTOR, 11 November.

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 budget 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).

The UK has agreed to pay a share of the EU's accrued liabilities (such as EU civil servants pensions) and to continue contributing to certain European-wide programmes (e.g., in science, education and culture) after formally leaving the EU. The total cost of this is estimated at between £35-39bn.[346]

Defence and security

Roger Boyes argued that the UK's military muscle should be a key bargaining chip: 'The divorce negotiations with the European union, if they follow the game plan of the European Commission, will fast degenerate however into a nightmarish battle over detail. Rather, what we should be seeking is a grand bargain whereby Britain's over-the-odds military contribution is taken into account in return for access to the single market. It should be a deal that recognises a common interest in security and Britain's disproportionately important role in fighting common enemies'.[347]

This view is reinforced by developments in the US, according to James Forsyth: 'The election of Donald Trump means that another card has fallen into the Prime Minister's hand. First, his ambivalence about NATO has made Britain more important to Europe's security than it has been for 60 years. Vladimir Putin clearly senses an opportunity. His plan to move nuclear-capable missiles to Russia's western enclave, Kaliningrad, is a sign of how he intends to probe for weakness and exploit irresolution over the coming months. If Europe cannot rely absolutely on President Trump to defend eastern Europe from Russian aggression and subversion, then Britain and its military forces, intelligence services and nuclear deterrent become far more important. This should create a more mature and cooperative atmosphere for discussions. After all, Britain's continuing security commitment to Europe is proof that this country is leaving the EU, not the continent itself'.[348]

Failure to exercise leverage

It is apparent from the joint report released on 8 December 2018 that the UK has not made maximum use of its leverage during the phase 1 negotiations on the withdrawal terms. Instead, it has been highly conciliatory in order to secure a good future relationship with the EU. But it is equally apparent that the EU is seeking to punish Britain in order to discourage other member states from leaving the EU too. Despite this, as the UK prime minister made

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[346] This cost range was first estimated back in 2016, see Alex Barker (2016) Brexit negotiators identify UK's trump cards, *Financial Times*, 28 November.
[347] Roger Boyes (2016) Military muscle is Britain's EU bargaining chip, *The Times*, 6 July.
[348] James Forsyth (2016) Britain holds the aces in Brexit talks, *Spectator*, 26 November.

clear, the EU will have no choice but to agree a trade deal with Brexit Britain.[349] This has been conceded by the Flemish Prime Minister, Geert Bourgeois: ‘It would be a fatal mistake to try to “punish” Britain… I can’t imagine a situation where we have more barriers on trade in both directions. You [Britain] are our fourth biggest export market. It is in our mutual interest to find a solution, and the majority of the EU now agrees that anything other than a “soft Brexit” would have a huge cost. We will be able to negotiate a trade agreement. It may be sui generis but it can be done’.[350]

20. Conclusion

Perhaps the most remarkable feature of the Brexit negotiations is that the trading arrangements between individuals and companies in the UK and those in the other member states of the EU will be determined by unelected bureaucrats and lawyers. As John Longworth, the former head of the British Chambers of Commerce and co-chairman of the lobby group Leave Means Leave, argues: ‘Trade consists of a willing seller and a willing buyer. If the buyer wants a product and it is the right quality and price there will be trade. Governments do not trade, they only get in the way’. The EU ‘government’ has, in particular, got in the way by failing to complete trade deals with the world’s largest economies – such as the US, China, Russia, Japan, India and Brazil – despite decades of trying.

How should the UK respond? One solution would be to follow the strategy proposed by the pro-Brexit MP Peter Lilley: ‘We should simply announce that for the time being we will maintain our zero tariffs on imports from the EU — unless they choose to impose WTO tariffs on us, in which case we will reciprocate’. Even if the EU imposes WTO tariffs averaging 3.5%, then when the 10% devaluation of sterling is taken into account, the UK will still be 6.5% more competitive and the EU 13.5% less competitive than before the EU Referendum.[351] However, Patrick Minford points out that, because under WTO rules, the UK would be obliged to impose the same import tariffs on all countries (with which the UK does not have a specific FTA), this strategy would still be costly to the UK if it did reciprocate: according to his model, it could reduce potential net UK GDP UK by 4% compared with the status quo and by 8% compared with unilateral free trade.[352] Another solution would be to start immediate negotiations on bilateral free trade agreements with key overseas partners. According to Andrew Lilico, the average US trade deal takes just 18 months to agree.[353]

Either way, ‘Brexit is’, as Suella Fernandes MP and vice chair of the European Research Group says: ‘a golden opportunity for Britain. We can lower barriers and encourage

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[349] James Slack (2016) You’ve got no choice but to do trade deals with us, May tells posturing EU leaders, *Daily Mail*, 19 September.
[350] Marian L. Tupy (2016) In Europe, National Interest Rules Supreme, CAPX, 26 August 26.
[351] Matt Ridley (2016) A golden opportunity for a free-trade bonanza, *The Times*, 3 October.
[352] Personal communication.
[353] Andrew Lilico (2017) Ignore EU complaints - we must start negotiating trade deals now, *Daily Telegraph*, 24 January.

investment. We can be the first big country to entirely open our markets – something so far only seen in smaller states like Hong Kong, Singapore and New Zealand. If we become the first country to have a completely open economy then we can truly make Brexit work for everyone'.[354] Even the Archbishop of Canterbury, the Most Rev Justin Welby, is optimistic: 'I'm not in the slightest bit pessimistic – quite the reverse, I think there are huge opportunities. I see this is a moment of reimagination of what the country is about. It is a moment of choice for our future. We've got to move forward as a society that has reimagined what it is about, that is outward looking, that takes its place confidently in the world, not merely for self-protection, but as a force for good in the world'.[355] Even some of the economic think tanks which predicted a recession before the Referendum are now saying that 'Brexit is not that much of an issue if the government is successful in terms of a transition agreement and free trade agreement'.[356]

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. Iain Martin believes that 'the entire structure of global finance, of fixed, large regulatory blocs (of which the EU is one) looks ripe for disruption and dramatic change', and asks: 'Will the markets and innovators of the future really do business according to the strictures of slow-moving bureaucrats when technology is moving so fast?'. He concludes that there will be 'an almighty struggle between central bankers who want to retain control of the financial system and the next generation of digital disruptors. Regulators addicted to the idea of standardised global rules will look for more power. But those self-same regulators, who rightly emphasised increased capital for banks, have also made regulation far too complex and unwieldy since the financial crisis. They have clogged up the arteries of the system. As hedge fund manager Crispin Odey put it in the summer: regulation, excessive cheap money and QE are killing capitalism. At some point there will be a rebellion against this post-crisis settlement, because there will be money to be made from disrupting a broken consensus. Technology will enable smart people and firms to do it'.[357] The City needs to be at the heart of this revolution, not dragged down by Brussels bureaucracy.

Our friends and trading partners overseas are supportive too. The Australian High Commissioner, Alexander Downer, says: 'We are encouraging the UK and the EU quickly to establish a new, mutually beneficial relationship that sustains the economies and global influence of both. We are also keen to strike a free trade agreement with the UK. That shouldn't be too hard to do because we are like-minded free traders who know that protectionism makes people poorer and costs jobs. Finally, we have another hope: that Britain will continue to recognise that it is a global power with global responsibilities, not

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[354] Suella Fernandes (2016) Britain must untie itself from EU shackles by using Brexit to leave the customs union', *Daily Telegraph*, 19 November.

[355] Quoted in Henry Camamile and Peter Dominiczak (2017) Welby: Brexit will let Britain reinvest itself, *Daily Telegraph*, 11 February.

[356] Michelle McGagh (2017) Brexit: economy may avoid hit until 2030 - The economic impact of Brexit is some way off, say Institute for Fiscal Studies and Oxford Economics, but five-year prospects remain tough, *Citywire*, 7 February.

[357] Iain Martin (2016) Lessons from the City's Big Bang – don't plan so much, *Financial News*, 13 September.

just a regional player. If it does so, this will mean Australia and the UK finding yet more ways to work together and promote the values and objectives we share'.[358] China's ambassador to the UK, Liu Xiaoming, states that: 'Britain now is China's major trading partner and investment destination in Europe. The Brexit Referendum has certainly not dampened the enthusiasm of Chinese businesses about investing in this country. On the contrary, it opens the door to the possibility of exploring a higher level of bilateral trade and investment arrangements…London's financial services sector stands to benefit from the ongoing internationalisation of the renminbi, if it continues to sell the City as an offshore centre for the currency. For China and the UK, renminbi internationalisation is an important part of our cooperation in [the] financial sectors. It is an area where we can dovetail respective strengths and produce mutual benefits'. He added that as the renminbi becomes a reserve currency, 'that will give London a further advantage and allow offshore RMB business in London to grow at an even faster speed'.[359] Similarly, the US ambassador, Woody Johnson, says: 'It is in everyone's interest that Brexit be transparent, smooth, and orderly. But whatever the outcome of the negotiations between the UK and the EU, Britain should know you will have a strong and reliable trade and investment partner in America. Our countries are among each other's largest inward investors. Americans and Brits hold roughly one trillion dollars of investment and employ approximately one million people in each other's countries — jobs that have increased prosperity and opportunity in all four countries of the United Kingdom and in every American state. As far as the president is concerned, the United Kingdom, our most enduring ally, is always at the head of the line'.[360]

But to make the best of Brexit, the City needs to address the following issues:

- It should 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'.[361]

- 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

[358] Alexander Downer *(2016) Australia is backing Brexit Britain all the way, Daily Telegraph, 17 December.*
[359] Tim Burke (2016) Brexit won't dampen China's enthusiasm for UK, says ambassador, *Financial News*, 11 October.
[360] Harriet Alexander (2017) New US ambassador to UK Woody Johnson defends Donald Trump: 'When you get to know him, you'll like him', *Daily Telegraph*, 12 September.
[361] Angela Monaghan (2009) City is too big and socially useless, says Lord Turner, *Daily Telegraph*, 26 August.

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'.[362]

- It should build on the protections afforded by international law – see Table 5. 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 many in the City have reacted following the Referendum. It is absurd for the EU to insist that a provider of financial services has to be physically located in a market to do business. It is just as absurd to expect that the City of London will have to 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. 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.[363]

- It should aim to quickly recover the competitive edge that it has lost in recent years. The WTO has estimated that the City's share of China's imports of financial services (mainly insurance) was 3% in 2015, unchanged since 2011. Over the same period, the US share increased from 11% to 28%.[364]

Table 5 - 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 European Union (Withdrawal) Bill 2017-19 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

[362] Lord Mayor calls for a bold Brexit plan, *Financial News*, 26 October 2016; Mark Sands (2016) The Lord mayor will tonight tell the City to draft plans for a "bold, bright, buccaneering" post-Brexit future, *City A.M.*, 26 October.
[363] Matt Ridley (2016) A golden opportunity for a free-trade bonanza, *The Times*, 3 October.
[364] Reported in David Wighton (2017) Beijing will still be five thousand miles away after Brexit, *Financial News*, 10 July.

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.[365] Lawyers for Britain dismiss the idea that negotiations are too complicated to complete in 2 years. They argue that an in-principle deal covering most aspects of Brexit is possible in 2 years, with smaller issues to be resolved later.[366]

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. 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.

EU laws, e.g., on 'reverse solicitation exemptions' or 'overseas persons exemptions', can be used to allow financial institutions to provide certain cross-border services. Similarly, EU laws allow cross-border dealings — 'including multiple on-the-ground visits' — without a local branch or licence.

Property rights under both the European Convention on Human Rights and the EU's own Charter of Fundamental Rights can be used to protect extant contracts which have an economic value on Brexit.

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

[365] 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.

[366] According to Martin Howe QC, chair of Lawyers for Britain: 'Article 50 empowers the EU to agree withdrawal arrangements as a legally binding treaty, and (implicitly) the "framework" of the future relationship but probably only as a political in-principle deal. Article 50 does not cover a trade treaty, which needs to be authorised under TFEU Article 207 on EU external treaties. The EU are taking the line that it cannot legally conclude an external agreement with the UK until after exit has formally taken place. So an in-principle "framework" can and should, if it going to be concluded at all, be agreed within 2 years. The process of reducing an agreed framework into a legally binding text ought to be quite rapid but we need to incentivise the EU to do this rapidly or it could be dragged out by them' (private communication).

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. 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[367] enables the UK to have a very 'clean' Brexit from the EU: the implications of this are given in Table 6. A golden post-Brexit era beckons for the City if it can return to its original roots of meeting the needs of the real economy both in the UK and globally.

Table 6 – Implications of the Lancaster House speech for a 'clean' Brexit

On 23 June 2016, the British people voted to leave the EU. This is due to take place on 29 March 2019. The prime minister's Lancaster House speech on 17 January 2017 made it 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 cooperation from the EU27, the City should plan its future operations using either:
    o a third-country enhanced equivalence model with guarantees about how equivalence will be granted and removed,
    o mutual recognition of financial regulations with mutual market access, or
    o a World Financial Centre model where the City 'goes it alone'.
• The City should make the most of the transitional or implementation period between 30 March 2019 and 31 December 2020 to secure existing commercial relationships and initiate new ones, now that it will no longer be a rule taker from Brussels.
• The City should encourage the government to support the development of legally

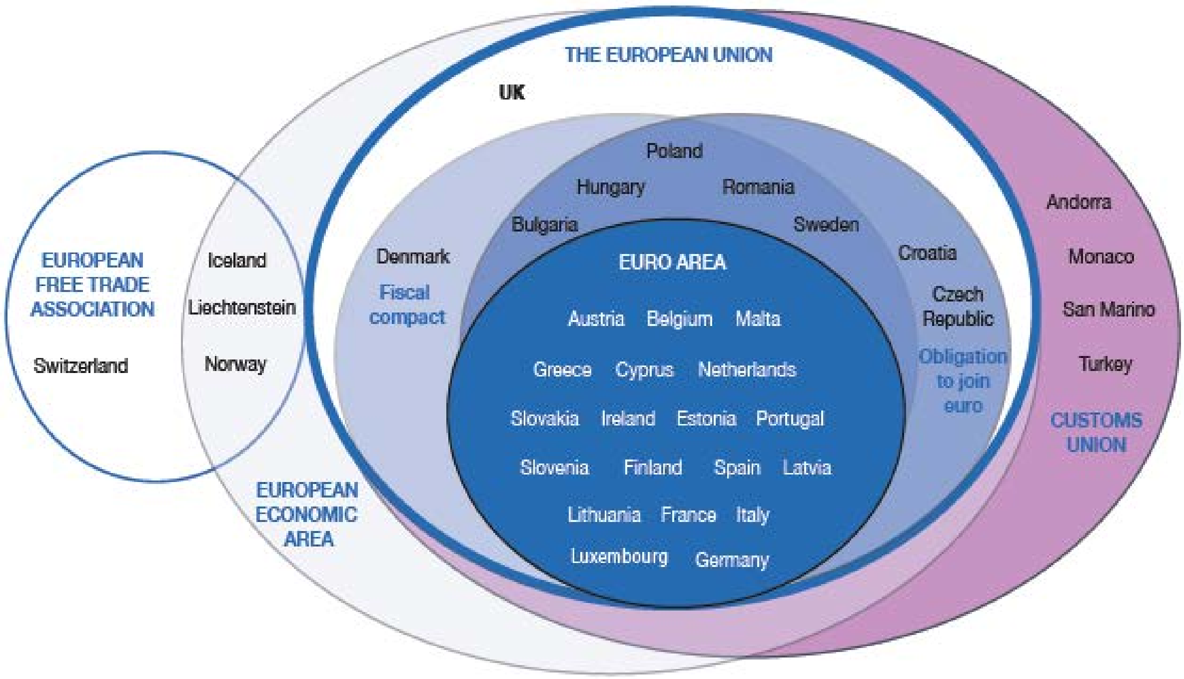
[367] See Appendix 8.

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.

Appendix 1: Economic Blocs in Europe

Figure A1: Economic Blocs in Europe



Source: Figure 1.B, HM Treasury analysis: the long-term economic impact of EU membership and the alternatives, Cm 9250 April 2016

The European Union

Figure A1 shows the member states of the European Union.

There are three economic elements of EU membership: the customs union, the single market, and budget contributions.[368] Net UK budget contributions equal 0.5% of GDP.

The customs union

Figure A1 shows that the customs union comprises the member states of the EU plus Andorra, Monaco, San Marino and Turkey.

There are three economic elements to the customs union: import tariffs, export tariffs and the ability (or otherwise) to negotiate free trade deals as a sovereign nation.

[368] Graeme Leach (2107) The optimal Brexit strategy is really quite simple – if Britain leaves the Customs Union, *City A.M.*, 5 January

Members of the customs union have to impose a set of around 13,000 Common External Tariffs (CET) on goods imported from outside the customs union, under the EU's common commercial policy.

Goods exported from one member of the customs union to another have to satisfy 'rules of origin'. Origin defines the 'economic' nationality of goods traded across borders. The nationality, the value and the tariff classification of goods must be determined in order to know which duties and charges apply to them, as well as any customs restrictions or special requirements. There are two different types of rules of origin:

- Preferential – preferential rules of origin are the instruments used to determine if a product exported from a beneficiary or partner country may be considered as sufficiently linked to that country and therefore originating there to the purposes of receiving from the EU the tariff preference granted to that country.
- Non-preferential - non-preferential rules of origin are used for establishing the origin of the good for tariff purposes.

The main principles applicable for imports in the EU are that:

- If a product is wholly obtained or produced in one country, it is considered to have origin in that country (and can be called an 'originating product').
- If a product has been produced in more than one country, it is considered to have origin in the country where the last substantial transformation took place.[369]

The single market

The single (or internal) market comprises member states of the European Union, and has been extended, with exceptions, to Iceland, Liechtenstein and Norway through the Agreement on the European Economic Area and to Switzerland (which is a member of the European Free Trade Association, but not the EEA) through bilateral treaties.

The single market is a trade agreement that allows participating countries to trade across borders with no extra tariffs, non-tariff barriers (such as additional regulations) or quotas.

But it is more than that, it is also a single regulatory regime. To quote Dan Hannan: 'Most people understand "single market" to mean something like "free trade zone". In fact, in the EU context, it means "single regulatory regime". Membership of the single market doesn't mean the right to buy and sell there (pretty much the entire world can do that); it means accepting EU jurisdiction over your domestic technical standards. … Only 6% of British companies do any business at all with the rest of the EU; yet 100% of our firms must apply 100% of EU regulations'.[370] Richard Patient, the former chairman of London Business for

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369 http://exporthelp.europa.eu/thdapp/display.htm?page=cd%2Fcd_RulesOfOrigin.html&docType=main&languageId=en

370 Daniel Hannan (2016) Repeat after me. Single market membership and single market access are not the same thing, *ConHome*, 1 September.

Britain, agrees: ‘In truth, the single market was always a misnomer. It should have been called the Single Protectionist Zone or the Single Regulatory Regime. The single market was never about opening up markets. It was always about imposing rigid common, anti-competitive standards’.[371]

The four freedoms (goods, services, people and capital) and EU product and employment law generally apply across the whole economy of each member state of the single market – not just the traded goods and services sectors. However, if a good or service being traded compromises one member state’s national laws regarding public policy, security or health, the national rules take precedence. Otherwise, the EU will create a single market law with EU-wide rules - for example on the noise made by electrical devices. There are also minimum and maximum standards. A minimum standards EU law allows individual member states to add tougher rules on top. A maximum standards EU law means that the EU law takes precedence over national laws.[372]

The European Economic Area

The EEA was set up in the 1990s and comprises all EU member states plus Norway, Iceland and Liechtenstein. The non-EU members are not part of the Common Agricultural Policy, the Common Fisheries Policy or the customs union, but get barrier free trade with the single market in return for making some EU budget contributions and accepting the four freedoms, including the free movement of people. The UK is a member of the EEA.

The European Free Trade Association

The European Free Trade Association comprises Iceland, Liechtenstein, Norway and Switzerland. The UK left EFTA when it joined the European Economic Community (the predecessor to the EU) in 1973.

Appendix 2: Treaties establishing the European Union

The Maastricht Treaty

The Maastricht Treaty (officially the Treaty on European Union or TEU) designed to lead to the economic integration of Europe was signed on 7 February 1992 by the members of the European Community (established by the Treaty of Rome[373] in 1957) in Maastricht, Netherlands. On 9–10 December 1991, the same city hosted the European Council which drafted the treaty. Upon its entry into force on 1 November 1993, during the Delors

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[371] Richard Patient (2016) The single market was never about opening up markets, but imposing rigid anti-competitive standards, *BrexitCentral*, 16 September.

[372] https://en.wikipedia.org/wiki/European_Single_Market

[373] Formally, the Treaty establishing the European Community (TEC) which, before the Maastricht Treaty, was called the Treaty establishing the European Economic Community (TEEC). It was signed on 25 March 1957 by Belgium, France, Italy, Luxembourg, the Netherlands and West Germany. It led to the founding of the EEC on 1 January 1958 and established the freedom of movement of persons within the EEC and later the EU. It also created a full customs union between members (https://en.wikipedia.org/wiki/Treaty_of_Rome).

Commission, it created the European Union and led to the creation of the single European currency, the euro. The Treaty formalised the powers of the EU's supra-national institutions—the European Commission, the European Parliament and the European Court of Justice. The Treaty has been amended by the treaties of Amsterdam, Nice and Lisbon.[374]

The Amsterdam Treaty

The Amsterdam Treaty (officially the Treaty of Amsterdam amending the Treaty of the European Union, the Treaties establishing the European Communities and certain related acts) was signed on 2 October 1997, and entered into force on 1 May 1999; it made substantial changes to the Treaty of Maastricht.

Under the Treaty of Amsterdam, member states agreed to devolve certain powers from national governments to the European Parliament across diverse areas, including legislating on immigration, adopting civil and criminal laws, and enacting a common foreign and security policy (CFSP), as well as implementing institutional changes for expansion as new member nations join the EU.[375]

The Nice Treaty

The Treaty of Nice was signed by European leaders on 26 February 2001 and came into force on 1 February 2003.

It amended the Maastricht Treaty and the Treaty of Rome. The Treaty of Nice reformed the institutional structure of the European Union to allow eastward expansion, a task which was originally intended to have been done by the Amsterdam Treaty, but failed to be addressed at the time.[376]

The Lisbon Treaty

The Treaty of Lisbon (initially known as the Reform Treaty) is an international agreement which amends the two treaties which form the constitutional basis of the European Union (EU). The Treaty of Lisbon was signed by the EU member states on 13 December 2007, and entered into force on 1 December 2009. It amends the Maastricht Treaty and the Treaty of Rome (1957), known in updated form as the Treaty on the Functioning of the European Union (2007) or TFEU.

Key changes included the move from unanimity to qualified majority voting (QMV) in at least 45 policy areas in the Council of Ministers, a change in calculating such a majority to a new double majority, a more powerful European Parliament forming a bicameral legislature alongside the Council of Ministers under the ordinary legislative procedure, a consolidated legal personality for the EU and the creation of a long-term President of the European Council and a High Representative of the Union for Foreign Affairs and Security Policy. The

[374] https://en.wikipedia.org/wiki/Maastricht_Treaty
[375] https://en.wikipedia.org/wiki/Amsterdam_Treaty
[376] https://en.wikipedia.org/wiki/Treaty_of_Nice

Treaty also made the Union's bill of rights, the Charter of Fundamental Rights, legally binding. The Treaty for the first time gave member states the explicit legal right to leave the EU and the procedure to do so (Article 50).[377]

Appendix 3: Treaties establishing the single (internal) market

The Single European Act

The Single European Act (SEA) was the first major revision of the 1957 Treaty of Rome. The Act set the European Community an objective of establishing a single (internal) market by 31 December 1992. It was signed at Luxembourg on 17 February 1986, and at The Hague on 28 February 1986. It came into effect on 1 July 1987, under the Delors Commission.[378] The single market was conceived by Arthur Cockfield who was appointed a European commissioner by Margaret Thatcher in 1984. He soon realised that the 'common market' was not working well because each country set its own standards and regulations for products and services. These were, in effect, hidden barriers to trade and were reducing the effectiveness of an open European-wide market, despite the fact that formal trade barriers, such as import duties, had been abolished. His 1985 White Paper made 300 recommendations for removing barriers to trade in goods and services and these were incorporated into the SEA.[379] The single market is, in reality, a 'common regulatory market'.

The Treaty on the Functioning of the European Union

The Treaty on the Functioning of the European Union (2007, TFEU) (which replaced the Treaty of Rome in 2009) formalised the freedom of movement of goods, persons, services and capital: Art. 26 (2) TFEU states that 'the internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured…'

Art. 63 TFEU stipulates that '…all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited'. The wording of the Treaty provision defines the fundamental features of this principle**:**

- '…all restrictions…'
- '…between Member States…'/ 'between Member States and third countries': capital movement concerned must contain a cross-border element
- 'third countries': this freedom also concerns third countries
- 'movement of capital': the wording of Article 63 TFEU contains no limitation as to who has the right to invoke this freedom

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[377] https://en.wikipedia.org/wiki/Treaty_of_Lisbon
[378] https://en.wikipedia.org/wiki/Single_European_Act
[379] Andrew Sentance (2017) As we leave the single market, a good transitional deal is vital, *Daily Telegraph*, 21 January.

- '…prohibited': Art. 63 TFEU has direct effect; it does not need any implementing legislation at Member States' level and it directly confers rights on individuals which they can rely on before national courts (see e.g. case C-101/05, Skatteverket v A, §21).
- '…all restrictions... shall be prohibited': Art. 63 TFEU prohibits all obstacles, not just discriminatory ones. It lays down a general prohibition, which goes beyond the mere elimination of unequal treatment on grounds of nationality (see case C-367/98, Commission / Portugal, §44).

On payments, Art. 63(2) TFEU stipulates that 'Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited'.[380]

The Court of Justice of the European Union (CJEU)[381] has established that the free movement of capital, as a fundamental principle of the Treaty, may be restricted only by national rules which are justified by reasons referred to in Art. 65(1) TFEU or by overriding requirements of the general interest (see e.g. cases C-463/00, Commission v Spain, §68 and C-174/04, Commission v Italy, §35, where the Court further notes that "…in order to be so justified, the national legislation must be suitable for securing the objective which it pursues and must not go beyond what is necessary in order to attain it, so as to accord with the principle of proportionality").

Regarding third countries, the CJEU has established (see case C-101/05, Skatteverket v A, §37) that it may be '…that a Member State will be able to demonstrate that a restriction on the movement of capital to or from third countries is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on capital movements between Member States…'.[382]

Appendix 4: The UK's legal position in respect of international trade agreements following Brexit

Lawyers for Britain have clarified the UK's legal position as follows:[383]

One consequence of the UK's membership of the EU is that many aspects of the UK's external relations are now conducted partly or wholly through the EU. As a result of Brexit, the UK would be able to re-assume direct control of its external relations, including trade relations. The pro-Remain camp suggested in the campaign that Brexit would result in years of uncertainty while the UK renegotiates its international trade arrangements.

This contention is not supported by the facts and evidence. The UK cannot currently decide the level of tariffs which we levy on imports, because these are set at a uniform level for the

[380] http://ec.europa.eu/finance/capital/framework/treaty/index_en.htm
[381] More commonly known as the European Court of Justice (ECJ).
[382] http://ec.europa.eu/finance/capital/framework/treaty/index_en.htm#excepttreaty
[383] Brexit and International Trade; http://www.lawyersforbritain.org/int-trade.shtml

EU as a whole under the EU's customs union. After exit, WTO rules would apply which would allow the UK to decide the level of our own tariffs on imports, provided that tariffs on average are no higher than under the EU customs union.

Again, because of the EU customs union and 'common commercial policy', the UK is not able to negotiate its own trade agreements with non-member countries – we can only do so as part of the EU. The UK will be able to participate in new trade agreements with non-member countries from the day after exit. The process of negotiating new trade deals can be started during the 2-year notice period leading up to Brexit, with a view to bringing them into force on or soon after the date of exit.

The EU has existing free trade agreements which currently apply to the UK as an EU member. Most of these EU agreements are with micro-States or developing countries and only a small number represent significant export markets for the UK. Both the EU and the member states (including the UK) are parties to these agreements. The UK could simply continue to apply the substantive terms of these agreements on a reciprocal basis after exit unless the counterparty State were actively to object. We can see no rational reason why the counterparty States would object to this course since that would subject their existing export trade into the UK market, which is currently tariff free, to new tariffs. There will be no need for complicated renegotiation of these existing agreements as was misleadingly claimed by pro-Remain propaganda.

The UK was a founder member of EFTA but withdrew when we joined the EEC in 1973. We could apply to re-join with effect from the day after Brexit. There is no reason why the four current EFTA countries would not welcome us back, given that the UK is one of EFTA's largest export markets. EFTA membership would allow us to continue uninterrupted free trade relations with the four EFTA countries, and also to participate in EFTA's promotion of free trade deals with non-member countries around the world.

The EU is seriously encumbered in trying to negotiate trade agreements by the large number of vociferous protectionist special interests within its borders. After Brexit, the UK would be able to negotiate new trade deals unencumbered by these special interests much faster than the EU, and with a higher priority for faciliting access to markets for our own export industries including services.

It is completely untrue that you need to be a member of a large bloc like the EU in order to strike trade deals. The actual record of the EU compared to that (for example) of the EFTA countries demonstrates the direct opposite.

The baseline of our trade relationship with the remaining EU states would be governed by WTO rules which provide for non-discrimination in tariffs, and outlaw discriminatory non-tariff measures. From this baseline, and as the remaining EU's largest single export market, we would be in a strong position to negotiate a mutually beneficial deal providing for the continued free flow of goods and services in both directions.

The EU and the common commercial policy

The EU is a customs union, not simply a free trade area. The point of a customs union is that all its members operate a single unified system of customs tariffs so that any particular category of goods will be charged the same tariff whether it enters the EU via, say, Rotterdam or via Felixstowe.

Because the external tariff wall is identical for all members, the members of a customs union need to operate as a bloc when they enter into trade agreements involving tariffs with other countries. An agreement to reduce or get rid of tariffs on imports from another country necessarily involves the customs union as a whole. For example, if one country in the customs union acting alone were to reduce tariffs on goods from an external country, those goods would then flow in through its ports and circulate around the whole customs union, by-passing the higher tariffs imposed at the ports of the other customs union members.

For this reason, a common external trade policy was built into the Treaty of Rome from the inception of the EEC, as a necessary counterpart of the customs union created by that Treaty. This was called the "common commercial policy". Under that policy, the European Commission is entrusted with the primary responsibility for negotiating trade agreements, under the supervision of the Member States acting through the Council of Ministers. Trade agreements may then be concluded by the EEC (now the EU) in its own name, which has so-called "exclusive competence" to conclude agreements with non-member countries falling within the field of the common commercial policy. The word "competence" here has the French legal meaning of the legal power to do something.

The WTO Agreements and "mixed competence"

In practice, trade agreements almost always extend to cover broader subject matter than just tariffs and related matters falling within the scope of the EEC/EU common commercial policy. Where an external agreement contains provisions which extend beyond the scope of the common commercial policy or the EU's other powers to conclude external agreements in its own name, it is necessary for the Member States as well as the EU to be parties to the agreement. This is called a "mixed" or "shared" competence agreement: where part of the competence to conclude the agreement belongs to the EU, but part of it remains with the Member States.

One particularly important series of agreements which involved mixed competence were the World Trade Organisation (WTO) Agreements which were concluded in 1993 as a result of the Uruguay Round Multilateral Trade Negotiations. This linked series of Agreements forms the bedrock of global trade.

Both the individual Member States including the UK, and the EU itself, are parties to the WTO Agreements. The respective legal powers of the EC (as it then was) and the Member States were ruled upon by the European Court of Justice in Op 1/94 *Re the Uruguay Round Agreements* [1994] ECR I-5267. The Court rejected a contention by the European Commission that the EC had across-the-board competence to conclude the WTO

Agreements in its own name. Although the core provisions of the WTO Agreements relating to trade in goods fell within the EC's exclusive competence under the common commercial policy, the Court ruled that other areas covered by the WTO Agreements relating to services (parts of the General Agreement on Trade in Services - GATS) and the Agreement on Trade-Related Aspects of Intellectual Property (TRIPS) were outside the EC's competence or were areas where the EC's competence was shared with the Member States.

The upshot of this "mixed competence" scenario is that vis-a-vis other parties, the EC/EU is responsible for compliance with, and entitled to the benefit of, certain aspects of the WTO Agreements; while the Member States individually remain responsible for, and entitled to the benefit of, the remaining aspects. The boundary between EC/EU and Member State competences is not stationary: under the ECJ's Lugano doctrine, the EU acquires external competence in areas where internal EU harmonisation occurs, and a significant shift in competence took place under the Lisbon Treaty which made the trade-related aspects of intellectual property part of the EU's commercial policy. While this fluctuating boundary line may be confusing for other WTO members, it is in general accepted by them.

However, the consequence of this after Brexit is straightforward. The EU will cease to have any competence in respect of the UK's trade or other external relations, and the UK will automatically assume rights and responsibilities in respect of 100% of its relationship with other members under the WTO Agreements. In addition, trade relations between the UK and the remaining EU ("the r-EU") will cease to be governed by the EU treaties, and will automatically be governed by the framework of the WTO Agreements - unless of course a replacement trade agreement is negotiated between the UK and the r-EU which comes into force on exit.

There is no question of the UK having to leave the WTO or to re-apply for membership. The UK is one of the original founding members of the WTO, as laid down by Article XI(1) of the WTO Agreement:

Article XI

Original Membership

1. The contracting parties to GATT 1947 as of the date of entry into force of this Agreement, and the European Communities, which accept this Agreement and the Multilateral Trade Agreements and for which Schedules of Concessions and Commitments are annexed to GATT 1994 and for which Schedules of Specific Commitments are annexed to GATS shall become original Members of the WTO.

Rights and obligations under the WTO Agreements

The WTO Agreements provide the present-day framework for global trade and contain a number of very important principles and rules, as well as a mechanism for the adjudication of disputes under the World Trade Organisation. Resort to the WTO disputes mechanism is at present precluded to the UK in any disagreement with the EU or other Member States by Article 344 of the Treaty on the Functioning of the European Union (TFEU), which states that: “Member States undertake not to submit a dispute concerning the interpretation or application of the Treaties to any method of settlement other than those provided for therein.”

One of the key principles of the WTO Agreements is non-discrimination in trade relations. This means that WTO members are not allowed, for example, to charge different tariffs on goods imported from different countries except in clearly defined and limited circumstances. Thus, following Brexit and assuming for the sake of argument that no trade agreement were reached between the UK and the r-EU, the r-EU would apply its standard external tariff rates to imports from the UK but would not be allowed to discriminate by charging higher rates to the UK than to other non-EU countries. Similarly, the UK would apply its standard external tariffs to imports from the r-EU.

However, the UK would not be obliged to charge tariffs on its imports at the same rates as it is obliged to charge while it is a member of the EU customs union, and would certainly have the legal right to reduce them as it sees fit. The EU has given a large number of commitments in multilateral trade talks not to increase its tariffs above certain levels (so-called "bound tariffs"). Because, as explained above, these commitments were given by the EU itself on a matter falling within its exclusive competence and not by the individual Member States, it is probable as a matter of legal theory that the UK after exit would not be bound by these commitments and therefore could in theory raise its tariffs above the levels of the EU's bound tariffs.

But it is in practice very unlikely that the UK would wish to raise tariffs after exit, except perhaps in some narrow and exceptional circumstances. As a global trading nation, the UK has a strong interest in the general reduction of tariff levels around the world and would certainly not wish to act in way which would be against the spirit if not the letter of the WTO Agreements. Under Article XXIV of GATT 1994, when a customs union is formed its overall weighted average of tariffs needs to be *the same as or lower than* the weighted average of tariffs of its component states, and the UK would certainly wish to apply a similar principle when it leaves; i.e. to keep its average tariffs the same as or lower than under the EU’s current tariff regime.

This is an important point. The UK would be under no obligation to maintain its tariffs at the same level as it is currently obliged to impose under the EU customs union. In many cases EU tariffs are set at high levels in order to protect industries in other parts of the EU where the UK has little or no domestic industry to protect, such as textiles and clothing, shoes and many kinds of heavily protected agricultural produce. In these cases the UK receives no benefit but pays twice over for the privilege of protecting foreign industries from lower cost competition in the world market: our consumers pay higher prices than they need for the products concerned, and on top of that and to add insult to injury, we have to hand over the tariffs collected at our ports to the EU as part of its so-called "own resources".

One astonishing aspect of the May 2016 Treasury study purporting to demonstrate the economic disadvantages of leaving the EU is its assumption that the UK post Brexit would continue to levy tariffs on imports at the same levels as those imposed under the EU customs union, so needlessly punishing our own consumers by forcing them to pay higher prices than available on world markets. It would be a clear and unequivocal benefit of leaving the EU to have the right to set tariffs at levels which suit our own circumstances and probably, as a nation with a bias to free trade, reducing them in many cases.

As a lawyers' group, we do not feel qualified to attempt to quantify this potential benefit in money terms but point to the study published by Prof Patrick Minford and others which suggests that leaving the EU and adopting a liberal tariff and trade policy will decrease prices and boost GDP.

Under Article XXIV paragraph 5 of GATT 1994, members of the WTO are entitled to form customs unions or free trade areas and to abolish tariffs between themselves without this being regarded as discriminatory against other countries. The EU is a customs union. After Brexit, the UK could therefore maintain a zero tariff regime in both directions between itself and the r-EU either by continuing to belong to the EU customs union or by entering into a free trade agreement.

According to the latest figures (2015, ONS "Pink Book") the UK exported £134.3bn worth of goods to the r-EU but imported £223.0bn. This indicates that the imposition of tariffs on bilateral trade between the UK and the r-EU after Brexit would be very substantially more painful for r-EU exporters than for UK exporters, were it allowed to occur.

We deal with the likely terms of a UK-EU post-Brexit trade agreement, in a later section. In this section we concentrate on the UK's post-Brexit trade relations with non-EU states.

The EU's Free Trade Agreements and the UK

The EU has concluded a number of free trade agreements with non-member States. These provide for the elimination of tariffs on trade in most goods, and typically also seek to eliminate or at least reduce non-tariff barriers. A number of these agreements provide for free trade in services as well as goods.

For the reasons explained above about 'mixed competence', the EU Member States (including the UK) are normally parties to these free trade agreements as well as the EU itself. This has important implications when it comes to Brexit, as we shall explain.

Taking for example the EU-Korea Free Trade Agreement concluded in 2011, both the EU itself and the Member States are parties to the treaty with the Republic of Korea. The definition of the Parties in Article 1.2 refers to the "mixed competence" explained above: the 'EU Party' is defined as '*the European Union or its Member States or the European Union and its Member States within their respective areas of competence as derived from*' the EU Treaties.

The substantive obligations in the agreement are expressed to apply between the Parties. Thus, for example, the obligation in Article 2.5 to eliminate customs duties states that "*each Party shall eliminate its customs duties on originating goods of the other Party in accordance with its Schedule included in Annex 2-A.*" The FTA also contains mutual obligations regarding freedom to provide services, intellectual property and other matters.

There would be no difficulty in the UK continuing to comply with the substantive obligations of this FTA after Brexit; and Korea on a reciprocal basis would have no difficulty continuing to apply these substantive provisions both to the UK and the r-EU. This step would not require any renegotiation of the substantive provisions of the FTA: all that would be needed would be a statement by the UK that it intended after Brexit to continue to operate the terms of the FTA between itself and Korea, and an acknowledgement by Korea that it would likewise continue to do so.

There are also procedural provisions in the FTA which involve bilateral joint committees or bilateral disputes and arbitration procedures between the EU and Korea. Clearly it would not be appropriate for the UK to continue to be represented by the European Commission or other EU organs in its relations with Korea after Brexit, so these would need to be operated on a bilateral UK/Korea basis in respect of the UK's obligations under the FTA.

In order to provide for the smooth and continued flow of trade in both directions on Brexit, no new FTA or renegotiation of the substantive terms of the EU-Korea FTA would be necessary. All that would be required would be a simple acknowledgement by the UK and Korea that they would continue to operate its substantive terms on a mutual basis until further notice, and to set up bilateral UK/Korea machinery to mirror the bilateral EU/Korea machinery of the FTA. It is likely that after Brexit the UK would wish to go further and both strengthen and deepen existing FTAs such as the one with Korea and negotiate new FTAs with other parties; but this longer term process would in no way prevent the rolling over of the terms of the existing EU FTAs into UK FTAs.

Korea could in theory object to the rolling over of the FTA in this way, but it is impossible to see what conceivable reason it would have to do so. If Korea were to bring to an end the existing free trade relationship between itself and the UK as an EU Member State, it would result in the renewed imposition of tariffs on Korea's goods exports to the UK, which are substantial and include cars and electronic goods.

We have taken the EU-Korea FTA as an example, but very much the same points would apply to the EU's other FTAs (which normally include the UK and Member States as treaty parties as well as the EU for the reasons explained above). In fact, this kind of "rolling over" of treaty obligations is a familiar process in international law. It happens in cases of "State succession" where an existing State splits and the component parts wish to continue existing treaty relationships with other States. For example, when Czechoslovakia split into the separate states of the Czech Republic and Slovakia on 31 December 1992, both new States agreed to assume and continue to honour the treaty obligations of the former State of Czechoslovakia, and other States and international bodies accepted the succession as being effective, where necessary agreeing new machinery for the separate representation of the two new States.

The exit of the UK from the EU is not legally a case of State succession. As explained above, the UK will reassume the full powers of its existing Statehood by re-assuming rights and responsibilities for its own international relations in areas at present where its interests are represented via the EU. However, the practical issues involved are very similar and there is a similar mutual interest in preserving the continuity of existing treaty arrangements, particularly those which affect day-to-day existing trade, unless there is some good and concrete reason for changing those arrangements. It follows that the international counterparties to the existing EU FTAs will almost certainly follow general State practice in State succession cases and accept the rolling over of FTA arrangements so that they continue to apply to the UK after Brexit.

The European Free Trade Association (EFTA)

The UK was a founder member of the European Free Trade Association (EFTA) when it was formed in 1960. EFTA operated as a free trade area in Europe alongside the EEC and contained, in addition to the UK, Norway, Sweden, Denmark, Switzerland, Austria, and Portugal. In 1973, the UK and Denmark joined the EEC and as a result withdrew from EFTA.

As explained above, the EEC is a customs union and it is not possible for individual member states who are within a customs union to belong to a free trade area with external countries: it is necessary for the customs union as a bloc to belong to a free trade area. It was clearly not desired for the UK and Denmark to terminate their free trade relationship with the other EFTA states when they joined the EEC in 1973, and the solution adopted was for the EEC as a whole to enter into free trade agreements with the remaining EFTA states. This preserved the free-trade relationship between the UK and Denmark and the other EFTA states, and indeed expanded it so the EFTA members also came into free trade relations with the other EEC Members (the original Six).

Sweden, Austria and Portugal also subsequently joined the EEC and as a result withdrew from EFTA, although preserving their free trade relationships with the EFTA states as a result of the bilateral free trade agreements between the EEC and the remaining EFTA countries. EFTA now consists of Norway, Iceland, Switzerland and Liechtenstein. As regards 3 of those States, the European Economic Area Agreement (to which the EU and the EU Member States are parties) now largely regulates free trade relations between those three states and between them and the EU. However, Switzerland declined to join the EEA and as a result the trade relations between itself and the other EFTA States are still governed by the EFTA agreement (now revised and known as the Vaduz Convention).

In the event of a Brexit decision, it would be logical for the UK to apply for readmission to EFTA in advance of Brexit, with a view to its membership taking effect immediately upon EU exit. There seems no reason why the four current EFTA states should not welcome such an application. The EU and its Member States are not parties to the EFTA convention and would have no say over such an application for membership. The immediate effect of the UK joining EFTA upon Brexit would be to preserve the existing free trade relations between the UK and the EFTA states, avoiding the risk of, say, Swiss exports into the UK being subjected to tariffs (and vice versa). Notably, in 2013, the UK was Switzerland's fifth most important export market in the world (Swiss official website), while the UK was Norway's single most important trading partner receiving 25% of Norway's total exports in that year (Norway official website).

The revised EFTA convention (the Vaduz Convention) extends beyond free trade in goods, and includes provisions on free trade in services and the free movement of capital and of persons. None of these should be problematical to the UK given that the Vaduz Convention only applies between its members and so would not act as a gateway for the free movement of persons from the r-EU or elsewhere. All four EFTA states have standards of living comparable to or even higher than the UK so do not present any mass migration risk. (The last occasion on which uncontrolled migration from Norway was problematical was when the invading Norwegian army under King Harald Hardrada was defeated by King Harold Godwinson of England at the Battle of Stamford Bridge on 25 September 1066).

Rejoining EFTA would have an importance beyond direct trade relations between the UK and the EFTA states. This is because in addition to facilitating and deepening free trade between its own members, EFTA also facilitates free trade relations between itself and other countries. In this regard, EFTA has been notably more successful than the EU, contrary to pro-Remain mythology peddled in the campaign which claimed, contrary to the facts and objective evidence, that it is beneficial to belong to a large bloc like the EU in order to forge trade agreements with other countries.

In fact, it is a positive barrier to the successful conclusion of free trade agreements to belong to the EU. As recently as 26 April 2016, El Pais reported that France and a group of other EU Member States pressed the EU Commission to delay the restart of the already heavily delayed free trade talks between the EU and Mercosur, the Latin American bloc which includes Brazil and Argentina. Their concern is the potentially harmful effects of free trade on some sectors of EU agricultural producers who would be exposed to competition from South American producers.

More recently, the coming into force of the long awaited Canada-EU trade agreement has been delayed by the refusal of Romania to ratify the agreement because of a visa dispute with Canada.

Similarly, the long drawn out EU-USA attempts to negotiate a Trans Atlantic Trade and Investment Partnership (TTIP) have been severely hampered by France's requirement that the EU should insist on the French film industry being shielded from open competition from Hollywood. Since Hollywood is one of the USA's most important export industries, this and other protectionist demands have caused severe problems in progressing the talks and it is far from clear that the EU will ever be able actually to conclude a free trade agreement with the USA.

As a consequence of the EU's lack of success in negotiating free trade agreements with major export markets, the EU’s trade agreements are heavily skewed towards agreements with less developed countries, in Eastern Europe and elsewhere, and a large number of micro-states (Map of EU FTAs). These agreements may be worthwhile for reasons other than trading self interest, for example to assist in the development and political stabilisation of these countries, and for those reasons the UK may well wish to continue these free trade arrangements after exit. But as regards significant export markets, the EU has only concluded its agreement with Korea in 2011 and has only just reached an agreement with Canada after years of negotiation.

By contrast, EFTA has been notably successful in reaching agreements with large and growing export markets around the world (EFTA Free Trade Map), and has ongoing negotiations with major and growing export markets such as India, Malaysia and Indonesia.

By rejoining EFTA, the UK would be able to seek the extension of existing EFTA FTAs to itself, and also to give a large positive impetus in collaboration with its EFTA partners to forging new agreements and extending existing free trade agreements particularly in the area of trade in services.

Negotiating trade deals with with non-EU countries before exit

The machinery of Article 50 of the Treaty on European Union means that there is likely to be a period of 2 years between the UK's formal notification of its decision to leave the EU and the actual exit date when the EU Treaties cease to apply to the UK and it ceases to be a member state. Although claims have been made to the contrary, it is clear that the UK is legally entitled to negotiate and conclude, during the period before exit, trade agreements which will come into force from and after the date of exit.

Appendix 5: EU directives and regulations relating to the financial services industry

Banking

MiFID II[384]

The Markets in Financial Instruments Directive (MiFID) is the framework of European Union (EU) legislation for:

- investment intermediaries that provide services to clients around shares, bonds, units in collective investment schemes and derivatives (collectively known as 'financial instruments') and
- the organised trading of financial instruments

MiFID was applied in the UK from November 2007, but was revised to improve the functioning of financial markets in light of the financial crisis and to strengthen investor protection (by taking notes of discussions with clients; having an 'appropriateness test' for investments in complex financial instruments; separating research and transactions costs; ensuring the best execution of client orders; improved the reporting of transactions; reporting transactions costs in both percentage terms and 'pounds and pence'; notifying clients if their portfolio falls by 10% or more; identifying the nationality of clients via a 'national client identifier', such as a national insurance number; identifying those engaged in financial transactions via a 'legal entity identifier').

[384] https://www.fca.org.uk/markets/mifid-ii

The revisions came into effect on 3 January 2018, with the new legislation being known as MiFID II – this includes a revised MiFID and a new Markets in Financial Instruments Regulation (MiFIR).

MiFIR

On 20th October 2011, the European Commission published two proposals: the revised Markets in Financial Instruments Directive (MiFID II) along with Markets in Financial Investments Regulation (MiFIR). Both the Directive and Regulation aim to establish a safer and more transparent financial system by enhancing regulatory requirements, market transparency and investor protection. The Regulation sets out to:

- Strengthen investor protection
- Reduce the risk of market disorder
- Reduce systemic risk
- Increase the efficiency of financial markets

MiFIR sets out a number of reporting requirements in relation to the disclosure of trade data to the public and competent authorities.

The new MiFIR reporting requirements will replace the build on the existing MiFID transaction reporting requirements, but will be more difficult in terms of scope and reporting content.

The MiFIR reporting obligations were introduced in January 2018.[385]

CRD IV

The Capital Requirements Directive IV (CRD IV) is an EU legislative package that contains prudential rules for banks, building societies and investment firms. Most of the rules in the legislation have applied since 1 January 2014.

CRD IV is made up of the:

- Capital Requirements Directive (2013/36/EU) (CRD), which must be implemented through national law, and
- Capital Requirements Regulation (575/2013) (CRR), which applies to firms across the EU

CRD IV is intended to implement the Basel III agreement in the EU. This includes enhanced requirements for:

- The quality and quantity of capital
- A basis for new liquidity and leverage requirements

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385 http://www.lseg.com/markets-products-and-services/post-trade-services/unavista/regulation/mifir-reporting

- Rules for counterparty risk
- Macroprudential standards including a countercyclical capital buffer and capital buffers for systemically important institutions.

CRD IV also:

- Makes changes to rules on corporate governance, including remuneration
- Introduces standardised EU regulatory reporting, referred to as COREP and FINREP
- These reporting requirements will specify the information firms must report to supervisors in areas such as own funds, large exposures and financial information.

CRD IV strengthens the prudential framework for individual institutions and responds to financial stability concerns that arose during the latest banking crisis.[386]

Asset Management

AIFMD

The Alternative Investment Fund Managers Directive (AIFMD) is a regulatory framework for alternative investment fund managers (AIFMs), including managers of hedge funds, private equity firms and investment trusts.

The AIFMD was implemented in the UK on 22 July 2013. Its scope is broad and, with a few exceptions, covers the management, administration and marketing of alternative investment funds (AIFs). Its focus is on regulating the AIFM rather than the AIF.

An AIF is a 'collective investment undertaking' that is not subject to the UCITS regime, and includes hedge funds, private equity funds, retail investment funds, investment companies and real estate funds, among others.

The AIFMD establishes an EU-wide harmonised framework for monitoring and supervising risks posed by AIFMs and the AIFs they manage, and for strengthening the internal market in alternative funds. It also includes new requirements for firms acting as a depositary for an AIF.

AIFMD has the following aims:

- To enhance supervisory practices among EEA competent authorities to support timely and pre-emptive action to prevent market instability and the build-up of systemic risk in the European financial system
- To improve investor protection by imposing new depositary standards and enhanced transparency through new investor disclosure rules and mandatory reporting to competent authorities

[386] Source: https://www.fca.org.uk/firms/crd-iv

- To foster efficiency and cross-border competition by deregulating national barriers and creating level playing fields through harmonised rules on an EEA-wide passport for full-scope EEA AIFMs to market and manage AIFs from 22 July 2013.

The following requirements are included in the AIFMD:

- The authorisation of the fund manager (full scope AIFM) or, alternatively, registration subject to a lighter regime for AIFMs managing AIFs with 'assets under management' below certain thresholds. Sub-threshold AIFMs may not benefit from the AIFMD's marketing and management passports; however, they have the right to opt-in to full authorisation to access AIFMD passports
- Conduct of business (fair treatment of investors, conflicts of interest, remuneration, risk management, valuation, disclosure to investors and regulators)
- Regulatory capital – initial capital, 'own funds' and professional indemnity insurance requirements
- The safekeeping of investments (via the mandatory appointment of depositaries and custodians)
- Controls over delegation of certain tasks, including portfolio management and risk management
- The marketing of AIFs to professional investors within the EEA
- The use of leverage by AIFMs for all AIFs under management. EEA regulators will have new powers to intervene, placing restrictions on leverage and other supervisory restrictions where needed to avoid the build-up of systemic risk.

AIFMD is currently being revised as follows:

- A number of fund managers in the UK hold a permission to manage investments. It is likely that some of these firms, dependent on business models, will need to be re-authorised under the AIFMD to operate as AIF managers. These may include:
    - MiFID firms carrying out portfolio management and/or risk management for EEA funds that are not UCITS funds or funds located offshore in third-country jurisdictions, such as the US and Cayman Islands, and
    - operators of collective investment schemes that are not UCITS funds carrying out portfolio management and/or risk management in-house
- The AIFMD will mean certain fund managers are being regulated for the first time. For example, investment companies that do not employ an external manager will need to be authorised or registered with us under the AIFMD
- Depositaries of AIFs will have to comply with new requirements
- The AIFMD brings in significant changes to the management/administration of AIFs in the EU and introduces new EU-wide passports for authorised full-scope AIFMs to market and manage AIFs from 22 July 2013
- Marketing and management passports will not be available to non-EEA managers of AIFs or to EEA managers in respect of their non-EEA AIFs (this may be adopted from 2015 subject to ESMA reports and Commission delegated acts). Marketing of such funds to professional investors is allowed under national private placement regimes.

It is envisaged that existing NPP regimes will be phased out after the non-EEA passport regime becomes operational, although not before 2018.[387]

UCITS V

Undertakings for collective investment in transferable securities (UCITS) are regulated investment funds that can be sold to the general public throughout the EU, and they have common standards of investor protection.

UCITS V aims to increase the level of protection already offered to investors in UCITS and to improve investor confidence in UCITS. It aims to do so by enhancing the rules on the responsibilities of depositaries and by introducing remuneration policy requirements for UCITS fund managers.

UCITS V also aims to ensure that all EU regulators responsible for the supervision of UCITS funds and their managers have a common minimum set of powers available to investigate infringements of national laws transposing the UCITS Directives and to sanction any breaches.

The changes introduced by UCITS V include:

- A requirement to appoint a single depositary for each UCITS, disallowing the appointment of multiple depositaries
- An exhaustive list of entities eligible to act as a depositary of a UCITS
- The harmonisation of the duties of a depositary to keep the assets of the UCITS safe, monitor cash movements to and from the fund, and oversee the fund manager's performance of its key functions
- Specific safe-keeping requirements that a depositary needs to comply with in respect of financial instruments that may be held in custody as well as for other assets, including segregation requirements for assets that are held in custody
- A requirement on Member States to ensure that assets held in custody by a depositary or its delegate are protected in the event of the depositary or its delegate becoming insolvent
- A strict liability regime making the depositary liable for the avoidable loss of a financial instrument held in custody
- A requirement for UCITS management companies to have remuneration policies, complying with certain remuneration principles, covering their key staff and a requirement to make those policies transparent
- The harmonisation of the administrative sanctions that must be available to EU regulators for breaches of the UCITS Directive.

The Directive setting out the UCITS V changes was published in the Official Journal of the EU on 18 August 2014. Member States will have to implement it into national law by 18 March

[387] https://www.fca.org.uk/firms/aifmd

2016. Unlike the UCITS IV Directive, the UCITS V Directive does not recast the UCITS Directive. Instead, it amends and stands alongside the UCITS IV Directive.

The Financial Conduct Authority is working with HM Treasury on the implementation of UCITS V in the UK. In CP15/27, published on 3 September 2015, the FCA consulted on the relevant proposed changes to the Handbook. In PS16/2, published on 2 February 2016, the FCA set out our final rules and guidance. These took effect on 18 March 2016.

The Directive provides for many of the detailed measures to be implemented through further delegated EU legislation (delegated acts, also referred to as level II measures).[388]

Insurance

Solvency II

Solvency II was implemented in all 28 Member States, including the UK, on 1 January 2016. It introduces a new, harmonised EU-wide insurance regulatory regime. The legislation replaces 14 EU insurance directives.[389]

The key objectives of Solvency II are as follows:

- Improved consumer protection. It will ensure a uniform and enhanced level of policyholder protection across the EU. A more robust system will give policyholders greater confidence in the products of insurers
- Modernised supervision. The "Supervisory Review Process" will shift supervisors' focus from compliance monitoring and capital to evaluating insurers' risk profiles and the quality of their risk management and governance systems.
- Deepened EU market integration: Through the harmonisation of supervisory regimes.
- Increased international competitiveness of EU insurers.

Solvency II is not just about capital. It is a comprehensive programme of regulatory requirements for insurers, covering authorisation, corporate governance, supervisory reporting, public disclosure and risk assessment and management, as well as solvency and reserving.

- The Solvency II programme is divided into three areas, known as *pillars* – see Table A1.

388 https://www.fca.org.uk/firms/authorised-recognised-funds/ucits-v-new-requirements
389 https://www.lloyds.com/the-market/operating-at-lloyds/solvency-ii/about/what-is-solvency-ii

Table A1: Solvency II pillars		
Pillar 1	*Pillar 2*	*Pillar 3*
Financial Requirements	*Governance & Supervision*	*Reporting & Disclosure*
Two thresholds: - Solvency Capital Requirement (SCR) - Minimum Capital Requirement (MCR) SCR is calculated using either a standard formula or, with regulatory approval, an internal model. MCR is calculated as a linear function of specified variables: it cannot fall below 25%, or exceed 45% of an insurer's SCR. There are also harmonised standards for the valuation of assets and liabilities.	Effective risk management system. Own Risk & Solvency Assessment (ORSA) Supervisory review & intervention.	Insurers required to publish details of the risks facing them, capital adequacy and risk management. Transparency and open information are intended to assist market forces in imposing greater discipline on the industry.

IDD

The Insurance Distribution Directive (IDD) came into force on 22 February 2016 and updates the 2002 Insurance Mediation Directive (IMD), which set out a framework for regulating EU insurance brokers, agents and other intermediaries. Member states have two years to transpose the IDD into national laws and regulations, i.e., before 23 February 2018 on which date it will repeal the IMD.

Like its predecessor, the IDD is a 'minimum harmonising' directive and member states will be able to 'gold-plate' it by adding extra requirements to it when implementing it. The IDD is intended to significantly raise the minimum standards of the IMD. On cross-border trade, in particular, the introductory wording to the IDD refers to the fact that the European insurance market remains very fragmented despite the existing single 'passport' systems for insurers and intermediaries.[390]

[390] http://www.out-law.com/en/topics/insurance/insurance-brokers-and-intermediaries/the-insurance-distribution-directive-changes-to-the-regulation-of-insurance-intermediaries-in-the-eu/

Market infrastructure

PSD II

The Payment Services Directive is an EU Directive, administered by the European Commission (Directorate General Internal Market) to regulate payment services and payment service providers throughout the EU and EEA.

PSD was published in late 2007 and was designed to:

- Help develop the Single Euro Payments Area (SEPA)
- Set common standards for terms and conditions
- Regulate payment institutions (to encourage non-banks to enter the market)
- Provide increased consumer protection and transparency
- Establish maximum processing times for payments in euro and other EU currencies including sterling.

The PSD was implemented in the UK through the Payment Services Regulations 2009 (PSRs) and was the first European law to affect sterling payments.

After reviewing the PSD in 2012, the EC proposed revised legislation, widely known as the Payment Services Directive II (PSD II), in July 2013. The agreed final text of PSD2 was published in the Official Journal of the European Union in December 2015 and entered into force in January 2016. PSD II will introduce further changes to the legislative framework governing payments and crucially in 2018 will force banks to open up their infrastructure to regulated fintech companies.[391]

EMIR

The European Market Infrastructure Regulation (EMIR) came into force in 2014 and covers derivatives markets and their clearing houses (also known as central counterparties) which guarantee the trades executed between buyers and sellers in these markets. Europe's key clearing houses are LCH.Clearnet (owned by the London Stock Exchange) and ICE Clear Europe (owned by Intercontinental Exchange) are based in London. EMIR was introduced in response to the global financial crisis with the aim of reducing systemic risk in over-the-counter derivatives through greater clearing, reporting and electronic trading of derivatives.[392]

CSDR

A central securities depository (CSD) is an institution that holds financial instruments, including equities, bonds, money market instruments and mutual funds. It allows ownership

[391] https://en.wikipedia.org/wiki/Payment_Services_Directive
[392] https://en.wikipedia.org/wiki/European_Market_Infrastructure_Regulation

of those instruments to be transferred in electronic form through updating electronic records which are often known as 'book-entry records'.

The UK CSD is Euroclear UK and Ireland (EUI). The Bank of England is the competent authority for the authorisation, supervision and policy for EUI.

The Central Securities Depositories Regulation (CSDR) is EU legislation that aims to harmonise the authorisation and supervision of EU CSDs and certain settlement aspects, such as dematerialisation of financial instruments. This means that the securities will be held in electronic form, much like cash is held in a bank account.

CSDR introduces a mandatory buying-in and cash penalty securities settlement discipline to tackle failed settlement transactions. It also reduced the standard securities settlement cycle to T+2 (with 'T' meaning the date of trade and the settlement of this trade being two days after the trade). This has been effective in the UK since 6 October 2014.[393]

MAR

The Market Abuse Regulation (MAR) took effect across the EU on 3 July 2016.

Certain types of behaviour, such as insider dealing and market manipulation, can amount to market abuse. Firms must have safeguards in place to identify and reduce the risk of market abuse and other financial crime.

Preventing, detecting and punishing market abuse is a high priority for us. It is important in fulfilling our statutory objectives of protecting consumers, enhancing market integrity and promoting competition.

Criminal insider dealing is an offence under Part V of the Criminal Justice Act 1993, and criminal market manipulation is an offence under sections 89-91 of the Financial Services Act 2012. The FCA works closely with the financial services industry, law enforcement agencies and other regulators to combat market abuse and other related financial crime. It also educates market participants.

The FCA undertakes surveillance of financial markets and has systems for identifying insider dealing and market manipulation in various financial markets. This includes analysing transaction reporting data, order book data, benchmark submission and other market data. Firms and operators of a trading venue must identify and reduce the risk of market abuse and report it to the FCA under the suspicious transaction and order reporting (STOR) regime.

The FCA takes enforcement action against market abuse and can impose significant penalties, such as order injunctions and prohibition of regulated firms or approved persons.

[393] https://www.fca.org.uk/markets/central-securities-depositories

Criminal sanctions for insider dealing and market manipulation can incur custodial sentences of up to 7 years and unlimited fines.[394]

Appendix 6: Full memo of David Davis meeting with the City, *Financial Times*, 9 December 2016

The memo

This is a memo taken by a City of London Corporation representative after meeting David Davis, the minister for Brexit, on 15 November 2016. It was circulated within the City and leaked to the Financial Times. It will, in due course, be interesting to see how this compares with the eventual outcome.

Overview

David Davis is bullish and not receptive to negative special pleading. He sees Brexit as a positive opportunity. But he is not close-minded. Well-constructed, factual solutions to problems can be made to him and he will be receptive. He is enjoying his role and appears to have a decent relationship with the Prime Minister. If anything he sees himself as a more flexible-minded problem solver than her. We can engage him but it needs to be in a way that he responds to positively.

Meeting Notes —

Impact on the City — Stated his desire for “facts and evidence” — would like to have clear, supported statistics and research about the impact on jobs and organisations as a result of not having access or adequate arrangements for different forms of trading or financial services activity.

With such evidence he plans to gauge how negotiations can be pitched and what negatives or positive effects would result from trade-offs being made or certain models being adopted. Viewed the City, in part, as not yet having moved on from the Referendum and accepting the outcome.

Relocation of banks — Commented that financial services PR firms are the most vocal groups warning of extreme negative consequences for financial services. Also queried whether the employees of US banks warning of relocating in Europe would actually relocate, given the unattractiveness of Frankfurt and other cities in the EU, in comparison with London. As a result, jobs will go back to New York not Europe.

Possible transitional arrangements — Stated that he was “not really interested” in the discussion around the arrangements, did not foresee any benefits and could be perceived as a delay to the process that is not something the Government can abide.

[394] https://www.fca.org.uk/markets/market-abuse

However, expressed concern that there is an argument that the stability of the EU could be compromised by the UK's "sudden" departure from the EU — the regulatory upheaval and potential for systemic risk could result in serious negative consequences for the whole of the EU. Davis emphasised the PM's conference speech, in which it was stated that the UK Government wants a strong UK and a strong EU. He went on to say that if the EU, rather than UK stakeholders, want to have transitional arrangements he would be "more in favour. I will be kind".

Trump — Recognised the fear in the EU Member States that a "wave of nationalism" would sweep across Europe.

Negotiations — Speculating on the positioning of certain countries, he thought that Spain would not, ultimately, pose a problem in the negotiations, neither would Germany but believed France would be the most hostile and difficult to compromise with.

Querying what might happen if there is a desire for a punishing or hard negotiation and settlement for the UK, Davis said they would then need to switch to his "alternative strategy" that the UK Government will have to take a position of competing with other EU Member States for business — lower tax, softer regulation and other strong business incentives.

Opined that the EU Member States, such as France had "no faith" in their economic models and ability to compete with an "Anglo-Saxon approach".

Immigration — Emphatic that UK will "take back control of its borders" but in the national interest. Speculated that a bespoke solution of permits and points style system would be used to determine entry to the UK.

Very much understood that the UK would not benefit from a labour shortage. Emphasised that new apprenticeships, vocational and training programmes would be implemented "in step" with immigration changes, to ensure that domestic workers are best placed to fill UK vacancies and there is not an unnecessary skills shortage.

Appreciated that the "up and coming" entrepreneur with little capital and poorly paid young scientific researcher would pose an issue in ensuring rising talent got through immigration control — did not currently have an answer but were looking at solutions.

Access to the single market — In light of the position on immigration and the EU's inflexible approach to the 'four freedoms', it is unlikely that the UK will achieve access. However, stated that if a trade deal such as CETA could be agreed, it would be unlikely to pose a significant problem as "most advantages" would be gained.

A deal of this nature and the 'Great Repeal Bill' would actually mean that a lot of common standards would already be in place to trade.

Equivalence — Addressing fears that the French would "pull out the rug", Davis understood concerns but indicated a mechanism "to stop that happening quickly" could be found. More widely on regulation, speculated that the US is about to liberalise their regulation and this would make it much tougher to penalise the UK for not having appropriate regulation — as they would then also need to penalise trading partners such as the US.

Passporting — Does not believe that business leaders actually understand when Passporting is actually required and is not as vital as many suggest.

Exports — Did not see logic for pharmaceuticals to relocate. Believed it can be more beneficial to be outside and trading in to the EU.

Trading models — Big spectrum of models, looking at somewhere in the middle of the models for Turkey, Switzerland and Norway.

Clearing — Referencing the ECJ decision on clearing, commented that US reserves the right for it to step in if an issue in trading arises, UK may have to allow EU to do the same in euro clearing.

Article 50 — Liked the fact it acts as a deadline and requires a resolution to be found. Court case means it will likely now be triggered in very late March. Will use an expedited process and allow five days for the Bill to pass. Hinted that he would allow longer than necessary to proceed through Parliament, as "they would run out of speakers" to oppose the Bill and the Lords would start to "tie itself up" and not make a coherent argument. Will trigger Article 50 with an opening approach of open access on all services and goods without tariffs in the UK.

[**ECJ** — PM emphatic that ECJ must not have a say in UK affairs.]

EU officials' reaction to the memo[395]

Brussels aghast at suggestion interim plan would be considered only to 'be kind' to EU

David Davis, Britain's Brexit secretary, said he was "not really interested" in a transitional deal to cushion Britain from the effects of Brexit and that he would consider one only in order to "be kind" to the EU.

Financial companies have pressed the government to agree a transition period after Britain leaves the bloc and before new trade terms are finalised, during which current arrangements remain in place.

But speaking in mid-November, Mr Davis told a private meeting with the City of London Corporation that negotiating a transition, as recently championed by Mark Carney, the Bank of England governor, would not benefit the UK and could delay the Brexit process.

Mr Davis accepted, however, that Britain's "sudden" departure could compromise the EU's financial stability and said he would be "more in favour" if the EU asked Britain for a transition. "I will be kind," he said, according to the CLC's account of the meeting.

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[395] Alex Barker (2016) David Davis rebuffed City hopes for Brexit transition deal, *Financial Times*, 9 December.

One senior EU official involved in Brexit preparations expressed astonishment at the idea that it would be the EU playing the role of *demandeur* on transition, calling it “deluded”. “There is a denial of reality in London,” the official said. Another EU representative who met Mr Davis said: “I’m fed up with British politicians . . . they have no clue.”

Mr Davis’s bullish views were aired during a meeting with the CLC on November 15, an internal note of which was leaked to the Financial Times. His reservations about a transition were repeated in meetings in Brussels and Strasbourg in late November, according to senior European figures.

Over the past week, however, Mr Davis has given more positive signals about potential arrangements to support a Brexit soft landing and he is working more closely with Philip Hammond, the chancellor and strong advocate of a smooth, gradual exit. Senior London bankers see the position of the government evolving.

Even so, the report of Mr Davis’s candid opinions — on groundless whingeing from the City, Britain’s upper hand in talks and “the unattractiveness of Frankfurt” for bankers — will risk adding to growing EU-UK tensions over Brexit.

Berlin and Paris are likely to be especially annoyed by Mr Davis warning that if the EU pushed for a punishing settlement, Britain would switch to a tougher “alternative strategy”, looking to fight for business with “lower tax, softer regulation and other strong business incentives”.

Mr Davis “opined that EU member states such as France had ‘no faith’ in their economic models and ability to compete with an ‘Anglo-Saxon approach’,” the CLC meeting note said.

The department to exit the EU said the government was “engaging widely” with businesses about the “challenges and opportunities” of Brexit. “These are two-way discussions about a whole range of issues and potential outcomes,” it said. “This account does not properly reflect government policy or [Mr Davis’s] view.

“He has made clear that the UK wants a smooth and orderly exit from the EU, a new partnership that works in the interests of both parties, and is looking at all options to deliver that.”

Mr Davis’s private views offer a window on the debate within the government not only over the goals of the Brexit negotiation, but the tactics for achieving them.

Part of his scepticism over a transition stems from his confidence in the possibility of agreeing a full fast-tracked trade deal by late 2018 that would negate the need for an interim deal after Brexit. The Treasury and Brussels see that timetable as almost impossible.

He told the City representatives that the EU’s “inflexible approach” on immigration in particular meant it was unlikely the UK would achieve access to the single market. But he said a trade deal such as the Canada-EU agreement would be relatively easy to secure and would not pose a significant problem for the UK because “most advantages” would be gained.

Mr Davis is also more confident about the balance of interests and the cost to Europe of abruptly cutting off corporate access to the City, the continent's main financial centre. It echoes a concerted effort across government in recent weeks to emphasise that Brexit is a shared problem for Europe, with costly spillover effects.

Speaking in Brussels on Monday, Mr Hammond stressed a smooth process was needed that "minimises the threat to European financial stability". He noted the "very many complex relationships that exist between European manufacturing businesses and their financial backers . . . in London".

Mr Carney has called London "the investment banker for Europe", pointing out that over half of the equity and debt raised by eurozone companies was issued "in the UK, by firms based in the UK, quite often to investors in the UK".

"It's absolutely in the interests of the EU that there is an orderly transition and that there is continual access to those services," he said.

The CLC said: "This note was the City's interpretation of our meeting with the secretary of state for Exiting the EU last month. It was a constructive discussion on the opportunities and challenges that leaving the EU presents to the financial services industry and how the City can work closely and positively with the government."

Appendix 7: We can have our Brexit cake and eat it

Joseph Hackett, research executive at Get Britain Out, argues that we can have our Brexit cake and eat it.[396]

EU leaders continue to insist on the inseparability of the much-vaunted "four freedoms" of the single market – free trade in goods, services, and capital, as well as free movement of people.

German Finance Minister Wolfgang Schäuble, for instance, told Britain: "There is only the whole menu or none." According to Schäuble and his fellow Eurocrats, if Britain wants to maintain, for instance, passporting rights for financial services, then it must also accept free movement and the entire range of EU trading standards.

This would seemingly leave Britain in a quandary: stuck between two options which, though vastly preferable to EU membership, are far from perfect.

Becoming a non-EU single market member, like Norway or Iceland, would not give us full control over our laws and borders, and would offer our businesses no relief from EU red tape.

[396] Joseph Hackett (2016) We can have our Brexit cake and eat it, *CAPX*, 19 December.

However, some aspects of the single market – such as the mutual recognition of standards – are economically beneficial, and retaining them would help Britain fully achieve its post-Brexit potential.

Fortunately, when it comes to the Single Market, the EU does not exactly practice what it preaches. It is quick to dispense with ideology when one of its failing flagship policies is at stake.

Take the notoriously inefficient Common Agricultural Policy and Common Fisheries Policy, which both involve the application of tariffs to agricultural and fisheries produce from the rest of the world – even from single market members like Norway.

There is no way the CAP and CFP can be considered anything other than flagrant violations of the principle of free trade in goods.

The single market in goods is further compromised for non-EU members by the EU's Customs Union. Being outside this bloc, Norway and Iceland find their exports to the EU subject to time-consuming "rules of origin" checks on their export goods, in order to ensure countries such as China are not using, say, Iceland as a middleman to avoid paying EU tariffs.

These customs checks are exactly the sort of irritating non-tariff barrier the single market was created to eliminate.

It is not only the EU which can break these supposedly unimpeachable rules. Even single market members are able to unilaterally impose an "emergency brake" on any of these four freedoms.

Little Liechtenstein has exploited this right to impose an effectively permanent limit on free movement. Liechtenstein might be small, but it has blown a big hole in EU leaders' insistence that all four freedoms must go hand-in-hand and must either be implemented wholesale or not at all.

Britain is not as small as Liechtenstein, but, then, we are not asking for single market membership. Britain should take heart from Switzerland, a country which has extensive access to the single market without being a member.

Although it currently accepts free movement, it is exempt from other aspects of the Single Market, such as the onerous requirement to make all its products abide by EU regulations, even if they are not being exported to the EU.

If Liechtenstein blows a hole in the Eurocrats' narrative, then Switzerland turns it into a slice of that country's famous cheese. Though Britain would not want to adopt the terms of the Swiss bilateral deals wholesale, it would do well to take inspiration from their path.

The all-or-nothing choice is a red herring. Especially considering how the "all" option does not actually exist for non-EU countries – except, of course, where it relates to free movement.

The single market in goods is compromised for non-EU states by customs checks, the CAP, and the CFP.

The single market in services is compromised for everybody, and it always has been. Though EU leaders are quick to congratulate themselves on their supposed progress in this regard, there is little evidence the single market in services is actually taking shape on the ground – or that service providers are actually benefiting.

The sheer diversity of the service sector means it is highly unlikely to ever be "completed", even if EU countries somehow mustered the political motivation to try.

So, as the triggering of Article 50 draws closer, it is time for the Government to challenge the EU's hypocritical narrative. The four freedoms are not inseparable – not even single market members have all aspects of all four freedoms.

The EU itself will not let the four freedoms get in the way of the CAP or CFP. And there is a fundamental inequality between the them – while the single market in services is nowhere near complete, free movement is virtually unregulated.

It is both unfair and inaccurate for Eurocrats to tell Britain the single market is an all-or-nothing choice. As we get Britain out of the EU, we should press for access to the aspects of the single market which are mutually beneficial to us and them alike, while rejecting aspects which are not.

This is not some unreasonable "have your cake and eat it" request. It's what's best for us and it's what's best for them.

Appendix 8: 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.[397] 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. It should give British companies the maximum freedom to trade with and operate within European markets – and let European businesses do the same in Britain. But I want to be clear. What I am proposing cannot mean membership of the single market. European leaders have said many times that membership means accepting the '4 freedoms' of goods, capital, services and people.*

[397] https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech

And being out of the EU but a member of the single market would mean complying with the EU's rules and regulations that implement those freedoms, without having a vote on what those rules and regulations are. It would mean accepting a role for the European Court of Justice that would see it still having direct legal authority in our country.

….[An] important part of the new strategic partnership we seek with the EU will be the pursuit of the greatest possible access to the single market, on a fully reciprocal basis, through a comprehensive free trade agreement. And because we will no longer be members of the single market, we will not be required to contribute huge sums to the EU budget. There may be some specific European programmes in which we might want to participate. If so, and this will be for us to decide, it is reasonable that we should make an appropriate contribution. But the principle is clear: the days of Britain making vast contributions to the European Union every year will end.

… But there is one further objective we are setting,…it is in no one's interests for there to be a cliff-edge for business or a threat to stability, as we change from our existing relationship to a new partnership with the EU. By this, I do not mean that we will seek some form of unlimited transitional status, in which we find ourselves stuck forever in some kind of permanent political purgatory. That would not be good for Britain, but nor do I believe it would be good for the EU. Instead, I want us to have reached an agreement about our future partnership by the time the 2-year Article 50 process has concluded. From that point onwards, we believe a phased process of implementation, in which both Britain and the EU institutions and member states prepare for the new arrangements that will exist between us will be in our mutual self-interest. This will give businesses enough time to plan and prepare for those new arrangements.

… I believe the framework I have outlined today is in Britain's interests. It is in Europe's interests. And it is in the interests of the wider world.

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.

Because we would still be able to trade with Europe. We would be free to strike trade deals across the world. And we would have the freedom to set the competitive tax rates and embrace the policies that would attract the world's best companies and *biggest investors to Britain. And – if we were excluded from accessing the single market – we would be free to change the basis of Britain's economic model.*

But for the EU, it would mean new barriers to trade with one of the biggest economies in the world. It would jeopardise investments in Britain by EU companies worth more than half a trillion pounds. It would mean a loss of access for European firms to the financial services of the City of London. It would risk exports from the EU to Britain worth around £290 billion every year. And it would disrupt the sophisticated and integrated supply chains upon which many EU companies rely.

Important sectors of the EU economy would also suffer. We are a crucial – profitable – export market for Europe's automotive industry, as well as sectors including energy, food and drink, chemicals, pharmaceuticals, and agriculture. These sectors employ millions of people around Europe. And I do not believe that the EU's leaders will seriously tell German exporters, French farmers, Spanish fishermen, the young unemployed of the eurozone, and millions of others, that they want to make them poorer, just to punish Britain and make a political point.

For all these reasons – and because of our shared values and the spirit of goodwill that exists on both sides – I am confident that we will follow a better path. I am confident that a positive agreement can be reached. It is right that the government should prepare for every eventuality – but to do so in the knowledge that a constructive and optimistic approach to the negotiations to come is in the best interests of Europe and the best interests of Britain.

The chancellor, Philip Hammond, subsequently added flesh to the PM's comment that she would 'change the basis of Britain's economic model'. He said that the UK must remain 'one of the most open economies in the world' and 'nobody wants to see Britain pulling up the drawbridge'. But he indicated that he is prepared to lower corporation tax if the EU does not agree to a suitable exit deal for the UK: 'If somehow, despite our best efforts, political retribution were to triumph over economic logic and we don't get a fair deal providing the reasonable access to each other's markets… we will have to do whatever is necessary to ensure the continued competitiveness of our economy in those circumstances'.[398]

On 2 February 2017, the government released a White Paper setting out its plans for Brexit and said it would aim for the 'freest possible trade in financial services between the UK and EU member states… In highly-integrated sectors, such as financial services, there will be a legitimate interest in mutual cooperation arrangements that recognise the interconnectedness of markets, as so clearly demonstrated by the financial crisis. Since that time, the EU has taken a number of steps to strengthen collective oversight of the sector... As the UK leaves the EU, we will seek to establish strong cooperative oversight

[398] Szu Ping Chan, Ben Marlow and Ben Wright (2017) Hammond: I guarantee the UK will be competitive, *Daily Telegraph*, 20 January.

arrangements with the EU and will continue to support and implement international standards to continue to safely serve the UK, European and global economy'.[399]

Reactions from the UK

The prime minister's speech was strongly supported by leading Brexiteers, such as Liam Halligan, the *Sunday Telegraph* columnist, and Gerard Lyons who had published a paper with Policy Exchange a few days before the speech.[400] They said it was essential for the UK to have a 'clean Brexit' outside the single market and the customs union, even if no trade deal with the EU had been agreed before Brexit. Instead, they argued that the UK should settle for WTO rules and 'less ambitious, sector-based agreements' – covering automobiles, pharmaceuticals and financial services – *where possible*. Lord Nigel Lawson, in a forward to the report, agrees that the UK should go for a 'clean Brexit' that avoids 'an acrimonious renegotiation' over the UK's single market and customs union memberships, as well as freedom of movement. But he questions the feasibility of the EU agreeing any free trade deal with the UK: 'We must accept that our free-trade offer will be rejected and that no remotely acceptable post-Brexit trade agreement between the UK and the EU is negotiable'. Mr Halligan agrees with this: '"Clean Brexit" works - avoiding "cliff-edge" chaos. So we should declare now we'll be outside SM and CU, spending the two-year Article 50 period negotiating our own trade deals with the wider world, while preparing for a knowable Brexit. Better that than tearing UK-EU relations to pieces, for extremely dubious economic gains'.[401]

Martin Howe QC, chair of Lawyers for Britain, also welcomed the PM's speech: 'This speech is excellent for charting the course for our future relationship with the world and with the EU after exit. It has cleared away a number of damaging suggestions which have been coming from diehards who still want effectively to stay in the EU and be subject to EU law despite the Referendum result…. Most importantly, she has said that "no deal is better than a bad deal" and that the UK is willing to walk away from negotiations with the EU rather than accept a bad deal. This is absolutely critical to our ability to negotiate a good agreement with the EU'.[402]

Trade specialists warned that there would be a range of difficulties that the UK would have in negotiating a trade deal with the EU within two years:[403]

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399 HM Government (2017) *The United Kingdom's exit from and new partnership with the European Union*, Cm9417, February 2017; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/588948/The_United_Kingdoms_exit_from_and_partnership_with_the_EU_Web.pdf

400 Liam Halligan and Gerard Lyons (2017) *Clean Brexit*, Policy Exchange, January.

401 Liam Halligan (2017) Clean Brexit can avoid the cliff-edge chaos, *Sunday Telegraph,* 15 January.

402 Lawyers for Britain press release, 17 January 2017.

403 Shawn Donnan (2017) Trade truths for Theresa May's vision of a 'Global Britain': Five hurdles on the prime minister's chosen path for the UK after Brexit, *Financial Times*, 18 January; Sam Coates (2017) High-stakes gamble risks border chaos, warn experts, *The Times*, 19 January.

- The UK is asking the EU to do something it has never done before, at a pace it has never managed before. It would also require a legion of trade negotiators that the UK simply does not have.

- The laws of economics say the EU is likely to remain the UK's biggest export market after Brexit, not least for geographical reasons. According to Jacob Funk Kirkegaard, a senior fellow at the Peterson Institute for International Economics in Washington: 'We know that in trade, distance matters. You can negotiate all you want with Australia or New Zealand and even the US. But we know that in the end the most important trade relationship will always be with your neighbours'. The US, for example, exports twice as much to both Canada and Mexico as it does to China.

- It is likely to take years to replicate the various EU trade agreements from which the UK economy now benefits, unless it is seen as an undemanding negotiator that is not interested in protecting sectors such as agriculture or key manufacturing industries. Most modern trade deals are complicated affairs and the UK would quickly have to establish its priorities, and how all-encompassing it wants its trade agreements to be. Would they tackle issues related to ecommerce and data privacy? Would they address topics such as labour and environmental rules? Or include what in other trade deals have been controversial arbitration provisions to allow disgruntled foreign investors to get around local courts?

- Not to pin too much hope on Donald Trump. Mr Trump is a dealmaker, but even a quick deal could take years to conclude. Mr Kirkegaard argues that 'Theresa May will be desperate beyond belief to get a deal with the US because it's the only deal that will get her some kind of economic meat for her vision of a 'Global Britain'. And Trump will know that. Let's see what kind of deal they can get. But I suspect it will be a deal that is beneficial to the US and may not be so beneficial to the UK. She seems to have an awful lot of eggs in Donald Trump's basket and that strikes me as pretty dangerous'.

- The UK still needs to negotiate the terms of its fallback option — membership of the WTO. The UK's current membership in the WTO is governed by EU-wide tariffs and other trade provisions. So it still needs to negotiate its own tariff schedule with the WTO's 163 other members. Some of that process could be relatively straightforward if it chooses to copy and paste the WTO-approved EU tariffs now in place for thousands of categories of goods and services. But there are other complexities, such as agricultural quotas, that could cause difficult negotiations.

- Lawyers have pointed out that there need to be clear rules governing how customs officials operate at ports, otherwise there might be 'chaos at the border'.

The City's response was much calmer than in the days after the Referendum. Gerard Lyons explained this as follows: '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'.[404]

Here are some reactions:[405]

- Rob Boardman, European CEO of equities broker ITG**:** **'**The EU should resist the temptation to punish the City, following Theresa May's confirmation that the UK will be outside the single market. While certain things remain unclear, such as the timetable for leaving, the truth is that the City is key to a healthy European financial system. Eurozone banks are still not strong enough to fund a new Marshall Plan for European business from their own balance sheets. They need global investors with risk appetite to invest, and London's expertise at financing, both listed and private equity, is essential. May's plan is clearly to develop other global trade alliances, but it is still unclear what trade deal if any will be made with EU. This is why, now clarity has finally been provided on the UK's objectives, both May and Brussels negotiators should plan specific measures to strengthen trade ties and promote financing for economic growth and prosperity'.

- Graham Vidler, director of external affairs, Pensions and Lifetime Savings Association: 'We welcome Theresa May's commitment to set up transitional arrangements to reduce any economic disruption due to leaving the single market. While it is not yet clear whether EU regulation, as a result of establishing equivalent rules for financial services, will encompass pension funds, we will be arguing strongly that EU rules on solvency requirements for DB pension funds should not apply to pension funds that only operate within the UK'.

- Anthony Browne then of the BBA**:** **'**The Prime Minister has provided important clarity today on the kind of relationship the UK will seek with the EU and we welcome the government's commitment to free trade with the EU and the rest of the world. All existing EU member states have a mutual interest in ensuring that there's a smooth exit. The government's support for interim arrangements is essential to ensure there are no cliff-edge effects when the UK leaves the EU'.

- Chris Cummings, now CEO of the Investment Association**:** **'**We welcome the Prime Minister's speech on Brexit, setting out the importance of avoiding a cliff-edge for financial services being provided to clients in the EU, and ensuring a pragmatic implementation period for the new trade deal with the EU. Much work is needed to ensure that the terms of the future relationship with the EU safeguard the interests of savers and investors throughout the world who make use of Europe's pre-eminent asset management centre in the UK. The prime minister also emphasised the urgency of providing certainty for EU workers in the UK - who make up 11% of

[404] Hayley Kirton and Mark Sands (2017) City eyes best possible access to Europe's Single Market, *City A.M.*, 16 January.
[405] Samuel Agini (2017) City reaction to Theresa May's Brexit speech, *Financial News*, 17 January; Tim Wallace (2017) City lobby group comes out fighting for global Brexit in dramatic u-turn, *Daily Telegraph*, 31 January.

workers in the asset management sector. The asset management industry relies on the UK remaining open and attractive to global talent. We look forward to working with government to deliver the vision of the UK as the world's leading investment hub'.

- In a striking about-turn, TheCityUK declared that it is now 'a strong believer in the potential opportunities that the UK's departure from the European Union will offer… It reflects the fact that there was a vote to leave the EU and as a result there are a whole range of challenges and opportunities, [such as] the opportunity for first time in 40-plus years to have an independent trade and investment policy. In many ways, global rules on services trade have lagged behind those on manufactured goods and agriculture. [There needs to be] a concerted effort led by UK and other like-minded countries to modernise, update and ensure the rules that govern services trade reflect the way services trade is done today. We will be absolutely freer to do it outside the EU. [While the UK exports financial services to the EU very successfully], over the next 10 to 15 years, 90% of global economic growth is expected to be generated outside Europe and these markets – developed and emerging – must be a priority focus for the country post-Brexit… [And while foreign direct investment into the UK has traditionally come from large, rich countries], the rise of the BRICS, notably China and India as exporters of capital means that the UK will need to develop an investment regime that will take account of a wider spread of sources of inbound FDI'. TheCityUK wants the government to liberalise trade on a unilateral basis, as well as striking bilateral trade deals and regional agreements.

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.[406]

Michel Barnier, the EU’s lead Brexit negotiator, responded by reiterating his declared bargaining strategy: divorce first, trade talks after. He said that talks on a trade deal would be contingent on the divorce settlement — and the UK paying a €60bn exit bill. He tweeted: ‘Agreement on orderly exit is prerequisite for future partnership. My priority is to get the right deal for EU27 [which would clearly demonstrate that] it is much better to show solidarity than stand alone’.[407] Despite this, Mr. Barnier said he wanted to maintain a ‘special’ relationship with the London and the UK's financial markets, according to leaked European parliament minutes.[408]

Joseph Muscat, the Maltese prime minister and the current EU rotating president, also repeated that the divorce terms would be prioritised over trade after Britain invokes the Article 50 exit clause in March. Trade talks would start only after Britain’s departure from the EU was settled and the UK had agreed to pay the €60bn exit bill.[409] Cecilia Malmström, the EU trade commissioner, said the UK would have to withdraw from all of the EU's 38 trade agreements with other countries, and can only begin fresh talks once it has actually left the union. The UK would then start at 18th place down the list of countries trying to negotiate a trade deal with the EU and will face a series of extremely difficult negotiations after Brexit: ‘We are negotiating 15-16 trade deals at the moment, so we are busy. It will take a couple of years for sure. It will not be done overnight. There will be some sort of transition period’.[410]

The idea of the UK exercising the ‘freedom to set the competitive tax rates’ attracted the ire of the German finance minister, Wolfgang Schäuble who warned the UK to stick to a 2015 agreement reached by the G20 in Turkey on tax cooperation and ‘not use the taxation of companies as an instrument for competition’. He said if the UK wanted to be ‘taken seriously’ after it left the EU, it should ‘stick to what has been agreed’.[411]

[406] Stefan Wagstyl and Duncan Robinson (2017) Angela Merkel pledges to block Brexit ‘cherry picking’, *Financial Times*, 18 January.

[407] Alex Barker in and Guy Chazan (2017) Barnier sticks to ‘divorce first, trade talks later’ mantra, *Financial Times*, 17 January.

[408] Hayley Kirton and Mark Sands (2017) City eyes best possible access to Europe's Single Market, *City A.M.*, 16 January. A European Commission spokesperson said the minutes did not ‘correctly reflect what Barnier said’, but a source at meeting told the *Guardian* that the minutes were ‘more or less accurate’.

[409] Bruno Waterfield (2017) Agree to £60bn bill before we talk about trade, EU tells May, *The Times*, 19 January. In an interview on BBC2’s *Newsnight* programme on 30 January 2017, Guy Verhofstadt MEP stated that the exit bill had risen to €600bn. He also said he wanted to help those British citizens who did not want to leave the EU with some form of continuing support from the EU.

[410] Ambrose Evans-Pritchard (2017) UK 'will be bottom of Brussels trade queue', *Daily Telegraph*, 20 January.

[411] Hammond makes fresh hints at UK tax cuts, *Professional Adviser*, 20 January 2017.

Sigmar Gabriel, the German vice-chancellor, said Mrs May was right to say those who wanted to be part of the single market must accept a political union. [412] And Guy Verhofstadt MEP, the chief Brexit negotiator of the European parliament and a former prime minister of Belgium, said that the solution for Europe is 'more union'. He wants Europe to 'abandon the artificial divisions of nation-states and instead embrace a unified democracy on a continental scale, a United States of Europe, …so that Europe remains secure, influential, and prosperous into the future'. However, he does acknowledge that European integration has not been entirely successful to date: 'Never – not in all my years as Belgium's prime minister and later on as a leader within the European parliament – have I seen Europe standing so close to the brink'.[413]

A different view was taken by Marine Le Pen, leader of France's National Front, who warned that imposing a punitive divorce settlement on the UK would be proof that Europe can only advance by 'threats, intimidation and blackmail': 'The way the EU has reacted to Brexit has put paid to the few in Europe who still believe that there is an ounce of democracy in this structure, that is the EU. Europe would be showing its true face, as it already has done so in Greece and tried to do with Britain. This EU doesn't move forward by consent because it knows its people no longer adhere to this political structure, it advances via threats, intimidation and blackmail… Brexit marks the great return of the nation. It is the notion that the nation wants to be independent, sovereign that only the nation can decide about its destiny, its future. It is this call for freedom that the British people launched by voting for Brexit'. This view was supported by Vincenzo Scarpetta, a senior policy analyst with Open Europe: 'An excessively punitive attitude in the Brexit negotiations could backfire by providing extra ammunition to the various anti-establishment parties across Europe. They would be able to claim that the EU is an undemocratic club where a sovereign nation gets punished for merely exercising a right enshrined in the Treaties'. A senior British official warned Brussels not to overplay it's hand: 'It hardly makes the EU look like a club you'd want to be a member in if they try and shoot the first member who decides to leave of their own accord'.[414]

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

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[412] Stefan Wagstyl and Duncan Robinson (2017) Angela Merkel pledges to block Brexit 'cherry picking', *Financial Times*, 18 January.

[413] Roland White (2017) The chief Brexit negotiator for the European parliament lays out his vision for the future, Sunday Times, 15 January; Guy Verhofstadt (2017) *EUROPE'S LAST CHANCE: Why the European States Must Form a More Perfect Union*, Basic Books.

[414] Peter Foster and Henry Samuel (2017) Europe will be the loser if Britain punished for leaving, warns Le Pen, *Daily Telegraph*, 7 January.

do whatever we can to avoid such a situation'.[415] Similarly, a leaked report from the European parliament's committee on economic and monetary affairs recognised that 'The exclusion of the main European financial centre from the internal market could have consequences in terms of jobs and growth in the EU… It is in the interest of EU 27 and the UK to have an open discussion on this point.. [It says the EU should seek a] workable deal with the UK. If financial services companies choose to leave the UK as a result of Brexit, the consequences should be carefully evaluated. A badly designed final deal would damage both the UK and the other 27 EU member states'.[416]

According to Ambrose Evans-Pritchard: '[There was] relief … after the UK promises to stand by Europe as a close ally and some of the most vocal former sceptics seek to minimise fall-out. The Brexit drama has taken an unexpected twist. Britain's strategy of full withdrawal from the single market and from the EU institutions has been remarkably well-received. Contrary to fears in some quarters in Britain, the pursuit of a "clean and hard" Brexit has, if anything, helped to clear the air, and been greeted with a degree of relief by political and business leaders in Europe. What has changed the mood, apart from the passage of time, is the parallel pledge by Britain's leaders to stand beside Europe as a close strategic and military ally, playing its full part in upholding a rules-based global architecture. There [are now] signs …. that the anger of recent months is slowly draining away, replaced by an acknowledgement of Britain's distinctive history and character. The imperative now is to limit the damage for all sides and find a way to make the new arrangement work. Not all divorces end in hostility'.[417]

Appendix 9: 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.[418]

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

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[415] Ambrose Evans-Pritchard (2017) Germany offers UK hand of friendship on Brexit outcome, *Daily Telegraph*, 20 January.

[416] Hayley Kirton and Courtney Goldsmith (2017) Leaked Brussels report says harming the City would backfire on EU, *City A.M.*, 2 February.

[417] Ambrose Evans-Pritchard (2017) EU accepts hard Brexit offers benefits for all, *Daily Telegraph*, 23 January.

[418] George Parker (2016) Fears EU Brexit delays will spur bank exodus to eurozone, *Financial Times*, 19 December.

most egregious of which was the introduction of the euro in 1999. So when it comes to Article 50 negotiations over financial services, we first ask how much damage does the EU want to do to itself? We then look at the existential crisis facing the EU itself.

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 ICMA's October 2016 working paper entitled *European Capital Market Integration Post-Brexit* states that maintaining European capital market integration after the UK leaves the EU would be of 'mutual benefit' to both parties. All sides should act to 'minimise uncertainty' and 'maximise continuity' so as to limit any disruption to the markets and any damage to the real economy in the UK and Europe.[419]

- Mark Carney has argued that the EU would do itself economic harm if it stopped European companies from accessing London's 'crucial' financial services. He said that London was the 'investment banker for Europe', with over half of the equity and debt raised by eurozone companies being issued 'in the UK, by firms based in the UK, quite often to investors in the UK…These activities are crucial for firms in the European real economy and it's absolutely in the interests of the EU that there is an orderly transition and that there is continual access to those services'. He said that costs would rise for European companies if the EU forced activities to take place within the eurozone.[420]

- Robert Rooney, CEO of executive of Morgan Stanley International, says: 'Anything that causes London to fragment, such as a loss of passporting, will result in higher costs, lower liquidity, more trapped capital and less-efficient capital markets. Ultimately that's not just bad for the UK, it's bad for Europe and the global financial system'.[421]

- David Harding, CEO of Winton argues: 'It may be that the regulatory agency in Europe, denuded of British influence, and the financial regulators may begin to take Europe in a much less market-driven direction. I don't think that is Angela Merkel's intention, but with the British out of the EU, the French and German tradition is different'.[422]

- David Folkerts-Landau, Deutsche Bank's group chief economist, also agrees that plans for a capital markets union in Europe will be 'seriously hurt by the UK's

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[419] Tim Burke (2016) ICMA: Brexit threatens capital markets integration, *Financial News*, 5 October.
[420] Chris Giles (2016) Carney warns EU against freezing out the City, *Financial Times*, 1 December.
[421] Laura Noonan, Patrick Jenkins and Harriet Agnew (2016) City's special relationship with EU finance system revealed, *Financial Times*, 25 September.
[422] Margareta Pagano (2016) City entrepreneurs say Brexit can work – for the bold, *Financial News*, 20 September.

absence', arguing that 'the Anglo-Saxon view of markets has been brought to bear in those negotiations' and that without it participants will become 'hopelessly bogged down in Franco-German discussions' about issues such as insolvency laws. He also said: 'The idea somehow that you can move a large chunk of [the financial services industry] onto the continent seems foolhardy – or, if you do it, you're going to destroy it. The key element of a good financial centre is proximity, You need people close together… it doesn't work if you move CCPs to Paris, move the accountants to Rome and move IT to Frankfurt. The efficiency and the price discovery and the stability and security London provides is going to suffer if we see a significant claim by Europeans to want to bring in that business….[It is more likely that] New York will be a net beneficiary'.[423]

There are widespread economies of both scale and scope in the provision of financial services – and for historical reasons London has exploited them both. London has a clear comparative advantage in providing financial services to the EU. Yet various European cities are vying to take over parts of the City of London's business – Frankfurt, Paris, Dublin, Amsterdam, Madrid and Warsaw. If an acceptable equivalence arrangement cannot be negotiated, then firms will be under pressure to move to one of these cities. But there will be enormous problems with this.

For a start, space is limited in all these centres. More significantly, the financial regulators for these financial centres will need to approve and then supervise the operations of these firms. Not only do they have limited capacity to do this, they are likely to be very selective in who they will let in. All these centres have said that they really want only prestige international names and will still focus on their own national institutions. One executive has reported that the German regulator is being very picky and his bank would not make the grade.[424] This suggests that it would be far better for the financial institutions in London to stick together and say that they are going to stay in London and accordingly expect the EU to offer a suitable equivalence deal that allows these institutions to serve their EU clients from London. Further, there is a danger that some markets might close rather than move simply because they are not profitable – an example being some primary bond markets.

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. Here are some examples:

- Implementation of the Total Loss Absorbing Capacity (TLAC) rules. The European Commission has plans to increase EU oversight of foreign banks. Foreign banks with significant activities in Europe would be required to operate via 'intermediate holding companies'. These would have to meet additional capital requirements, to meet an internationally agreed rule, known as TLAC, and other minimum

[423] Tim Burke (2016) Deutsche economist- Brexit could 'seriously hurt' EU's capital markets, *Financial News*, 20 October.

[424] David Wighton (2016) Brexit's passporting debate stamped through with confusion, *Financial News*, 23 September.

internationally agreed standards to ensure that they could be wound down safely if they fail. The banks would have to issue equity and junior debt that would be written off in the event of a crisis. Yet when, in 2014, the US revealed similar proposals, known as the foreign banking organisation rule, Michel Barnier, then the EU's financial services commissioner, said they were protectionist and threatened retaliation. However, the current commissioner, Valdis Dombrovskis, argues that the EU's proposals are different: supervisors would not be allowed to set TLAC rules that are tougher than the minimum agreed standards unless these can be shown to be 'necessary and proportionate'. Nevertheless, Philip Hammond has described the proposals as anti-competitive and could harm the City after the UK leaves the EU. They could also 'constrain prudential authorities in a way that could have an impact on financial stability'. [425]

- MiFID II. Jeff Sprecher, CEO of Intercontinental Exchange, has described MiFID II – which came into effect in January 2018 and introduces new trading and transparency rules – as 'a terrible piece of legislation that imposes tremendous costs on the industry'. MiFID II grew out of the G20 financial regulation principles established in 2009 to reduce systemic risk following the GFC, but has been criticised as being excessively complexity and its implementation has been delayed by a year. One particular issue is the unbundling of investment research and transaction costs.[426] MiFID II, in order to achieve full cost transparency for end customers, will end the standard industry practice of brokerage firms providing investment research free of charge in return for execution business. VAT would also be chargeable on paid research. McKinsey has estimated that the profits of European asset managers that pay for research in full could be reduced by 15-20%. Larry Fink, CEO of BlackRock, expressed concern that MiFID II could lead to a dearth of research coverage focused on smaller listed companies.[427] Crispin Odey, of Odey Asset Management, believes that MiFID II will lead to fewer trades, reduced price discovery and less efficient markets.[428] Another issue is the reporting of trades to regulators within a specified time – the cost of which has encouraged some hedge funds, such as Brevan Howard and Tudor, to register under the Alternative Investment Fund Managers Directive rather than under MiFID II.[429] The total cost to the finance industry of implementing MiFID II has been estimated at more than €2.5bn.[430] Within months of its introduction, trading in a number of futures and options contracts was being shifted

[425] Jim Brunsden (2016) Hammond clashes with Brussels over new bank oversight rules, *Financial Times*, 7 December.

[426] European equity research and advisory service costs are estimated at $1.35bn, compared with $2.9bn in cash equity commissions in the year June 2016 – June 2017 (Samuel Agini (2017) Mifid II will spark $1.3bn-a-year research battle, *Financial News*, 23 August).

[427] David Ricketts (2017) BlackRock's Fink voices concern over Mifid II, *Financial News*, 12 October.

[428] Tom Eckett (2017) Odey warns of 'terrifying' MiFID II and tapering combination, *Investment Week*, 2 October.

[429] Lucy McNulty (2017) Will others follow Brevan and Tudor's regulatory route?, *Financial News*, 21 August.

[430] Attracta Mooney (2017) €2.5bn cost of Mifid II rattles asset managers, *FTfm*, 27 January; Carlo Svaluto Moreolo (2017) Briefing: MiFID II – The birth of a market, *IPE Magazine*, July/August.

from London to the US and European investment banks were losing business to their US rivals.[431]

- The Capital Requirements Directive IV is damaging for EU financial markets in terms of restrictions such as the proposed bankers bonus cap and financial transactions tax.

- Solvency II. The Treasury select committee has announced an inquiry into the 'manifest shortcomings' of the Solvency II directive dealing with insurance companies. Andrew Tyrie said: 'Brexit provides an opportunity for the UK to assume greater control of insurance regulation to see what improvements can be made in the interests of the consumer'. The inquiry's report was published in October 2017. While the evidence submitted to the committee highlighted problems with the legislation as drafted (e.g., in respect of the risk of procyclicality and market distortion, the calibration of the Risk Margin, the approval of Internal Models and subsequent model change, and the volume and complexity of data required from firms), the report was concerned with the way it has been implemented in the UK by the Prudential Regulation Authority (PRA): 'An excessively strict interpretation of the requirements of Solvency II, and of its own obligations, has limited the PRA's thinking in a way which could be detrimental to UK plc'. The report also 'strongly encourages the insurance industry and the PRA to come to an understanding on what aspects of Solvency II can be changed unilaterally while the UK remains an EU member state'.[432]

As another protectionist measure, the EU wants to ring fence certain euro-related activities, a key example being euro clearing (i.e., the clearing of euro-denominated derivatives).[433] The French government, in particular, are proposing legislative changes that will force euro clearing to be conducted in the eurozone.[434] Xavier Rolet, CEO of the London Stock Exchange said: 'Any attempt to take [euro clearing] away will only hurt the EU. It is in the interest, of the European Union, the 27 states left, and the UK to ensure that a positive, constructive framework remains here in London'.[435] An Intercontinental Exchange (ICE) report published in December 2016 warned that forcing euro clearing out of the UK could lead to a significant increase in costs for European banks. The UK clears 75% of euro derivative transactions with an average daily value of £458.9bn. ICE sees 'no reason why this

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[431] David Wighton (2018) City on the defensive as regulation tilts playing field for Wall Street, *Financial News*, 30 April; Paul Clarke (2018) Morgan Stanley says EU banks are losing ground as MiFID II bites, *Financial News*, 30 April.

[432] House of Commons Treasury Committee (2017) *The Solvency II Directive and its impact on the UK Insurance Industry*, HC 324, 27 October; https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/324/324.pdf

[433] See Patrick Young (2017) The EU's euro clearing plan is an act of protectionist self-harm, *CAPX*, 13 June: 'The EU's attempt to exert control on the "euro clearing" trade isn't merely an arcane argument about money, or regulation. It's a case study in the limits of government's ability to control free markets – and their boundless capacity to screw things up when they try'.

[434] In 2015, the ECJ came down on the side of the UK against an attempt by the European Central Bank to take euro clearing to the eurozone.

[435] Margareta Pagano (2016) Amid the wild ideas, Theresa May has a plan, *Financial News*, 7 October.

should change'. The report argues that clearing needs a critical mass and any fragmentation would damage Europe's financial markets. The EU wants to move euro clearing into the eurozone after the UK leaves. However, such a 'protectionist move could severely damage confidence in the currency within the global economy'.[436]

Similar sentiments were expressed in a Financial Services Negotiation Forum (FSNForum) report published in January 2017: 'any ill-thought through attempts by the ECB to snatch euro clearing out of the UK might wind up damaging Europe's markets. A clampdown by the ECB could make it look like it's trying to build "fortress Europe", potentially provoking "tit for tat" retaliation from other markets'. Anthony Belchambers, chair of the advisory council of the FSNForum, said : 'The EU should not rush to make a decision on this topic as a political backlash to Brexit. Yes, the ECB's systemic risk concerns, following the global financial crisis, are understandable, but relocation of euro clearing to the Eurozone also carries potential risks for market economics and the international standing of the euro'.[437]

Further, it is not clear how practicable ring fencing is. Markets are adept at creating synthetics that circumvent constraints. An example is American depositary receipts (ADRs) which are in effect UK shares traded in the US in a way that avoids UK stamp duty.[438] A House of Lords report also published in December 2016 gave this warning: 'The question is whether any eurozone location could provide the same benefits to the wider economy as London and New York, and whether a politically-driven attempt to repatriate euro clearing to the eurozone would invite retaliation by other non-eurozone states, leading to the breakdown of the system of multicurrency clearing'.[439]

Jonathan Ford nicely sums up the EU's problems with financial services in the *Financial Times*: 'while some frictional costs may, of course, be inevitable, …[t]he worry is that this process will not be minimised. Out of some desire to punish Britain, or perhaps a hope that their own financial centres may benefit from fragmentation, the EU and its member states might pursue measures that serve little purpose other than to carve business out of the UK, even at a cost to the wider European economy….. Applying a location policy would do little to achieve its ostensible purpose, which is to ensure the systemic resilience of Europe's clearing infrastructure. Meanwhile, repatriation would raise costs for banks (and, ultimately, their customers) by fragmenting liquidity and making it harder to pool multicurrency swaps in one clearing pool as presently happens in London. The industry has estimated that these changes could force participants to put up an additional €77bn in margin just to back the same volume of trades….But the point of the whole exercise would principally be political. It

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436 Intercontinental Exchange (2016) *Access to Global Markets to Sustain Jobs and Growth: A Financial Infrastructure Perspective*, December.

437 FSNForum (2017) *Examining Regulatory Equivalence*, January.

438 Raised by Patricia Jackson speaking at 'Brexit Beckons: Thinking ahead by leading economists', Cass Business School, 13 December 2016

439 Samuel Agini (2016) Euro clearing threat spelled out by Lords, *Financial News*, 15 December.

would — to employ the words of French president François Hollande — provide "an example to those who would seek the end of Europe"'.[440]

In addition to excessive regulation, there is another important factor that is limiting the growth of Europe's capital markets and that, according to Larry Fink, CEO of BlackRock, is Europe's 'excessive reliance' (around 70%) on borrowing from banks and insurers to fund growth. He claimed that the problems European companies face when accessing bond and equity markets had 'stifled economic recovery' on the continent: 'In the years since the crisis, much of Europe's economic potential has been locked up. Strengthening capital markets and retirement systems can help unlock that potential, and doing so will be vital to Europe's economic future'. He also said that European bond markets are also complicated by different insolvency laws across member states: 'The lack of a unified European corporate bond market raises costs for companies, deters investors and holds down liquidity'. He praised the European Commission's efforts to unify European capital markets, under the Capital Markets Union project, but he also warned that the EU was 'pulling itself in two directions', claiming that other initiatives, such as new capital rules for insurers under Solvency II, could 'severely restrict a key source of funding for European companies. While a long-term objective is greater funding from capital markets, limiting insurance companies' capacity for investment before capital markets are fully developed could significantly damage growth'.[441]

While all this is happening in the EU, the US, under president Donald Trump, is de-regulating its financial services industry by scrapping significant parts of the Dodd-Frank Act which was introduced in 2010 following the Global Financial Crisis. A report from consultancy Opimas estimated that US banks could save more than $27 billion, with the 'easiest part of Dodd-Frank to eliminate' being the Volcker Rule forbidding proprietary trading, the removal of which could result in gains of $6 billion from trading activities. JP Morgan's CEO Jamie Dimon agrees that 'over-regulation has been holding growth back'. On the other hand, there are dangers if there is a divergence of standards between different regulatory regimes. As Simon Gleeson from lawyer Clifford Chance points out: 'The reason for international standards is to facilitate the globalisation of regulation, and any retreat from those standards by a major player makes regulating international banks harder, and harms the ability of those regulators to cooperate'. Similarly, Slaughter and May lawyer Jan Putnis said there was a 'risk to the ability of financial centres to reach mutual recognition and other deals on financial regulation if the international consensus set by the G20 begins to fragment'.[442]

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[440] Jonathan Ford (2016) City should make its case in Europe where Brexit costs are wider, *Financial Times*, 19 December.

[441] James Shotter and Thomas Hale (2017) Larry Fink calls for Europe to bolster its capital markets: 'Excessive reliance' on banks and insurers to fund growth hobbling region's economy, *Financial Times*, 17 January.

[442] Tim Burke and Lucy McNulty (2017) Risks and rewards eyed as Trump sharpens Dodd-Frank axe, *Financial News*, 3 February.

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. According to George Greenwood, 'our exit risks being perceived as a direct attack on an already embattled Brussels'. John Mills, of the Labour Leave campaign, warns of the systemic issues that the EU will now have to face and highlights, in particular, the growing disparities between European haves and have nots: 'I think you are likely to see more and more protest movements and anti-austerity. Part of the problem is that a third of the population in the EU are actually doing very well. Globalisation, internationalism, trade, it really suits them. You then have another section of the population…who have seen blue collar jobs disappearing, who are left in very insecure positions, compounded in Europe by very high unemployment. Sooner or later, this national disparity will have to be addressed, or Europe will start to seize up. It seems to me that this is a pretty dangerous political cocktail. You are moving to a position where a majority of people think they are really not doing well. Eight years down the track, people don't feel the establishment parties have dealt with the aftermath of the financial crisis. They may start to look for alternatives. This engine of political instability could be the undoing of the EU if it's not very careful'.

Some other leave campaigners go further. 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. There's no such thing as a one size fits all policy. You only need to look at the rows between [then Italian prime minister] Renzi, [German finance minister] Schäuble and Merkel to realise how serious this is. Schäuble and Merkel will not allow any wiggle room on the Stability and Growth Pact. And yet back in 2004, Germany completely ignored the rules and nobody said boo to a goose. On any issue of any substance, Germany calls the shots. [But], just going along with the German consensus within the EU will soon cease to be attractive, especially if it is Germany that benefits most. Other states may decide sooner or later they want to get out as well. I don't think they will accept effective control…I attend meetings of COSAC,[443] the assembly of European affairs committees of national parliaments, about once a month. At the last meeting, about two weeks ago, there was an enormous row between the French and the Eastern European countries, and some of the Mediterranean countries, to the point at which they were clamouring around the platform besieging the Slovakian presidency chairman, and literally it was a shouting match. That was all about the refugee crisis.[444] That Germany has torn up the regulations to admit young Syrians, to the despair of other European nations and many within Germany itself, is yet another example of the costs of integration, felt unevenly throughout the union. In other words, Britain has got out just in time. Collapse is nearer than people think. The Greeks are a basket case, the Italians are in dire straits, the French

[443] http://www.cosac.eu/en/

[444] Europe's immigration policy is now determined by Turkey's president Erdogan (Roger Boyes (2016) Migrant-filled Europe is spiralling out of control, *The Times*, 27 July).

economy is also in tatters, and Germany faces massive internal pressure from the AfD [Alternative for Germany]'.[445]

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:

> *'One day, the house of cards will collapse. The euro has been betrayed by politics, the experiment went wrong from the beginning and has since degenerated into a fiscal free-for-all that once again masks the festering pathologies. Realistically, it will be a case of muddling through, struggling from one crisis to the next. It is difficult to forecast how long this will continue for, but it cannot go on endlessly…The Stability and Growth Pact has more or less failed. The moral hazard is overwhelming. Market discipline is done away with by ECB interventions. There is no fiscal control mechanism from markets or politics. This has all the elements to bring disaster for monetary union. The no-bailout clause is violated every day and the European Court's approval for bailout measures as simple-minded and ideological.…The ECB has crossed the Rubicon and is now in an untenable position, trying to reconcile conflicting roles as banking regulator, Troika enforcer in rescue missions and agent of monetary policy. Its own financial integrity is increasingly in jeopardy.*
>
> *The venture began to go off the rails immediately, though the structural damage was disguised by the financial boom. There was no speed-up of convergence after 1999 – rather, the opposite. From day one, quite a number of countries started working in the wrong direction. A string of states let rip with wage rises, brushing aside warnings that this would prove fatal in an irrevocable currency union. During the first eight years, unit labour costs in Portugal rose by 30% versus Germany. In the past, the escudo would have devalued by 30%, and things more or less would be back to where they were. Quite a few countries – including Ireland, Italy and Greece – behaved as though they could still devalue their currencies. The elemental problem is that once a high-debt state has lost 30% in competitiveness within a fixed exchange system, it is almost impossible to claw back the ground in the sort of deflationary world we face today. It has become a trap. The whole eurozone structure has acquired a contractionary bias. The deflation is now self-fulling. The first Greek rescue in 2010 was little more than a bailout for German and French banks. It would have been far better to eject Greece from the euro as a salutary lesson for all. The Greeks should have been offered generous support, but only after it had restored exchange rate viability by returning to the drachma. [The fear was a chain-reaction reaching Spain and Italy, detonating an uncontrollable financial collapse. This nearly happened on two occasions, and remained a risk until Berlin switched tack and agreed to let the ECB shore up the Spanish and Italian debt markets in 2012.]*

[445] George Greenwood (2016) Can the EU survive Brexit?, *CAPX*,12 October.

Cloaking it all is obfuscation, political mendacity and endemic denial. Leaders of the heavily indebted states have misled their voters with soothing bromides, falsely suggesting that some form of fiscal union or debt mutualisation is just around the corner. Yet there is no chance of political union or the creation of an EU treasury in the forseeable future, which would in any case require a sweeping change to the German constitution – an impossible proposition in the current political climate. The European project must therefore function as a union of sovereign states, or fail'.[446]

The European Central Bank's quantitative easing programme is also failing, according to economist Andrew Hunt in a report published for OMFIF[447] The programme has so far pumped €1.2 trillion of liquidity into the banking system through the purchase of both government and corporate bonds. The corporate bonds are close to junk, and the haircuts can barely deal with a one-notch credit downgrade.[448] In return, the banks were supposed to increase corporate lending and hence stimulate the economy. But, no more than 30% of the additional liquidity has been used for this purpose. Some of the remainder has been absorbed into the banking system itself. For example, over the last year, the Italian central bank has bought €100bn of Italian government bonds on behalf of the ECB. This is five times the normal rate of issuance and helps the Italian government circumvent EU rules on monetising its debt. The rest has been used by investors to buy assets in the stronger European economies, especially Germany and Luxembourg. The money passes through the EU's off-balance sheet money transfer system Target 2. The ECB is therefore funding capital flight from Europe's weaker economies.

All this is a direct consequence of Germany's long-running strategy of maintaining the euro at a level that suits its own economic policies, at the expense of making it difficult for peripheral European economies to compete both internally and externally. Germany will record the world's largest current account surplus in 2016 at around 9% of GDP and this is needed to bridge a huge funding gap in its state pension system, according to Hunt. History, of course, repeats itself – precisely the same problems emerged when the Exchange Rate Mechanism was set up a quarter of a century ago. It is a great pity that this important lesson has been lost on the current generation of European leaders. Michael Hintze, CEO of the CSQ hedge fund, argues: 'EU peripheral countries face economic and fiscal challenges as well as possible referenda on EU membership. Further instability and a potential break-up of the euro cannot be discounted as a zero probability and would, in my view, represent material risk'.[449] As Allister Heath notes, there's nothing the UK can do to save the eurozone from its own folly.[450]

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[446] Ambrose Evans-Pritchard (2016) Euro 'house of cards' to collapse, warns ECB prophet, *Daily Telegraph*, 16 October.

[447] The Official Monetary and Financial Institutions Forum, https://www.omfif.org/

[448] Ambrose Evans-Pritchard (2016) Euro 'house of cards' to collapse, warns ECB prophet, *Daily Telegraph*, 16 October.

[449] Mike Foster (2016) History may be about to teach Europe a lesson from the ERM, *Financial News*, 22 August.

[450] Allister Heath (2016) There's nothing the UK can do to save the eurozone from its own folly, *Daily Telegraph*, 6 December.

Marie-Hélène Caillol (President of LEAP - Laboratoire Européen d'Anticipation Politique) is a strong supporter of the EU, yet argues:

> '*The current crisis of the EU is multiple; the integration of the Eastern countries was rather a failure. In the Southern Europe, the "magic" of the European dream has also disappeared; the EU no longer means "democracy and prosperity", but the opposite: austerity and imposition. The Franco-German couple is, unofficially, divorcing….*
>
> *There is no need to destroy the EU. It has already been done. Thirty years of complete diversion from the original European construction project in favour of so many exclusively economic interests, disconnected from that of the European citizens; all this has resulted in the Brexit affair, which signed the death of the EU as we knew it; isn't it ironic, from a historical point of view, that it is the British who put an end to the Europe they wanted? Indeed the drifts summarised above are essentially linked to the vision of an economic Europe conveyed mainly by the UK and its American sponsor. In any case, the end of the EU as we knew it does not mean the end of the European construction project; the latter is actually being liberated, for better or for worse, from the EU model implemented in 1992 within the Treaty of Maastricht.*
>
> *In 1992, it was the Treaty of Maastricht that was supposed to finalise the process of economic integration and should therefore have opened the era of political and democratic integration. Total failure! Maastricht was the Treaty which greatly increased the budget and the areas of competence of Europe and should have imposed a complete change of method of governance based on the assertion of the following principles: transparency, efficiency and democratisation. Failure! Along with the increasing responsibilities, there is the change of project name: from "European Community" to "European Union*".[451]

The Brexit Referendum has opened the eyes of European citizens to the possibility of having their own Referendum on the EU. The cases of France and Germany have been long-standing, but there is now pressure in Germany which has been the biggest economic beneficiary of the EU. A poll conducted in November 2016 found that 42% of Germans wanted a Referendum on EU membership and that 62% think the EU is 'heading in the wrong direction'. Around 67% want the bureaucratic superstate to change its political direction and just 39% believe EU membership is exclusively positive. As many as 96% want the EU to be become 'more transparent and closer to the people'.[452] As if to illustrate the distance between itself and its citizens and the folly of its overweening ambitions, Federica Mogherini, the EU foreign policy head, is preparing plans for a European Army 'to act autonomously' from NATO.[453]

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[451] Interviewed by *la Vanguardia*, 30 December 2016.

[452] Charlie Bayliss (2016) GEREXIT? Merkel in MELTDOWN as nearly HALF of Germans want EU referendum, poll finds, *Daily Express*, 30 November.

[453] Martin Banks and Peter Foster (2016) Europe will march on with plan for a EU army, *Daily Telegraph*, 7 September.

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'.[454] As Roger Bootle notes, it's not too early to start planning for the end of the EU.[455] This view is supported by Professor Ted Malloch in an interview with the BBC and who at the time was expected to be appointed president Trump's ambassador to the EU: 'I am not certain there will be a European Union in which to have negotiations… The one thing I would do in 2017 is short the euro. I think it is a currency that is not only in demise, but has a real problem and could in fact collapse in the coming year or year and a half'.[456]

Appendix 10: Alternatives to the EU, the single market, the customs union and the EEA

There are some influential supporters in the UK of the EU, the single market, the customs union and the EEA. Typical is the Institute of Fiscal Studies (IFS) which points to the huge difference between 'membership' and 'access' to the single market. It described the latter as a 'meaningless concept': 'Any country in the World Trade Organisation – from Afghanistan to Zimbabwe – has 'access' to the EU as an export destination'. In contrast, membership involves the elimination of barriers to trade in a way that no existing trade deal, customs union or free trade area achieves: 'In particular it means reducing "non-tariff" barriers like licensing and other regulatory constraints to supplying goods or services. These sorts of barriers have become relatively more important to trade than tariffs (taxes on trade), and especially so for services'. The IFS estimates that single market membership adds 4% to UK GDP and argues that no new individual trade deals will have the capacity to compensate fully for any loss of EU trade: 'The EU accounts for 44% of our exports and 39% of our service exports…. China and India together account for 4.6% of all exports and 2.6% on services. Even small proportionate losses in trade (or lost growth in trade) with the EU would require quite dramatic - and probably implausible - increases in trade with such countries'. However, the report recognises that 'outside the EU, single market membership also comes at the cost of accepting future regulations designed in the EU without UK input. This may be seriously problematic for some parts of the financial services sector'.[457]

Ryan Bourne, then head of public policy at the Institute for Economic Affairs, on the other hand, has a very different view of the single market:

> *It has all the hallmarks of a last stand. Having abandoned resisting the Referendum result itself, Remainers rally to the cause of staying in 'the single market'. Re-using*

[454] Edward Lucas (2017) Divided and deluded, Europe faces crisis on every front, *CAPX*, 3 January.
[455] Roger Bootle (2016) It's not too early to start planning for the end of the EU, *Daily Telegraph*, 12 December.
[456] Kamal Ahmed (2017) Euro 'could fail', says man tipped as US ambassador to EU, *BBC News*, 25 January.
[457] Dylan Lobo (2016) Brexit: IFS brands single market access 'meaningless', *Citywire*, 10 August.

the Referendum hymn sheet, the exact same politicians, businesses and pressure groups who predicted doom and gloom from the decision to vote Brexit are now forecasting postponed doom and gloom if we opt to choose a 'hard Brexit' or 'closed Britain' – leaving the EU's single regulatory zone and trading under WTO rules.

Of course, established businesses who do well under the status quo are always afraid of even minor changes to the trading and regulatory environment. But politicians have a duty to set conditions for the general good of the whole economy in the long-term. On this the Remainers are severely overestimating the gains from single market membership whilst underestimating both the gains from leaving and the huge risks of remaining in. This facilitates their bizarre assertion that being outside somehow need lead to a more closed Britain.

… The Treasury of course believes that… leaving the single market could somehow cost up to 6% of GDP in the long-term. But this is based on huge dynamic gains, for which there is little to no historical evidence. Indeed, in future we expect EU trade to become relatively less important. Yet despite the hope of a flexible economy able to adjust to the changing pattern of global demand, single market membership would mean that 100% of the economy would continue to be bound by the often damaging regulation emanating from Brussels. This should be of particular worry to the City, given the EU's frequent attacks on so-called 'Anglo-Saxon' finance. Indeed, as Remainers helpfully pointed out during the campaign, the single market solution is undesirable because we could no longer vote against new regulation imposed upon us.

This is not the only risk. Staying in the single market too would mean a continuation of budget payments to the EU (net 0.5% of per GDP), something only likely to expand given the centralising ambitions of Brussels. The need for the eurozone to integrate further to solve the eurozone crisis also risks the institutions of the EU increasingly being dominated by a eurozone block, potentially to the detriment of the UK.

Of course, what business might fear is a big bang – a changed tariff and regulatory environment all in one go. But steps can be taken to mitigate that transition from the single market. The depreciation of the pound already vastly outweighs any adverse tariff effect on exporters to the EU. Last week's announcement that existing EU workers have a right to remain within the UK negates risks for businesses employing EU workers. And the government's Great Repeal Bill, through repatriating the body of EU law and regulation, means that any changes to the regulatory environment would be incremental. It also means that the EU should be willing to agree to an equivalence tariff-free arrangement on the point of exit – given the mutually beneficial nature of free trade.

Whether we become a 'more open' or 'more closed' economy has nothing per se to do with the single market. Indeed, whilst the common regulatory zone prevents damaging government action in certain areas, the most significant upside gains from leaving the EU come from leaving the single market and customs union altogether.

Being willing to leave both and trade under WTO rules would at a stroke end the uncertainty that protracted negotiations would bring. The UK could declare unilateral free trade, slashing tariffs which would lead to more specialisation and an effective tax cut for consumers. We would repatriate our gross contributions, be able to deregulate or reassess regulation in areas where it was beneficial incrementally and kill stone dead the ratchet of more EU centralisation. This would not only fulfil the electorate's instruction to 'take back control', but could, alongside a programme of agricultural reform, leave the UK more 'open' not less.[458]

Lord Anthony Bamford, chairman of JCB, also believes that the cost of EU regulations for companies means that the UK is better off leaving the single market: 'Hidden barriers to businesses caused by red tape and regulations proves that this single market has not created a level playing field. I want British business to get behind the government. We need the government to secure an exit deal that is in Britain's best interests. A deal that will allow us to become a truly global trading nation. If tariffs are the price we have to pay to leave the EU, well so be it. British business people are very adaptable. They adjust very quickly to changes in the trading environment. So rest assured they would take tariffs in their stride. If tariffs are the price we have to pay to secure free trade agreements with the rest of the world, I think it's a price worth paying'.[459]

Ryan Bourne – now in a new role as the R. Evan Scharf Chair in the Public Understanding of Economics at the Cato Institute in Washington DC – also wants the UK to leave the customs union, describing it as a 'protectionist racket':

Bizarrely, the front-line debate on the economics of leaving the EU now centres on whether Britain should stay or remain within the EU's customs union. This is bizarre because, unlike with the single market, Brexiteers of all stripes took the departure from this customs union as given and a boon.

By definition, a customs union is an agreement between countries to embrace tariff-free trade between members but impose common tariffs on goods imported from non-members. At an EU-level, this means a Common External Tariff (CET), a dizzying array of over 12,651 different taxes (and some quotas to boot) imposed on goods from the rest of the world. The long and short of it is that the EU is internally trade liberating but outwardly protectionist.

The argument for remaining a member of this block (as articulated by the UK chancellor Philip Hammond) seems to be concern at the impact leaving might have on "complex pan-European supply chains where often components and self-assemblies move backwards and forwards across European borders several times".

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[458] Ryan Bourne (2016) The 'Single Market' battle is the Remainers last stand in the Brexit war, *City A.M.*, 10 October.

[459] Peter Dominiczak and Steven Swinford (2016) JCB boss: EU regulations mean that Britain is better off outside the single market, *Daily Telegraph*, 27 October.

That's because outside of the customs union, and in the absence of a bilateral free-trade deal with the EU, UK exporters would face the EU's Common External Tariff and importers would face the UK's decided tariff rates under WTO rules (applied equally to EU imports). In other words, businesses could face two-way tariffs if they import and export simultaneously.

This is certainly a possibility. But the degree of disruption is dependent on the government's own policy decision on tariff rates. In my view, the case for remaining in the customs union is overwhelmed by the advantages and opportunities from leaving.

After leaving, the UK would be able to set its own import tariffs to prevent the hike in input prices. Most UK Brexiteers desire a free-trade agreement with the EU. In the absence of such a thing, the UK would set its own tariff structures, applied to all countries as per WTO rules.

…Remaining within the block would mean the UK had no say on tariff rates, despite suffering the consequences of their imposition.

Finally, remaining a member of the EU customs union would severely hamper the ability to sign free trade deals with other countries too. Contrary to popular belief, the customs union in itself does not preclude Britain signing free trade deals (the EU's Common Commercial Policy does). But without being able to offer up tariff-free deals to third parties, continued membership would in reality severely limit the UK's leverage and attractiveness for trade agreements.

…All this is not to say that leaving the customs union will not lead to some costs for certain firms and industries, or disruption. There will be more in the way of customs checks (though these would likely quickly become routinised). But the aggregate benefits of a UK controlling its own trade and tariff policy, particularly for consumers, are likely to be much greater.[460]

Shanker Singham (then at the Legatum Institute Special Trade Commission) argues that if the UK leaves the EU, it cannot also remain in the EEA: 'Since services form 80% of the UK economy – an unusually high proportion – we will need them to be part of any trade deals we strike. But in order to persuade other countries to open up their service sectors to ours, we need to be able to put our domestic regulatory agenda on the table for negotiation, so that they can gain access and benefits of their own. Under the EEA rules, this is impossible'.[461]

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)[462] involves trade with the EU/EEA, but

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[460] Ryan Bourne (2017) The EU's customs union is a protectionist racket, *CAPX*, 13 January.

[461] Shanker A Singham (2017) The Brexit blueprint Theresa May needs to follow, *CAPX*, 16 January.

[462] Daniel Hannan (2016) Repeat after me. Single market membership and single market access are not the same thing, *ConHome*, 1 September.

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.

The prime minister, Theresa May, has said: 'I want the UK to be the global leader in free trade. I think that's important. I think there genuinely is a real opportunity for us. We should be around the world, promoting that message of free trade. Seeing what we can do outside [the EU]'.[463] A useful example of a recent FTA is the EU-Canada Comprehensive Economic and Trade Agreement which has been described as a 'high quality agreement that uses a superior "negative list" approach to services liberalisation and includes significant provisions on domestic regulation, mutual recognition and electronic commerce, and chapters on telecommunications and financial services… CETA gives Canadian service suppliers the best market access the EU has ever conceded in an FTA and in most sectors Canadian suppliers "will be on an equal footing with EU service providers." …Since Brussels has been willing to open services markets to Canada, without the conditions of free movement and EU budget contributions it previously demanded of Norway and Switzerland, the UK should be able to negotiate a high-quality services agreement with the EU, including reciprocal passporting arrangements if the UK government wanted to keep them'.[464]

More general than this is the Heritage Foundation's idea of a Global Free Trade Association (GFTA) of free economies. GFTA member countries would commit to free market economic policies, such as low tariffs and few non-tariff barriers, openness to foreign investment,

[463] James Forsyth and Fraser Nelson (2016) Theresa May: 'I get so frustrated with Whitehall', *Spectator*, 10 December.
[464] Geoff Raby and Andrew Stoler (2016) Britain's services trade can flourish outside the EU Single Market*, City A.M.*, 15 December.

strong adherence to property rights, and regulations that are not overly burdensome on businesses.[465]

Further, the UK would be free to negotiate a FTA before leaving the EU, since as Lawyers for Britain argue: 'Since the United Kingdom's Referendum vote to leave the European Union, it has been suggested that the UK may not negotiate future FTAs with countries outside the EU while it remains a member state. [However], this view has no support from the EU Treaties or the ECJ; and that the EU has no competence to prevent the UK negotiating and entering into FTAs with third countries providing that they may not come into force until the UK withdraws from the EU'.[466]

Another opportunity, according to Alan Oxley, former ambassador to and chairman of the GATT, predecessor to the WTO, is for the UK to 'lead action in reconstructing the WTO, transforming it into a fresh global platform that liberalises global trade in services and investment. Taking such a role does not depend on the terms of Brexit. The UK is already an independent member of the WTO. Regardless of when and how it settles with Brussels, it has a place to speak now in the WTO. And an active, influential and independent UK voice on global trade and investment is sorely needed there. It has become fashionable to opine that the era of globalisation is ending and a retreat to protectionism looms. What such commentators overlook is the institutional impediment to a global resort to protectionism – and that is the WTO. 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 worst that can occur is that further liberalisation stalls'.[467]

New Prosperity Zone

This is a proposal of the Legatum Institute Special Trade Commission's Shanker Singham:[468]

> *What if, instead of making deals on a country-by-country basis, we were to lay the foundations for a new Prosperity Zone, bringing together countries around the world that believe in free trade and competition?*
>
> *…The lesson of the [stalled] TPP [Trans-Pacific Partnership] is that the more countries [that] are around the table, the harder a deal is to do. So the founding principle of the Prosperity Zone should be that it will not sacrifice quality for quantity.*
>
> *We should start with countries such as New Zealand, Singapore and Australia, who are all committed to free trade and have jettisoned agricultural protectionism*

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[465] Iain Murray (2016) How a US-UK free trade deal could revolutionise world trade, *Brexit Central*, 22 December.
[466] http://www.lawyersforbritain.org/files/uk-right-to-negotiate-free-trade-agreements-before-leaving-eu.pdf
[467] Alan Oxley (2016) Things move slowly in the WTO – there's a significant leadership opportunity for the UK, *City A. M.*, 20 September.
[468] Now at the IEA.

(assuming in the UK's case that it will have come out of the Common Agricultural Policy and Common Fisheries Policy when it leaves the EU).

This small group could maintain an alignment around the core concepts of economic development, open trade, competition and property rights protection. It could also go further than TPP by dealing with distortions inside borders – what are termed Anti-Competitive Market Distortions or ACMDs.

This… would be done not via traditional remedies, such as anti-dumping measures, which are damaging to trade and competition, but by disciplining countries that used government privileges or benefits to confer a cost advantage on their companies that could then increase their market share overseas.

Such rules would be needed because distortions inside borders are inevitably exported – as happened in Port Talbot or Redcar, where local producers went bust as a result of distortions in the Chinese steel market.

The initial grouping of countries would have the advantage of being largely open economies – the UK, New Zealand, Australia and Singapore can boast the least distorted markets in the world. But the platform would be open: other countries, such as Switzerland or the members of NAFTA, could be added in future. The ultimate goal – even if you started with the most likely partners – would be to include all like-minded countries.

Under this vision, the UK would still need to negotiate bilateral FTAs with other major trading partners such as India, China and the EU itself. But in each of these cases, we must be realistic about what we can achieve.

There are many things that could derail this vision. Since it depends on the negotiation of agreements with a range of countries in goods and services and over domestic regulatory issues, remaining within any part of the EU customs union, or even remaining a member of the European Economic Area, will prevent its realisation.

Far better to negotiate a comprehensive FTA that does not leave our hands tied elsewhere – which is why the recent suggestion that the UK would be seeking a "CETA-plus" deal modelled on arrangements with Canada was so encouraging.

Viewed in this light, the entire Brexit process should be regarded as part of a wide-ranging exercise – government departments must work together so that we can exit the EU in such a fashion that the high-level vision of growth, prosperity and hope can remain intact in our negotiations with other countries.

We must also use this opportunity to embrace a regulatory reform agenda at home which will eliminate our own domestic distortions and lead to the lowering of prices for key staples, such as food and energy.

This is, as we are all aware, a time of uncertainty. But if the process is handled correctly, the prospects for the British people are bright indeed.[469]

Variations on this are the Anglosphere countries trade deal proposed by Graeme Leach[470] and the CANZUK (Australia, Canada, New Zealand and UK) trade deal proposed by Andrew Lilico.[471]

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.[472]

The New Atlantic Growth Pact would involve the US, the UK and the EU. It would 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 (TTIP) talks] would spur growth. It would also provide a framework to address the EU's qualms about appearing to reward Brexit and encouraging other exits. With a new trade deal in place or on the near horizon, other countries contemplating an exit would now be choosing to leave both the single market and a trading bloc with the US. The British could not conclude a trade deal before departing the EU, but they can begin negotiations as soon as they invoke Article 50, the formal mechanism for leaving. On the American side, efforts to launch a new trans-Atlantic agreement would show that the US remains serious about defending its role in setting standards for global trade. In this presidential campaign, both candidates have sent signals that the US is no longer prepared to lead on trade. Yet the candidates also have said they support trade in principle but want to negotiate better deals. A pro-growth trade pact with developed economies offers a good opportunity for the next administration to do this, and a process to address key Brexit risks to the UK may enjoy stronger support in Congress.*
>
> *The Atlantic Growth Pact could eventually serve as the anchor to bring in other countries—though with Brexit looming the US should start with a three-party deal. The US could spur the new talks by offering a significant new concession—the willingness to tackle financial services in the negotiations. This would meet a major European demand from the TTIP negotiations. It would also provide a unique opportunity to address one of the core questions surrounding Brexit—how to avoid a*

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[469] Shanker Singham (2016) Brexit can enrich not just Britain, but the world, *CAPX*, 13 December.

[470] Graeme Leach (2016) GEOPOLITICAL INSIGHT: The Anglosphere: Realpolitik or romance?, Macronomics, September.

[471] Andrew Lilico (2016) CETA is dead? Long live CUKTA. How Canada can save the best of CETA with a U.K. trade deal, *Financial Post*, 21 October or http://www.canzuk.co.uk/.

[472] Kristen Silverberg and Phil Levy (2016) The Benefits of a New Atlantic Growth Pact, *Wall Street Journal*, 30 October.

> *costly disruption of the City of London's role as a centre for international finance. Trilateral negotiations would be challenging. In contrast, it would be relatively easy for the US and the UK to reach a bilateral agreement, and the US should be prepared to pursue bilateral talks if the three-party negotiations fail. But economically and diplomatically, a trilateral trans-Atlantic deal has more to offer. The potential costs to the US of a Europe left fractured and faltering are very high. The next president should seize the opportunity to take a new approach.*

US-UK free trade deal

How the deal might work

Iain Murray, vice president of strategy at the Competitive Enterprise Institute in Washington DC argues that:

> *A US-UK trade deal could set the stage for a major rethink of trade policy that could set the stage for productive liberalisation in the future. [This is because American trade deals began to go wrong from the early 1990s:] non-tariff barriers such as regulatory requirements became the big issue, so American trade deals started to concentrate on those. The way they went about it, however, was very European. It was similar, in fact, to the European Union's "harmonisation" scheme, which aims for every EU member country to regulate in more or less the same way. That, of course, resulted in a significant increase in the regulatory burden on British business. America's approach was to require similar regulatory reforms from every country with which it negotiated trade deals, especially in the areas of environmental and labour standards. As these requirements came to dominate trade deals, negotiators dropped "free trade" from the deals' monikers and came to call them "partnerships," all of them hundreds of pages long…*
>
> *[I]nstead of "harmonisation," [a] new-style trade deal would include Mutual Recognition Agreements (MRAs), which allow the free flow across borders of goods manufactured in accordance with member countries' different regulatory standards. An example is the MRA between Germany and its EU partners that allows the sale in Germany of beer not brewed in accordance with the Reinheitsgebot, the country's centuries-old Beer Purity Law. As it happens, Germans quite like the law, so foreign beers have not diluted the market noticeably. For German brewers, however, the MRA means they can produce beers for export not subject to the law, allowing them to cater to different consumer tastes across Europe. MRAs would also lead to regulatory competition. If one country's regulations proved to be clearly superior to another's, then the latter country would have an incentive to change its regulations for the better, whether to reduce costs or enhance consumer safety.*

The first step towards that arrangement is with informal trade talks between America and Britain.[473]

Shanker Singham adds:[474]

The UK and the US are by far the largest investors in each other's economies (the US accounts for 41 per cent of all foreign direct investment in the UK). They have maintained a strong trading relationship for more than two centuries. They have the strongest ties of any two countries in defence and intelligence. The UK and the US share a foundation in English common law. They have the same economics-based approaches to regulation and to competition.

The UK was the birthplace of the modern free trade movement in the nineteenth century and carried the torch for free trade until it was extinguished by protectionism in the rest of Europe in the latter half of the nineteenth century. When free trade was again embraced after the Second World War, it was the UK and the US that rebuilt the global trading system in the form of the General Agreement on Tariffs and Trade.

This shared approach to the centrality of open trade, competition on merit as an organising economic principle, and property rights protection as the key tools to create wealth and grow economies is what has bound the nations together, and could be the foundation of a high level trade agreement that removes existing tariff barriers, eliminates government regulations that damage competition in markets, and better protects investors and other property owners' rights.

James Forsyth of the *Spectator* argues that, while Transatlantic Trade and Investment Partnership (TTIP) – the proposed free-trade deal between the US and the EU – is dead, it would be relatively straightforward for a simple US-UK deal to be negotiated with the Trump administration and for Congress to ratify.[475] Of particular importance to the City would be a deal that made it simpler for a firm authorised in one country to operate in another and for there to be closer co-ordination over future regulation.[476]

Attitude of Donald Trump

The feasibility of a US-UK FTA would depend on the attitude of the new US president, Donald Trump. He won the US election based on a campaign of isolationism and anti-trade rhetoric that was critical of both NATO and the WTO. According to Thomas Raines, of Chatham House: 'The twin pillars of UK foreign policy for 40 years has been the special

[473] Iain Murray (2016) How a US-UK free trade deal could revolutionise world trade, *Brexit Central*, 22 December.
[474] Shanker Singham (2016) Post Brexit Britain can get a much better US trade deal than the EU's failing TTIP, *City A.M.*, 30 August.
[475] James Forsyth (2016) Brexit means Britain can benefit from this result, *Spectator*, November. See also Philip Webster (2016) US result may help May's cause in Brexit talks, *The Times*, 11 November.
[476] David Wighton (2017) City's answer to Brexit lies closer to home, *Financial News*, 30 January – 5 February.

relationship with Atlanticist US and active membership of the EU. Both are in tatters'.[477] Patrick Wintour argues that: 'There will … be concern for Britain's Brexit talks. Trump is a Brexit supporter, but…. the Trump victory could drive the EU to one of two Brexit responses. The union could circle the wagons and try to prevent Marine Le Pen from winning the French presidential election by driving a harder bargain with the UK. Alternatively, it could conclude that the wider geopolitical stakes, including dealing with Russia and terrorism, are so high that a quick and dirty deal with the UK is a necessity'. He goes on to say that 'No 10 policymakers viewed the Trump triumph through the same prism as Brexit, and May will probably offer herself as the western leader who shares lead responsibility with Trump in responding to the populist revolt. The head of the No 10 policy board, George Freeman, saw Trump's victory in that context, tweeting: "At its heart this is about a broken contract through the failure of globalised market economics to serve the interests of domestic workers"'.[478]

Some believe that Trump's isolationism will help the UK. According to James Forsyth, there is: 'keenness of those around him to cut a quick trade deal with the UK. His team views an Anglo-American agreement as a way of showing that they are not anti-trade per se — just against deals with low-wage economies that they believe cost American jobs. No one would think that a deal with Britain would lead to workers being undercut in Ohio, Michigan and Pennsylvania — three manufacturing-heavy states that swung from the Democrats to Trump. The incoming administration's enthusiasm for a deal with the UK, in stark contrast to Barack Obama's "back of the queue" approach, makes it less easy to claim that Brexit will leave Britain isolated and alone'.[479] A similar point was made by Daniel McCarthy, editor at large of *The American Conservative*: 'In trade, Mr Trump's populism and conservatism come together in surprising ways. While he scrapped the Trans-Pacific Partnership trade pact, and the Transatlantic Trade and Investment Partnership looks similarly doomed, new bilateral trade agreements may be in the offing, not least in the UK. Multilateral "free trade" agreements in recent years have been as much about environmental, labour and other regulations. Free-market conservatism provides good reason to look askance at many of these agreements'.[480]

Some believe that Trump's protectionist stance will also help the City. Saker Nusseibeh, CEO of Hermes Investment Management, points out that London's emergence as the world's financial centre came after the US tightened its immigration controls in the early 2000s: 'The reason London became number one is not because we were brilliant – people found it difficult to travel to New York to do deals. London rose to number one because it was easier for Russians, Chinese and Indonesians and such businessman to come to see their banks in London. Maybe this is good for the City of London. Until last night, the City was sinking to

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[477] Thomas Raines (2016) Britain is Caught Between Trump and a Hard Place, *Chatham House Comment*, 16 November.
[478] Patrick Wintour (2016) Brexit and Trump could leave UK stranded between estranged allies, *Guardian*, 9 November.
[479] James Forsyth (2016) Britain holds the aces in Brexit talks, *Spectator*, 26 November.
[480] Daniel McCarthy (2017) He achieved the impossible during the election race…he may be doing it again, *Daily Telegraph*, 11 February.

number two in the world and New York looked likely to grab the title of number one that we grabbed in 2002-03'.[481]

On the other hand, leading UK fund manager Neil Woodford is concerned about contagion in Europe in response to the Trump victory: 'If we get a Brexit or Trump-like situation, if we get Marine Le Pen [elected in France] or a far-right movement gaining votes in Germany...then lots of things can happen that will destablise the equilibrium that Europe currently enjoys. If anything, I am more concerned about the political risk in Europe than what is likely to happen under a Trump presidency. I am watching very carefully what may happen [in Europe]. If investors start to doubt the sustainability of the euro then that will be quite a moment for markets'.[482]

David Wighton argues that European investment banks 'fear is that an administration headed by an unabashed protectionist will use financial regulation to discriminate against foreign banks operating in the US market. Many European bank leaders believe that US financial regulation and enforcement is already skewed against overseas banks. How much worse could it get under a President determined to "put America first"'.[483]

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': 'I'm a big fan of the UK, we're gonna work very hard to get it done quickly and done properly. Good for both sides'. He also predicted that other countries would follow Britain's lead in leaving the EU, claiming it had been deeply damaged by the migration crisis: 'I think it's very tough. People, countries want their own identity and the UK wanted its own identity. [The EU] is basically a vehicle for Germany and Germany's dominance is why the UK was so smart in getting out'. He continued to criticise NATO as an 'obsolete' organisation that has not defended itself against terror attack and he was also critical of member states that were not paying their fair share, although he acknowledged that the organisation is still 'very important to him'.[484]

The UK is hoping to sign a 'statement of intent' with the US within months of Trump's inauguration to work on reducing trade US-UK barriers.[485] Donald Trump's commerce secretary, Wilbur Ross, confirmed that one of his top priorities will be to secure a free trade deal between the US and UK. He has extensive business and social links to the UK after decades as an investor and wants to embolden the 'special relationship' by lowering barriers between the two countries.[486]

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481 Andrew Pearce (2016) Shock US election result may be a Trump card for the City, *Financial News*, 9 November.
482 Michelle McGagh and Gavin Lumsden (2016) Neil Woodford: right-wing Trumpists could topple euro, *Citywire*, 18 November.
483 David Wighton (2016) COMMENT: Banks are suffering from Trumpanoia, *Financial News*, 17 November.
484 Michael Gove (2017) Donald Trump: I'll do a deal with Britain, *The Times*, 16 January.
485 Ben Riley-Smith (2016) Donald Trump trade deal? Ministers aim for UK-US 'statement of intent' within months to reduce trade barriers, *Daily Telegraph*, 19 November.
486 Ben Riley-Smith (2016) Britain will be front of the queue for trade deal with US under Donald Trump's new commerce secretary, *Daily Telegraph*, 17 December.

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':[487]

> *The UK will want to have some control over labour mobility, as well as leaving behind the EU's supranational decision-making. The proposed continental partnership would consist in participating in goods, services, capital mobility and some temporary labour mobility as well as in a new system of inter-governmental decision making and enforcement of common rules to protect the homogeneity of the deeply integrated market. The UK would have a say on EU policies but ultimate formal authority would remain with the EU. This results in a Europe with an inner circle, the EU, with deep and political integration, and an outer circle with less integration. Over the long-run this could also serve as a vision for structuring relations with Turkey, Ukraine and other countries.*

The CP would involve:

- *Participation in a series of selected common policies consistent with access to the single market*
- *Participation in a new CP system of inter-governmental decision making and enforcement*
- *Contribution to the EU budget*
- *Close cooperation on foreign policy, security and, possibly, defence matters.*

> *The CP would build a wider circle around the EU without sharing the EU's supranational character, except where common enforcement mechanisms were needed to protect the homogeneity of the single market. Members of the CP would be the EU, all EU-countries, the UK together with any other countries that participated.*
>
> *The obvious challenge for EU-CP cooperation will be to preserve the processes and structures of the EU as a supranational entity and at the same time to ensure that CP members that are not part of the EU have a say in common matters. Two basic cases must be distinguished. The first concerns matters for which the EU already has an intergovernmental decision-making process. Here, the issue of cooperation can be relatively easily solved as the CP by its very nature is intergovernmental. Politically, this area of intergovernmental cooperation is important. In particular, the activity of the CP in the fields of foreign, security and defence policy – the areas in which Europe has to face a range of complex, persistent and existential threats – would be included.*

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[487] Jean Pisani-Ferry, Norbert Röttgen, André Sapir, Paul Tucker and Guntram B. Wolff (2016) *Europe after Brexit: A proposal for a continental partnership*, Bruegel, 29 August; http://bruegel.org/2016/08/europe-after-brexit-a-proposal-for-a-continental-partnership/

The second, and arguably more difficult case, concerns areas in which the EU acts as a supranational body with (partial) sovereignty, including in particular all single market matters. Cooperation in this area means that although a CP member is not a member of the EU, it would get full access to the respective parts of the single market with all rights, opportunities and obligations other than freedom of movement for workers.

One issue concerns the law making itself: We propose that CP countries would meet in a CP council, in which EU institutions would participate. At the level of the CP council, the UK would thus continue to participate in the numerous different formations where the details of single market regulation and other policies in which it would continue participating are discussed and negotiated. Obviously, the CP council could not pass EU legislation but CP partners would be involved in CP council readings of draft EU legislation and they would have a right to propose amendments.

EU law on the single market would, however, continue to be adopted through the normal EU legislative process. In practice, in the areas that concern the CP, the CP council would deliberate the legislative proposals before they are formally passed in the council of the European Union and the European Parliament, so that positions expressed by non-EU members could be taken into account throughout the legislative process and in the final decision.

Formally, it would be a political – not legal – commitment by EU member states to take into account the positions and deliberations in the CP council. Our CP council would therefore deal with this major political task. If the EU and its partners disagree within the CP council, the final say would formally remain with the EU. The non-EU CP members would then still have to implement the single market legislation in their national legislation or face restrictions on participation in the single market. The CP partners therefore would not have veto rights over the EU decisions but they would be closely involved in law-making at the intergovernmental level of the CP council.

Conversely, CP members would have to accept the enforcement measures and jurisprudence that safeguards the relevant freedoms of the single market. Otherwise the integrity and coherence of the single market would erode. The key challenge will be to balance fairness with the necessity of homogeneity in application. In the case of EEA countries, an EFTA court is responsible. It consists of judges from the three EEA countries. However, rules ensure that the court follows the relevant case law of the ECJ. Whether such a mechanism would be sufficiently strong in the case of the CP with a major country as the UK is for political and legal debate. We think that it may be necessary to contemplate instead an extended ECJ court composition involving judges from all CP countries. However, this court would still be bound by ECJ case law.

Another important question is competition policy enforcement and state aid control. In the case of EEA/EFTA countries, the European Commission is largely in charge for any cases that have repercussions beyond borders. Whether this is a feasible model for the CP should be for political debate.

Participation in the EU budget would also be vital. While many spending items of the EU budget might look outdated, the budget still constitutes an essential element of the integrated economic space. It is indispensable in the area of agricultural policy but, with its aim of structural convergence, is also important for opening up economic opportunities for less-developed parts of the EU. The EU budget also provides support for 'catch-up' countries. While the effectiveness of Structural Funds is a matter for debate, they serve as a quid pro quo for the adoption by cohesion countries of demanding single market legislation that might exceed what would be appropriate at their development level. Participation in the budget is therefore the necessary counterpart to participation in the single market. The UK would need to make a budgetary contribution.

From a political point of view, our proposal would constitute a significant concession by the EU to the UK on the free movement of workers. Politically, there may be a tendency in continental Europe to demand limits in other areas of the single market such as financial services. We would note, however, that under our proposal there is already a political 'price' to be paid by the UK, as CP membership entails significantly less political influence compared to EU membership. Whether that price is appropriate is a matter for political judgement.

If David Cameron had returned from his renegotiation exercise with this type of proposal for a new relationship between the UK and a 'reformed' EU, the Referendum result might well have been different. But is now too late. The EU has proved itself to be incapable of reform. It is therefore unlikely that it would now accept such a proposal.

Further, as John Redwood argues, without the UK, EU27 can go ahead with their aim of full political union:

More interesting and in a way more important are the aims of the rest of the EU. We should question the European Commission's sometimes expressed view that it wants to punish the UK. Other EU luminaries have said they want a smooth transition, as anyone sensible would.

The member states are what matters in this case. None of them have stated they want to be charged tariffs on their exports to the UK, implying they are nervous about suggesting damaging the current trading arrangements which help them more than the UK. The rest of the EU has a far bigger export trade with the UK than the other way round, and sells far more goods that could be subject to tariffs if we fall back on World Trade Organisation rules.

Nor have any of the member states expressed a wish to lose their financial passports to London or to set back their access to the largest and most liquid financial market in Europe. We start from a position where both the UK and the rest of the EU have the same regulations, so it should be possible to carry on trading one way or another by keeping the passports or going over to the doctrine of equivalence. Services are tariff free anyway under WTO rules.

The aims of the rest of the EU must be to ensure a smooth transition without loss of trade and jobs for them through exporting to the UK. They will want to keep access to the London financial markets. They will probably want to use the exit of the UK to speed up their work on their full political, monetary and economic union. The UK has been a brake on progress, a country urging caution or seeking opt outs from many centralising proposals.

A smooth and relatively rapid exit of the UK will help them get on with the hugely important task of providing the proper political and governmental backing to the euro, which is the most important part of the EU scheme so far. It is now being tested by political movements in various EU countries by electors impatient with slow growth or no growth, with high unemployment and stagnant wages.

In single country currency unions far more money is transferred as grants between the richer and poorer parts of the zone. The euro area has found this difficult, in part because the UK is a large member state which did not want to pay for any euro transfers. Instead, in the euro area the money has been transferred as loans, using the mechanism of the European Central Bank.

In the case of Greece this has produced extreme stresses in the financial system, with the need to write off or ease the terms of loans made to the country. There are still substantial strains on the commercial banking systems of other weaker eurozone members.

Germany, as a major paymaster of the zone will want further disciplines and reassurances. There has to be more control centrally over budget deficits and total zone borrowing, as in a single country system. In return Germany will need to allow suitable spending of money on investment and improvement in those parts of the zone that are struggling to keep up and have high unemployment.

Travellers from the continent regularly say that Brexit is not the main item on their agenda. They need to help get Brexit out of the way, smoothly, without damage to their economies. They have a much bigger agenda to pursue, to put the tax capacity and the government power behind the euro which all successful currencies need. That should be so much easier without the UK in the EU.[488]

Challenges

We should not forget the significant challenges involved in attempts to increase trade. In particular, the world as a whole is becoming considerably more protectionist. According to Mark Field, MP for the Cities of London and Westminster: 'Between 1990 and the onset of the crisis, global trade expanded at twice the rate of world GDP growth; since then, these two indices have risen more or less in tandem. The effect of the global economy hitting the buffers was that ailing governments found it ever more difficult to resist domestic pressure to shield their own companies and workers from the recessionary tailwinds'. Global Trade

[488] John Redwood (2017) What the EU wants (needs) from Britain post-Brexit, *Financial News*, 3 January.

Alert estimated in 2010 that protectionist measures introduced after the crash led to a 10% reduction in global trade. Protectionist measures increased by 50% between 2014 and 2015. Even if free trade deals can be negotiated, there will always be the potential for governments – even members of the WTO – to impose non-tariff barriers to protect domestic suppliers.[489] Further, Brexit and Trump could put a dampener on post-crisis attempts to harmonise global financial regulation.[490]

[489] Mark Field (2016) Britain is embracing free trade just as the world turns to protectionism, *City A.M.,* 7 November.
[490] Samuel Agini (2016) Brexit and Trump prompt fears for regulation, *Financial News*, 24 November.