A BRIEF ON THE CITY AFTER BREXIT

Written Submission to House of Commons International Trade Committee

Economists for Brexit

22 December 2016

This submission provides additional support to our oral answers on November 29th to the question, “Why do you think there are not great risks on losing passporting rights outside of the Single Market?”.

There is much misunderstanding of the City’s prospects after Brexit. Some Remainers suggest that the City (ie, the UK’s financial services sector) could be hit by large-scale relocation of banks and other financial houses to the Continent as large amounts of EU business are lost. This is quite wrong. These concerns- principally obsessing about the potential loss of Passporting - have neglected to take into account the degree to which Passporting matters, fail to see the nature of potential EU protectionism in perspective, do not appreciate the City’s strong position in the global financial services market, and have dismissed the advantages of the City’s enhanced freedoms outside the EU.

We conclude that the City - rather than concentrating on maintaining a relatively unimportant regulatory feature (Passporting) - should instead embrace a post-Brexit future as a World Financial Centre establishing its own financial regulatory regime attuned to the requirement of global financial markets.

This submission should be read in conjunction with *The Economy after Brexit*[1] published by Economists for Brexit in April this year.

The Importance of Passporting

It is essential to understand that only a start hasbeen made in regulating trade in ***services*** within the EU –known somewhat misleadinglyas the ‘Single Market in Services’. In reality, there essentially is no single market in services to leave. The vast bulk of service regulation hitherto hasbeen done by national governments; EU actions so far have been limited mainly to financial services.The primary achievement in terms of trade protection has occurred in financial services with ‘Passporting’–ie, reducing national barriers so as to reduce the existing level of protection exerted by nation states.

Passporting – a series of rules and regulations within the Single Market provided via such regulations as MIFID I & II, CRD IV, and AIFMD - provides sector specific relief from some, but not all, of the national barriers erected over the years by EU countries. The assertion that the success of the City is based on full and complete “access” to the EU’s financial services markets because of Passporting is not true. In some sectors, the Passport is important to doing business and others it has much less importance or none. Even equipped with Passports, national regulations must often still be met by financial services firms wishing to do business across EU county borders.In sectors where Passporting provides little value (eg, insurance), City firms have long since developed ways of working around the problems.

Importantly, because UK national protection of services is minimal, Passporting has had no observable effect on the demand for UK financial servicesor prices; but has enabled more penetration of EU markets by UK suppliers. In terms of product regulation, more has been done, but as we argue below much of it is potentially damaging to the interests of the City as the world's leading financial centre - see Congdon, 2014.

Critically, analysis of reports published by Oliver Wyman and Open Europe and discussions with City practitioners suggest the amount of City business that might be lost as a consequence of losing Passporting rights is relatively small. The insurance and asset management sectors have littlebusiness at risk because insurance companies – given there is no EU single market in insurance – already conduct most of their EU business through subsidiaries and most EU asset management business is already managed in the UK via the international norm of 'delegation of managed assets'. Lloyds of London has stated publicly that only 4% of their business is EU-related and we understand from Lloyds' practitioners that ithas low profitability. Only Businesses Banking and some parts of Investment Banking have any significant revenue at risk.

Thus, we estimate –based on discussions with City practitioners and analysis of figures from the Oliver Wyman and Open Europe reports - that only about 9% of total City revenues is potentially at risk from loss of Passporting rights (see Table A). In practice, the true "at risk" figure is likely to be even lower because the 9% figure implicitly assumes that Passporting provides comprehensive coverage of all Banking business, which is not the case.

For this "at risk" business to be lost, one would have to assume post-Brexit that (a) all Passporting rights would be lost, (b) none of the "passported" rights lost would be compensated by the continuation or evolutionof "Equivalence" schemes, and (c) that centuries of City creativity and innovation would not be able to discover "work-arounds". If even half of this "at risk" business were to be lost, the potential impact on City revenues would be only about £8 bn or 4 ½ %. Experienced City practitioners find it very difficult to imagine losing half of these 'at risk' revenues. Losing a quarter of these revenues amounts to only about 2% of revenue. To put this into perspective, UK auto manufacturing industry revenue in 2015 was £ 72 bn and 44% of UK manufactured cars were exported to the EU.

Our estimatecontrasts sharply with garish headlines claiming thatmore than £50 bn of City business could be lost –stemming largely from the Oliver Wyman report produced for City UK. Their figuresassume an unlikely scenario they called,"LowAccess", in which the City would lose essentially all its access to EU markets and this impact is assumed to be almost tripled by the loss of supporting jobs – primarily in IT and data provision services. We have not met any City practitioners who believe this.

Oliver Wyman also produced a more realistic and less alarming access scenario but did not publish the result. We understand, on good authority, that this was because the result was "not bad enough". The full report has not been made public and circulation of it has been so severely restricted that even individuals in CityUK who worked on the report have notbeen allowed to see it.

PotentialEUHostility in Perspective

A key concern by those who worry about the loss of Passporting is the threat that, post-Brexit, the EU will resort to hostile behaviour toward the City; for example, taking an unreasonably aggressive line with regard to granting Equivalence to City firms that, in principle, should alleviate the loss of Passporting rights. Such equivalence schemes have already been granted to third countries.

But how threatening is the possibility that the EU will act in such a protectionist way towards the City after Brexit? There are, at least, two major factors to consider:

***Maastricht and Free Capital Mobility*.** First, the EU has traditionally sought to act in a non-discriminatory way towards capital markets around the world. It awards ‘equivalence’ to other countries – ie, many EU financial services laws allow financial institutions in third countries to access the single market if the third-country's laws are deemed "equivalent" to the EU's in a relevant area. 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 (see Reynolds, page 5 and Annex C). The reason for this approach is that under the Maastricht Treaty the EU has aimed for free movement of capital and it also participates in the Bank for International Settlements, which aims similarly to ensure that financial markets remain open and non-discriminatory.

***London as Europe’s Investment Banker*.** It is a well-known fact that there are significantly more “Inbound” Passports awarded to EU financial services firms’ desiring to do business in the UK than “Outbound” Passports to UK firms. This reflects the importance of the City as the financial centre of Europe, and the world. If Passporting were to be eliminated and no “equivalent” regime substituted, it is difficult to see how EU corporate and sovereign capital demands could be met. It is virtually impossible to imagine that the minor financial centres of Frankfort (19^{th} in the world just between Dubai and Vancouver), Paris (29^{th} in the world just behind the Cayman Islands), or Amsterdam (33^{rd} in the world tied with Calgary) could ever fulfil Europe’s financial needs.

Thus, in addition to the potential loss of Passporting not being material to either the City’s or the country’s interest, there is some reason to believe that ultimately the EU will not adopt a hostile posture toward the City that would go against some of its fundamental principles and would be self-harming.

The Fundamental Economics of theCityOutside of the EU

An important omission by those obsessed with Passporting and all the technical details of it, is failure to understand the underlying economics that will drive the City’s future success.

***The City’s Future Size*.**After Brexit, the City is likely to expand as EU protection is removed and UK resources move towards the UK’s central area of comparative advantage - traded services, with the City as the prime element of these. Our research, based on a long-proven world trade model,suggests that the City is likely to expand on the order of 10% over a decade or so purely on the basis of economic fundamentals. It is mistaken to think that the size of the City depends on demand for its services; it depends instead on the availability of UK resources, especially of skilled labour (relatively little unskilled labour is employed) and available office sites, as capital can flow in from around the world. Think how the City expanded after Big Bang; this happened because new powerful banks and other operators moved into London, boosting available supply and lowering its cost base. Brexit will redirect resource supply to the City.

Regulation Pre and Post-Brexit. A key element in the City’s ability to supply the right services at low cost is the regulative system it faces. What often is missing in the discussion about Passporting and attendant suggestionsthat the City should attempt to maintain its SingleMarket status in one form or other, is the negative impact that future EU regulatory actions are likely to have on its ability to prosper and compete with its real competitors – New York, Singapore, and Hong Kong. EU regulations brought in over the past ten years or so have been of uneven quality to say the least. The EU, in fact,is currently threatening the City with a variety of hostile actions such as the Financial Transactions Tax, which is still alive and kicking. Its bonus caps have also been a nuisance, while in general it has a fussy and over-prescriptive approach.Now that the traditional regulative authority over the City - the Bank of England- has beenrestored, much better regulation than the EU is likely to be forthcoming. Brexit will therefore strengthen the quality of regulation, an essential element in the expansion we predict for the City.

Potential Trade Diversion by the City.Last and by no means least, there is the position of the City in world markets to be considered. As mentioned earlier, the size of the City depends on its available supplies, not on its potential demands. The latter are virtually infinite compared with the City's size, remembering that the UK, while one of the world's larger economies, has only around 3% of world GDP. No UK business sector, including the City, can as a whole supplya lot more than this fraction of the world's markets for their products. Because of the UK's comparative advantage in financial services, the City might supply somewhat more – say, 6% overall. If the EU employs protection to reduce UK financial services sales in its countries, all this does is divert demand from UK to EU suppliers without affecting overall EU demand for financial services in total; thus world prices, which depend on the overall balance of demand and supply across all world markets, will remain unchanged. UK financial servicesoutput will also therefore be the same in total; and so output not sold in the EU will be diverted in the long term to other world markets - a process known as 'trade diversion'.While there are some adjustment costs involved, these are short term and are relatively trivial when set against the massive long term, permanent gains to the City from Brexit (see Reynolds (2016) and Minford (2016)).

The City's Future Role as a World Financial Centre

For all the reasons explained above, the City will thrive after Brexit, continuing as the world's leading financial centre and expanding further. The Bank of England should have the confidence to grasp the regulative challenge and simply ignore EU protectionist threats; these have little credibility and, in any case, if carried out would lead only to losses within the rest of the EU. Such actions would reduce their ability to access the most competitive financial services.This notion of serving as a World Financial Centre establishing its own regulatory regime compatible and competitive with global financial services markets has been carefully argued and set out by Barnabas Reynolds in a Politeia paper, *A Blueprint for Brexit*. We believe it merits careful consideration.

References:

1. ***The Economy after Brexit*, Economists for Brexit (2016). Downloadable from www.economistsforbrexit.co.uk**
2. ***The City of London in Retreat,*Congdon, Tim (2014). The Bruges Group, www.brugesgroup.com**
3. ***The Impact of the UK's Exit From the EU on the UK-Based Financial Services Sector* - Oliver Wyman**
4. ***How the UK Financial Services Sector Can Thrive After Brexit* - Open Europe**
5. ***A Blueprint for Brexit: The Future of Global Financial Services and Markets in the UK*, Reynolds, Barnabas (2016). Downloadable at www.politeia.co.uk**
6. ***Trading Places- Consumers versus Producers in the New Brexit Economy*, Minford, Patrick (2016). Downloadable at www.politeia.co.uk.**

Table A: The Impact of Passporting on Financial Services Revenue

TABLE A: THE IMPACT OF PASSPORTING ON FINANCIAL SERVICES REVENUE

SECTOR	REVENUE [3]		EU-RELATED REVENUE				Passport Coverage	EU-RELATED REVENUE AT RISK DUE TO LOSS OF PASSPORTING			LOSS OF REVENUE UNDER TWO PASSPORTING LOSS SCENARIOS			
			Oliver Wyman[4]		EfB Assumption*						25% At Risk Revenue Lost		50% At Risk Revenue Lost	
	£ bn	%	£ bn	%	£ bn	%		£ bn	Per Cent Of Total Industry Revenue	Comment	£ bn	Per Cent Of Total Industry Revenue	£ bn	Per Cent Of Total Industry Revenue
Banking	**109**	**64%**	**25**	**23%**	**13.8**	**13%**		**14**(Max)	**7.6%**	Represents the maximum amount at risk because Passporting does not comprehensively cover all sub-sectors of banking	**3.5** (Max)	**2.0%**	**7.0** Max	**4.0%**
Sales/Trading	30				4.5	15%	Yes							
Investment Banking	11				2.8	25%	Yes							
Retail & Business Banking	62													
Retail (say, 50%) *	31				0	Nil	No			Virtually no EU-related business				
Business (say, 50%) *	31				6.2	20%	Yes							
Private Banking & Wealth Management	6				0.3	5%	Partial							
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%**	**0.25**	**0.2%**
Domestic Retail & Commercial	28						No							
Corporate & Speciality	9						No							
Reinsurance	3						No							
Asset Management	**22**	**13%**	**6**	**25%**	**3.3**	**15%**	Partial	**1.1**	**0.6%**	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]	**0.28**	**0.16%**	**0.55**	**0.32%**
TOTAL	**171**	**100%**	**35**	**20%**	**21**	**12%**		**15**	**9%**		**3.8**	**2.2%**	**7.5**	**4.4%**

*** EfB assumption based on discussions with City practitioners**