10/2016

Open Europe

How the UK's financial services sector can continue thriving after Brexit

Open Europe

We drive change in Europe

Open Europe is a non-partisan and independent policy think tank. Our mission is to conduct rigorous analysis and produce recommendations on which to base the UK's new relationship with the EU and its trading relationships with the rest of the world. We aim to ensure that Government policy and public debate is rational and well informed.

In the wake of the UK's vote to leave the EU, our programme of research and consultation will focus particularly on:

- The UK's new relationship with the EU, including trade, security and political cooperation.
- The most important opportunities for new trading relationships with nations outside the EU.
- Productive international cooperation across areas such as immigration, research and development, cross-border investment and financial services.

Our starting point is the promotion of democratically grounded economic, trade and investment policies which foster growth, employment and freedom under the rule of law.

Guided by these free market and liberal principles, we are committed to an open Europe and an open Britain.

ISBN: 978-1-907668-50-0

About the Authors

Vincenzo Scarpetta
Senior Policy Analyst

Vincenzo joined Open Europe at the end of 2009, first in Brussels and then in London. During his time at Open Europe, he has written extensively about EU financial services regulation and supervision – particularly with regard to asset management. He also specialises in the politics and economics of Southern Europe, EU law and institutions, and EU migration policy. He is a regular commentator in print and broadcast media across Europe.

Stephen Booth
Acting Director and
Director of Policy and Research

Stephen leads Open Europe's policy and research projects and has directed Open Europe's research projects on EU regulation, free movement and immigration, justice and home affairs and the UK's trade relationship with the EU. Stephen is a regular contributor to print and broadcast media.

Edited by Eleanor Shawcross Wolfson

Offices

Open Europe
7 Tufton Street
London
SW1P 3QN
+44 (0)20 7197 2333
www.openeurope.org.uk
info@openeurope.org.uk
@OpenEurope

Open Europe Brussels
113-115 rue du Trône
B-1050
Brussels
+32 (2) 540 86 25

Open Europe Berlin
Oranienburger Straße 27
10117 Berlin
Germany
+49 (0)30 2758 1365
info@openeuropeberlin.de
www.openeuropeberlin.de

CONTENTS

Executive Summary

London is one of the most successful financial centres in the world. There has been much debate about whether the financial services industry will be able to survive Brexit. This report examines how the current financial services 'passport' operates in reality and its relative importance to different financial sectors. It also considers how UK firms could continue to access European markets if the UK decides not to stay in the single market.

Key conclusions

The financial services 'passport' is not a single thing. There is no one passport. 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, that is not to say it has no value. There are areas where it will be important to try to retain a similar relationship to the one the UK has now.

Banking

The passport works best for the banking sector. Around a fifth of the UK banking sector's annual revenue (between £23bn and £27bn according to Oliver Wyman) is estimated to be built on the access afforded by the passport. Our analysis suggests that, via their London bases, an absolute maximum of 14.5% of the US investment banks' revenues can be linked to the passport. The banking passport relies on two key pieces of EU legislation – CRD IV and MiFID. CRD IV allows banks to provide deposit taking, lending and payment services, while MiFID allows them to provide advisory services, investment services and portfolio management across the EU from a base in London. Essentially, wholesale banking is done via CRD IV and investment banking via MiFID. As it stands, the CRD IV legislation does not allow for equivalence, or meaningful third party access. Therefore without a bespoke agreement, giving passport-like access, UK banks and the London-based US investment banks could see significant disruption to their business lines across Europe.

Asset management

The story for non-banks, namely asset managers, is a bit different. The key regulations, UCITS and AIFMD, theoretically provide passports to allow funds to be marketed across the EU and managed from a single base, but in reality a number of technical barriers remain. Supervisory and legal fees, as well as different national definitions of 'marketing', make it particularly challenging for small or medium-sized asset managers to expand into other markets in Europe. Meanwhile, many of the larger funds already choose to operate European subsidiaries, rather than relying on a passport. A recent industry survey by the Investment Association suggests that 21% of assets managed in the UK are tied to EU clients.

Under certain conditions, the UCITS and the AIFM directives envisage the possibility of delegating portfolio management functions outside the EU – meaning that in future UK-based asset managers might be able to keep providing portfolio management services for funds domiciled within the EU/EEA. This would ultimately amount to keeping indirect access to the passport, built on existing regulations. Under such a scenario, only around 7% of total assets managed in the UK would be under direct threat from the loss of the passports in this sector.

Insurance

For insurance, the story is again completely different. The industry is less reliant on the European markets – in 2015, 28% of insurance exports went to the EU, compared to 44% for other financial services. This is not surprising, because fundamentally there is no real single market in insurance in the EU. The large majority of services provided in other countries are done so via subsidiaries rather than via a passport – up to 87% of insurers operating across borders in the EU do so via subsidiaries rather than branches. 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. But even this only accounts for 11% of the market's gross written premium, £2.9bn, (with possibly as little £800m directly reliant on the passport). Therefore, from an insurance perspective, the loss of the passport is not likely to be life or death for the industry.

What are the alternatives that the UK could negotiate?

If the UK loses its financial services passport, there are three broad options to retain access to the European markets: under certain EU regulations, the Government can apply for 'equivalence'; the Governments of both sides could negotiate a bespoke EU-UK agreement; or finally individual firms can make use of existing local arrangements to set up branches or subsidiaries.

Equivalence

Many cite 'equivalence' as an alternative to the passport. In some cases, this can offer access to the single market when a country is judged by the EU to have a broadly equivalent regulatory regime. However, it is, at best, a partial solution. Whether or not equivalence is available varies regulation by regulation, and while some do offer passport-like rights for third countries – MiFIR for example – others offer no equivalence at all – e.g. CRD IV. Granting equivalence is also a political decision, requiring a judgment from the Commission, and can take many years to be granted. Moreover, if regulation diverges over time then it can be in jeopardy – though, so far, equivalence has never been revoked. All that said, the UK also starts from the basis of having the exact same regulation as the EU, something no other country has done – which should make equivalence easier to achieve.

Bespoke agreements

The limitations of equivalence mean that the UK will want to try and negotiate bespoke agreements to protect certain markets. 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 – although not via cross-border services. Clearly, it is a very specific agreement, but nonetheless it provides an interesting precedent.

Local arrangements

Financial firms can set up local branches if they wish to continue to provide services in certain member states. These branches would be subject to local requirements and authorisations. However, they would not be eligible to passport into other states, and as such, a branch would need to be set up in every state in which the firm wished to operate. Alternatively, firms could set up a subsidiary in an EU member state which could then provide services across the bloc. However, this would require significant investment in terms of capital, staff and infrastructure.

<table>
<tr><th>Industry</th><th>Main EU law</th><th>Importance of EU passport</th><th>Is EU equivalence available?</th><th>Does equivalence grant passport-like rights?</th><th>Other alternatives and recommendations</th></tr>
<tr><td rowspan="2">Banking</td><td>MiFID (MiFID II/MiFIR in 2018)</td><td rowspan="2">High
Long established, few barriers
(<u>CRD IV:</u> deposit-taking, lending, payment services, etc.
<u>MiFID II:</u> portfolio management, investment advice, etc.)</td><td>Yes</td><td>Yes</td><td rowspan="2">• 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)</td></tr>
<tr><td>CRD IV</td><td>No</td><td>No</td></tr>
<tr><td rowspan="2">Asset management</td><td>AIFMD (professional clients)</td><td rowspan="2">Medium
Distribute funds across bloc, manage from single location
(marketing and management of funds across borders)</td><td>No</td><td>Potentially (via MiFIR)</td><td rowspan="2">• 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</td></tr>
<tr><td>UCITS V (retail clients)</td><td>No</td><td>No</td></tr>
<tr><td rowspan="2">Insurance</td><td rowspan="2">Solvency II</td><td rowspan="2">Low
Globally diversified, use subsidiaries
(direct insurance and re-insurance, cross-border and via branches)</td><td>Yes (re-insurance)</td><td>Yes</td><td rowspan="2">• Bespoke UK-EU deal covering Lloyd's of London
• Expand existing subsidiaries in EU countries and/or set up new ones</td></tr>
<tr><td>No (direct insurance)</td><td>No</td></tr>
</table>

Key recommendations

The UK should prioritise negotiating a new deal for the sectors that depend on passport access, and where the alternatives are limited. The approach should look to a mixture of Government-negotiated specific bilateral agreements and equivalence, as well as individual firms establishing local branches and subsidiaries where necessary.

1. The Government's primary objective, with regards to financial services, should be attempting to keep the CRD IV passport in place, given the importance of banking, and the lack of equivalence. This could take the form of a specific bilateral agreement (similar to the EU-Swiss deal on insurance) or it could be 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 – which already exists to an extent between the BoE and the ECB, but will need to take account of the UK outside of the European Supervisory Authorities. The UK should also seek equivalence under MiFIR, which will allow many of the investment banking services provided by the passport (including those by foreign firms) to continue.

2. For asset managers there is less urgency for new arrangements, as the regulations (theoretically) allow for funds to be managed outside the EU – provided they have some presence in the EU. Many UK-based asset managers already operate via two separate vehicles – one domiciled in the UK and another one located in a different European hub (often Dublin or Luxembourg). Achieving equivalence under MiFIR will also give asset managers a chance to retain a passport for some of the services they offer to professional investors.

3. Insurers are unlikely to be as concerned about the loss of the passport, given the industry's global nature and tendency to operate via subsidiaries. Nonetheless, the UK should seek equivalence under Solvency II to help smooth the transition, and a bespoke agreement will be important for Lloyd's of London. Again, this could be a specific bilateral agreement allowing it to continue to be treated as a single entity and provide services across the bloc, provided it adheres to the relevant EU regulation. Steps 2 and 3 will be particularly important. 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) are also more likely to maintain the bulk of their operations in London.

4. 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.

5. Since equivalence can be a time-consuming and complicated political process, 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.

6. 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.

7. The UK should offer reciprocal access to its markets to EU firms, and maintain the current access offered to third countries (currently granted through EU equivalence). This will mean creating and establishing the UK's 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).

8. Domestic reform would help to ensure that London, and the UK more widely, remains an attractive place 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.

Glossary

AFME	Association for Financial Markets in Europe
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive (i.e. Directive 2011/61/EU)
BCG	Boston Consulting Group
BIS	Bank for International Settlements
BoE	Bank of England
CCP	Central Counter-Party
CDTA	Comprehensive Double Taxation Agreement
CEO	Chief Executive Officer
CETA	Comprehensive Economic and Trade Agreement
CFTC	Commodity Futures Trading Commission of the United States
CRD IV	Capital Requirements Directive IV (i.e. Directive 2013/36/EU)
CRR	Capital Requirements Regulation (i.e. Regulation (EU) No 575/2013)
EBA	European Banking Authority
ECB	European Central Bank
ECJ	European Court of Justice
EEA	European Economic Area
EIB	European Investment Bank
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation (i.e. Regulation (EU) No 648/2012)
EMEA	Europe, the Middle East and Africa
ESAs	European Supervisory Authorities
ESMA	European Securities and Markets Authority
FINMA	Eidgenössische Finanzmarktaufsicht (Swiss Financial Market Supervisory Authority)
FMRD	Financial Markets Regulatory Dialogue
FSAP	Financial Services Action Plan
FTA	Free Trade Agreement
FX	Foreign Exchange
GATS	General Agreement on Trade in Services
GFCI	Global Financial Centres Index
IDD	Insurance Distribution Directive (i.e. Directive 2016/97/EU)
IMD	Insurance Mediation Directive (i.e. Directive 2002/92/EC)
IMF	International Monetary Fund
LSE	London Stock Exchange
MAS	Monetary Authority of Singapore
MEP	Member of the European Parliament
MiFID	Markets in Financial Instruments Directive (i.e. Directive 2004/39/EC)
MiFID II	Markets in Financial Instruments Directive II (i.e. Directive 2014/65/EU)
MiFIR	Markets in Financial Instruments Regulation (i.e. Regulation (EU) No 600/2014)
OTC	Over The Counter
PRIIPs	Packaged Retail and Insurance-based Investment Products
PwC	PricewaterhouseCoopers
QMV	Qualified Majority Voting
SWIFT	Society for Worldwide Interbank Financial Telecommunications
TEU	Treaty on the European Union
TFEU	Treaty on the Functioning of the European Union
TTIP	Transatlantic Trade and Investment Partnership
UCITS V	Undertakings for the Collective Investment in Transferable Securities Directive V (i.e. Directive 2014/91/EU)
WTO	World Trade Organisation

Introduction

Following the vote to leave the EU, the UK needs to consider what relationship it wants to have with Europe in the future, and its national priorities for the upcoming negotiations. Few sectors are as important to the UK economy, or as tied in with the EU, as financial services. This paper examines how UK financial services currently operate in the single market, and considers what alternative arrangements the UK should pursue in the future.

A crucial question will be whether the UK seeks to stay in the single market (i.e. join the European Economic Area) or looks to negotiate a bespoke free trade agreement. As we explained in our recent paper on the EEA, we think such a model is unlikely to be the end point of the UK's new relationship with the EU – it does not address the concerns raised in the referendum, in particular on immigration, and compromises too much on sovereignty.[1] Of course, if the UK were to stay in the single market, little would change with regards to market access for financial services. Consequently, the premise of this paper is that the UK will seek to negotiate a comprehensive FTA and, therefore, we will need a new settlement for financial services.

There is reasonable evidence and precedent for an agreement on free trade of goods. The EU has 30+ FTAs with 60+ states, all of which provide fairly comprehensive reduction in tariffs on goods and access to the single market in goods (in terms of a level playing field for selling into the market). Furthermore, the UK and the EU are starting from a point where they have zero tariffs and their product standards are fully harmonised.

However, services are more complicated. There is no precedent for access to the single market in services without full membership of the single market and acceptance of all EU rules and regulations (as under the EEA model). Of course, the single market in services is far less complete, so in some sectors there is little access to be lost. However, in financial services where the 'passport' – which allows financial firms to provide services from a UK headquarters to the rest of the EU – is seen to work relatively well, there is much anxiety about exiting the single market.

Thus, it is of crucial importance to get a handle on the exact value of this passport. In which sectors is the passport most important? How hard should the UK fight to retain a passport and what would be the cost of losing it? What are the alternative arrangements?

[1] For further details, see Open Europe, 'As the UK searches for a post-Brexit plan, is the EEA a viable option?', 4 August 2016: http://openeurope.org.uk/intelligence/britain-and-the-eu/as-the-uk-searches-for-a-post-brexit-plan-is-the-eea-a-viable-option/

We attempt to begin to answer these complex questions in this paper. We focus on the key regulations and sub-sectors of the financial industry (banks, asset managers and insurers).[2] The paper starts to identify what could and should be the UK's key asks in the negotiations around financial services. Indeed, it is too early to predict what will be negotiable. It is unlikely the UK will be able to keep everything as is, but it also seems unlikely there will be no agreement at all. This paper examines what might lie in between.

[2] There are several other sub-sectors (such as fin-tech) or related sectors (professional services) which will also be impacted by Brexit and whatever the new arrangement for financial services is. These are areas for future research but are not explored in depth in this paper.

1. UK financial services – important for the UK economy and the EU

1.1 Value to the UK economy

For many years, London has been at the top of the Global Financial Services Index. Financial services is one of the UK's key export industries and, as is well documented, makes a crucial contribution to the UK economy.

Tax revenue
The financial services sector is a significant source of revenue for the Government. In 2014/15, it provided £66bn - 11% of overall tax revenue. A significant chunk of this, £30bn, came from employees' national insurance and income tax contributions.[3]

Employment
The financial services sector employs a significant number of people across the UK. A narrow definition of the financial services and insurance activities suggests that the sector employed 1.1m people in the UK in 2015. This amounts to 7% of total employment. However, broadening out the definition to include associated professions and administrative financial roles suggests the sector employed up to 1.9m people in the UK as of the end of June 2016.

Furthermore, while London is often seen as the main beneficiary of financial services, the sector is actually a major employer across the country. According to data from the ONS, 66% of jobs in the sector are outside of London.[4]

UK Financial services employment (March 2016)		
Region	Numbers	% of total jobs
East	73,000	2.3
East Midlands	38,000	1.6
London	397,000	7
North East	27,000	2.3
North West	99,000	2.7
Northern Ireland	22,000	2.5
Scotland	85,000	3.1
South East	145,000	3
South West	92,000	3.1
Wales	34,000	2.3
West Midlands	56,000	2
Yorkshire and The Humber	85,000	3.1

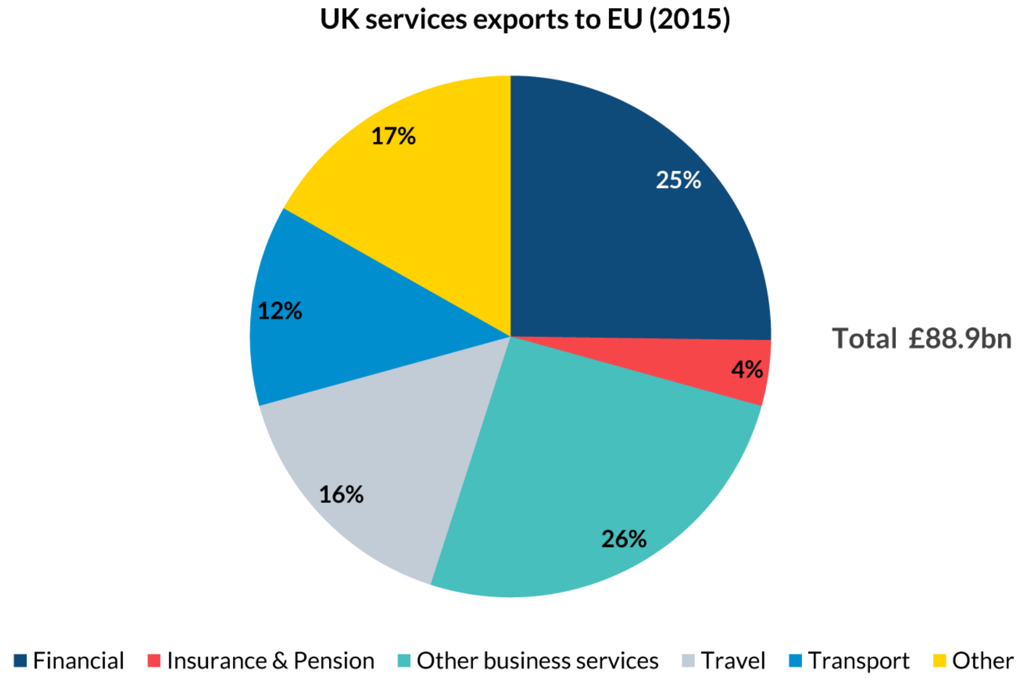
[3] Data from TheCityUK, 'Key facts about UK financial and related professional services', 7 March 2016: https://www.thecityuk.com/research/key-facts-about-uk-financial-and-related-professional-services-2016/
[4] Data from ONS, 'Workforce jobs by region and industry', released on 14 September 2016: https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/workforcejobsbyregionandindustryjobs05

Value added

The sector also accounts for a sizeable chunk of Gross Value Added (GVA) in the UK. In 2015, financial and insurance activities accounted for 7% of total UK GVA, £120bn, not including associated and related professions. According to The City UK, once exports have been added in, the sector's contribution to UK GDP amounts to £180bn - or 11.8% of the total.[5]

Trade

In terms of trade, the financial services sector is one of the few that produces a large and sustained surplus. In 2015, the UK's surplus in services with the EU was £20.9bn, largely driven by the £19.1bn surplus in financial services and £3.6bn in insurance services. In terms of services exports to the EU, financial services accounted for 25% of exports, while insurance accounted for a further 4%.



Source: ONS Pink Book

Foreign Direct Investment (FDI)

The financial services sector also draws a significant amount of Foreign Direct Investment (FDI) into the UK, accounting for around 45% of the stock of FDI in the UK.[6]

[5] Figures refer to 2014. See TheCityUK, 'Key facts about UK financial and related professional services', 7 March 2016.
[6] UK Trade & Investment (UKTI), 'Inward investment report 2013-2014', 18 July 2014: https://www.gov.uk/government/publications/ukti-inward-investment-report-2013-2014/ukti-inward-investment-report-2013-2014--2

A survey by Ernst & Young also found that 43% of investors see the banking, insurance and wealth management industries as the key drivers for growth in the UK. The UK also attracts a significant amount of investment in this area relative to the rest of Europe. In 2015, it accounted for one third of all financial services FDI in Europe.[7]

1.2 Value to the EU economy

While the value of financial services and the City of London to the UK economy is clear, its value to the EU more broadly is less understood. Despite the animosity, and more than a bit of jealousy, directed towards the City, Europe benefits hugely from having the premier global financial centre within its borders.

The main impact would be the disruption to the liquidity lines which European governments and businesses have to the huge pool of liquidity and capital markets in London. This fragmentation and break-up of existing business lines could change the funding environment for businesses across Europe.

112 companies from other EU member states are listed on the London Stock Exchange (with a market cap of £378bn), out of 2,299 firms and a total market cap of £4 trillion.[8] Rather than listing in their own or other EU member states, they sought to list in London to take advantage of the large and diverse pool of investors.

Consultancy firm Oliver Wyman has estimated that the UK accounts for £45bn out of the total £58bn in European capital markets and investment banking revenue.[9] Of this, £25bn comes via clients in the rest of Europe served from the UK, while only £10bn comes from sterling-linked products. This highlights the extent to which the UK is the centre of European capital markets and investment banking.

---

[7] See Ernst & Young, 'Foreign Direct Investment in UK financial services industry at highest level since 2006', 13 June 2016: http://www.ey.com/UK/en/Newsroom/News-releases/16-06-13---Foreign-direct-investment-in-UK-financial-services-industry-at-highest-level-since-2006

[8] See London Stock Exchange, List of all companies as of 31 August 2016: http://www.londonstockexchange.com/statistics/companies-and-issuers/companies-and-issuers.htm

[9] Oliver Wyman, 'EU scenarios and the UK financial centre', 28 April 2014: http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2014/jun/EUScenarios_UKMembership_OliverWymanResearch.pdf

TheCityUK has also highlighted the dominance of the UK as a financial services centre in the EU – across all different businesses. The UK accounts for 78% of foreign exchange turnover, 74% of over-the-counter interest rate derivatives, 85% of hedge fund assets, 64% of private equity assets and 59% of the international insurance premiums in the EU.[10] Overall, the group estimates that 35% of wholesale EU financial services take place in London.[11]

The UK insurance industry generates almost a quarter of the total insurance premiums in the EU. Of the 379 life insurance companies authorised in the UK, 179 are headquartered in another European country and passport in under the EU's Third Life Directive. Of the 903 general insurance companies authorised in the UK, 563 are headquartered in another EU country and passport in under the EU's Third Non-Life Directive.[12]

This spills over into other sectors. For example, 96% of trading done under the EU's Emission Trading Scheme currently takes place in London.[13]

There are also more qualitative measures where the UK has proven important to the development of financial services in the EU. For example, there has often been a reliance on the technical work of the UK civil service and financial regulators/supervisors when drawing up EU financial regulation. Furthermore, the UK has often been at the forefront of driving integration and openness in this sector, for example under the Financial Services Action Plan (FSAP).

The UK's value in terms of financial services also arises from the fact that its role is unlikely to be easily replicated by another EU country, particularly in the short term. Looking at the ranking of Global Financial Centres, London again ranked number 1 in 2016.[14] The next highest ranked EU city was Luxembourg at 12, followed by Frankfurt at 19, Munich at 27, Paris at 29, Dublin at 31, and Amsterdam at 33. Clearly, despite all having EU market access, London is some way ahead in other factors: infrastructure, human capital and business environment for example.

---

[10] TheCityUK, 'A guide to the EU referendum', 25 May 2016: https://www.thecityuk.com/assets/2016/Reports-PDF/A-guide-to-the-EU-referendum.pdf

[11] TheCityUK, 'The UK: Europe's financial centre', August 2016: https://www.thecityuk.com/assets/2016/Reports-PDF/The-UK-Europes-financial-centre.pdf

[12] Association of British Insurers (ABI), 'UK insurance and long-term savings – Key facts 2015', September 2015: https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2015/Statistics/Key%20Facts%202015.pdf

[13] City of London, 'London: Europe and the world's financial centre': http://www.cityoflondon.gov.uk/business/eu-and-regulation/publications/Documents/london_europe_and_the_world's_financial_centre.pdf

[14] See Z/Yen Group Limited, 'Global Financial Centres Index 20', September 2016: http://www.longfinance.net/global-financial-centres-index-20/1037-gfci-20.html

The human capital point in particular seems important. As noted in Section 1.1, the UK financial services sector employs anywhere between 1.1m and 1.9m people – all skilled or highly-skilled workers. Replicating such a large pool of skilled human capital is far from simple. For example, the entire population of the city of Frankfurt is around 725,000 – meaning that a significant proportion of the population would have to be employed directly in financial services to come anywhere close to the levels seen in London currently. This is also linked to softer issues. For example, the ability of a city to attract high-skilled labour – as a political, cultural and financial centre London is almost unique in this regard.

All of this highlights the degree to which European financial services are intertwined with the UK, and how much the EU stands to lose when the UK exits.

Of course, the passport and the single market in financial services clearly play a part in the UK's success to date, but there are a host of other reasons why this business runs through London rather than other EU capitals, including: a large skilled labour force; language; legal environment; and global integration.

A crucial point to bear in mind is that a decline in activity and investment in London is far from certain to bring significant investment or jobs to Frankfurt, Paris or Munich. Financial hubs located outside of the EU – notably New York, Hong Kong and Singapore – would be just as, if not more, likely to be the beneficiaries.

As Oliver Wyman put it in a recent study commissioned by TheCityUK,

> "This is not a 'zero sum game' within the EU. Organisations will not shift activities and employment on a one-for-one basis out of the UK to the EU. For some institutions, the cost of relocation and the on-going inefficiencies associated with a more fragmented environment could cause them to close or scale back part of their business. Others, particularly those with parents located outside of the EU, could move businesses back to their home country, reducing their overall footprint in Europe."[15]

[15] Oliver Wyman, 'The impact of the UK's exit from the EU on the UK-based financial services sector', p3.

A similar warning was also issued by Xavier Rolet, CEO of the London Stock Exchange Group, who argued,

> "The UK financial ecosystem, with clearing at its heart, makes London the most economically attractive and stable destination for global investors and issuers…This ecosystem must be championed and protected…But people in Europe and the UK should realise this isn't a zero sum game. If business leaves the UK, the European economy would suffer – and very little of that business is likely to go to Europe anyway."[16]

Perhaps even more importantly, if certain business lines no longer look profitable from the UK they may simply be discontinued altogether – a deadweight loss for the UK and EU economy.

2. How does the financial services passport work in practice and how important is it?

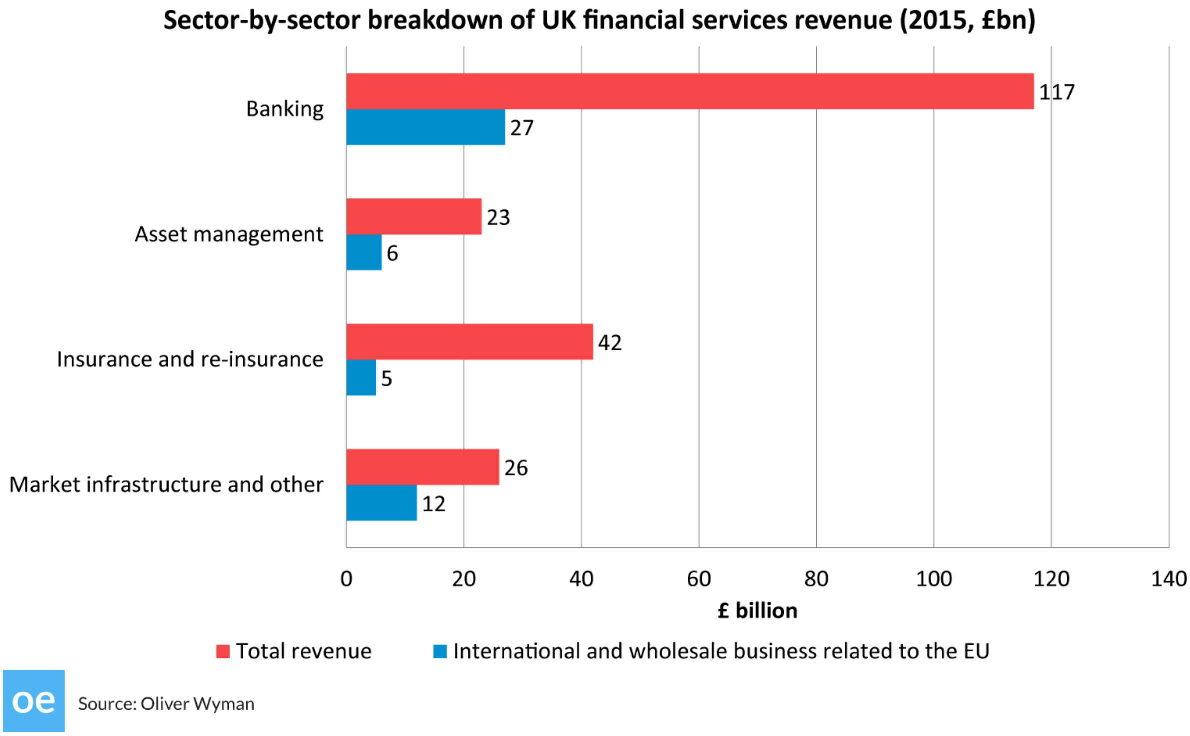
The financial services industry is diverse, so it is important to consider individual sub-sectors in turn. In this section, we look at the major sectors that account for the large majority of the industry: banking (wholesale and investment), non-banks (investment funds, asset managers, hedge funds, etc.) and insurance.

The recent Oliver Wyman study for The CityUK we mentioned briefly in Section 1.3 provides a useful overview of the data. The study estimates that, in 2015, about a quarter (£40-50bn of a total of around £200bn) of all revenues of the UK-based financial services sector came from "international and wholesale business related to the EU."[17] The report also estimates that, even in a worst case scenario (where the UK falls back on WTO terms with the EU post-Brexit), a maximum of £20bn (40% to 50%) of the EU-linked revenue would be at risk – that is, around 12.5% of overall revenue.[18]

[16] Op-ed for The Daily Telegraph, 'The City of London will be fine after Brexit – and a vengeful Europe would be shooting itself in the foot', 2 October 2016: http://www.telegraph.co.uk/business/2016/10/02/the-city-of-london-will-be-fine-after-brexit--and-a-vengeful-eur/

[17] Oliver Wyman, 'The impact of the UK's exit from the EU on the UK-based financial services sector', p6.

[18] For the graph below, we used the upper bound values provided by the study. See Oliver Wyman, 'The impact of the UK's exit from the EU on the UK-based financial services sector', p6.



2.1 Banking and wholesale finance

The banking sector is the single largest part of the financial services industry and a significant employer in the UK. The UK banking sector is integrated across the EU – with total foreign claims of UK banks in other EU states reaching $666bn at the end of the first quarter in 2016. However, it is also globally diversified and integrated, with this accounting for 21% of total UK banks claims globally.[19] When the data is expanded to include all banks based in the UK (including foreign subsidiaries) the share of claims in EU states falls to 6% of total foreign claims.[20]

Banks benefit from the EU's relatively liberal 'passporting' regime which facilitates cross-border trading. Based on the principle of mutual recognition, it allows firms from one member state to directly provide certain services to clients in other member states – for example, under the Capital Requirements Directive IV (CRD IV), a bank based in the UK can provide credit services to a corporate based anywhere in the EU once it is authorised under the passport. It also entitles them to establish branches in other member states, conducting business on the balance sheet of the parent company and under the supervisory authority of their 'home' member state (including prudential regulation on issues such as recovery and resolution).

[19] For further details, see Catherine Koch, 'The United Kingdom as a hub for international banking', BIS, 18 September 2016: http://www.bis.org/publ/qtrpdf/r_qt1609w.htm
[20] Total foreign claims of banks based in the UK taken from BIS: http://www.bis.org/statistics/a5-gb.pdf. The figure for claims on EU counterparties is calculated using BIS locational banking data on an immediate counterparty basis.

This avoids the need to set up separate subsidiaries in other states where they wish to do business. Subsidiaries are separate legal entities and therefore have their own balance sheets and are subject to host country supervision and regulation. Operating branches is therefore far more time and cost effective and requires little additional capital.

From the banking perspective, the most important regulations are CRD IV and the Markets in Financial Instruments Directive (MiFID) – as well as MiFID II and the Markets in Financial Instruments Regulation (MiFIR) which will be coming into force in 2018. But exactly which services and business lines are provided via these passports?

Original Open Europe analysis, laid out in the table below, details the most common services for which large UK banks have passports in place and whether these services are provided via branches or via cross border services. Under CRD IV the main business lines covered by the passport are: deposit taking, lending, broking, payment services, securities issuance and portfolio management. Under MiFID, they are: executing orders for clients, trading/dealing on own account, investment advice, underwriting, foreign exchange services and portfolio management.[21]

[21] This data has been compiled in-house by Open Europe and is based on each firm's submissions to the Financial Conduct Authority register, available here: https://register.fca.org.uk/

		RBS Plc		Barclays		Lloyds Banking Group								HSBC Plc			
						Lloyds Bank Plc		Lloyds Private Banking		Bank of Scotland		TSB Bank		HSBC		HSBC Private bank	
		Branch	*Service*	*Branch*	*Service*	*Branch*	*Service*	*Branch*	*Service*	*Branch*	*Service*	*Branch*	*Service*	*Branch*	*Service*	*Branch*	*Service*
Number of EEA states passport active for		15	30	10	31	4	31	0	17	4	31	0	30	10	30	0	30
CRD IV (prev BCD)	*Deposit taking*																
	Money broking																
	Portfolio management																
	Lending (consumer & commercial)																
	Trading own account/for customers																
	Securities issuance or related services																
	Advice (M&A, strategy)																
	Payment services																
MiFID	*Reception/transmission of orders*																
	Executing orders for clients																
	Dealing on own account																
	Portfolio management																
	Investment advice																
	Underwriting financial instruments																
	Admin of financial instruments for clients																
	Foreign exchange services																
	Investment research/financial analysis																
Insurance mediation	*Insurance/reinsurance mediation*																
EEA authorised subsidiary passporting into UK		NL	NL, GI		IRE, ESP		GI								FR, DE, NL, PL, MT		LX

Source: Open Europe analysis, FCA register

There are a few other points we can draw from the table. All the big UK banks have the option of passporting their services across the EU/EEA. RBS operates branches in 15 EEA states, Barclays and HSBC in ten, while Lloyds has far fewer. Barclays, RBS and HSBC also have EEA companies (subsidiaries) which passport into the UK and possibly also around the rest of the EU. These findings are relevant, since turning a branch into a subsidiary will likely be slightly more cost effective than starting from scratch, if the passport were lost. Similarly, for those banks which already have European subsidiaries, expanding them further to cover more EU business may be even easier and cheaper than doing so for a branch.

But how much revenue do these operations generate for the UK banking sector? Once again, looking at the stylised example of the big four banks, we can see that they all generate less than 10% of the global revenue in the rest of Europe (UK excluded).[22] However, much of the revenue generated by branches and cross-border services under the passport will be booked in London and as such would likely fall under UK revenue.

UK banks % of revenue 2015		
	r-EU	*UK*
RBS	7.4	87.2
Barclays	8.8	47.8
Lloyds	N/A	N/A
HSBC	9.0	24.4

Industry reports suggest that around a fifth of bank revenue in the UK could be at risk if the passport is lost, which implies that around 20% of the revenues are generated via the passport.[23] The recent Oliver Wyman study for TheCityUK we cited earlier estimates that the total revenues of the UK-based banking sector in 2015 was between £108bn and £117bn. Of this, between £23bn and £27bn were "international and wholesale business related to the EU" – that is, approximately between 21% and 23%.[24]

Combining all the data above, a few things become clear in terms of UK banks' reliance on the passport. Lloyds Banking Group seems to make less use of the passport, particularly via branches, and is heavily focused on domestic revenue. HSBC is a globally diversified bank, meaning a lower share of overall revenues is likely linked to the passport.

[22] Lloyd's revenue from outside the UK is negligible and is therefore no longer separately classified.
[23] See, for instance, the Financial Times, 'Fifth of City revenues could be hit by hard Brexit', 2 September 2016: http://www.ft.com/cms/s/0/72aa537a-7116-11e6-a0c9-1365ce54b926.html#axzz4JN0IX4sc. Similar figures and proportions came up in our private discussions and meetings with industry representatives as background for this paper.
[24] Oliver Wyman, 'The impact of the UK's exit from the EU on the UK-based financial services sector', 5 October 2016, p6: http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/oct/Brexit_POV.PDF

It also has a number of other EU subsidiaries, which have access to the passport. The situation for RBS and Barclays is less clear, although the former is clearly more domestically focused than the latter. Their extensive branch network also means they have options in terms of expanding into subsidiaries or apply for local licences (explored in detail in Section 3).

Looking beyond just UK national banks to the sector as a whole, in a recent letter to the House of Commons' Treasury Select Committee, Chief Executive of the Financial Conduct Authority (FCA) Andrew Bailey said that 5,476 UK firms currently hold a total of 336,421 passports which they utilise to provide financial services across the EU.[25] The table below details how many firms hold at least one passport in respect to CRD IV and MiFID – the regulations relevant for the banking sector. Outbound refers to UK firms utilising the passport to provide outward services to firms in other EU/EEA states, while inbound refers to firms in other EU/EEA states using the passport to provide services in the UK.

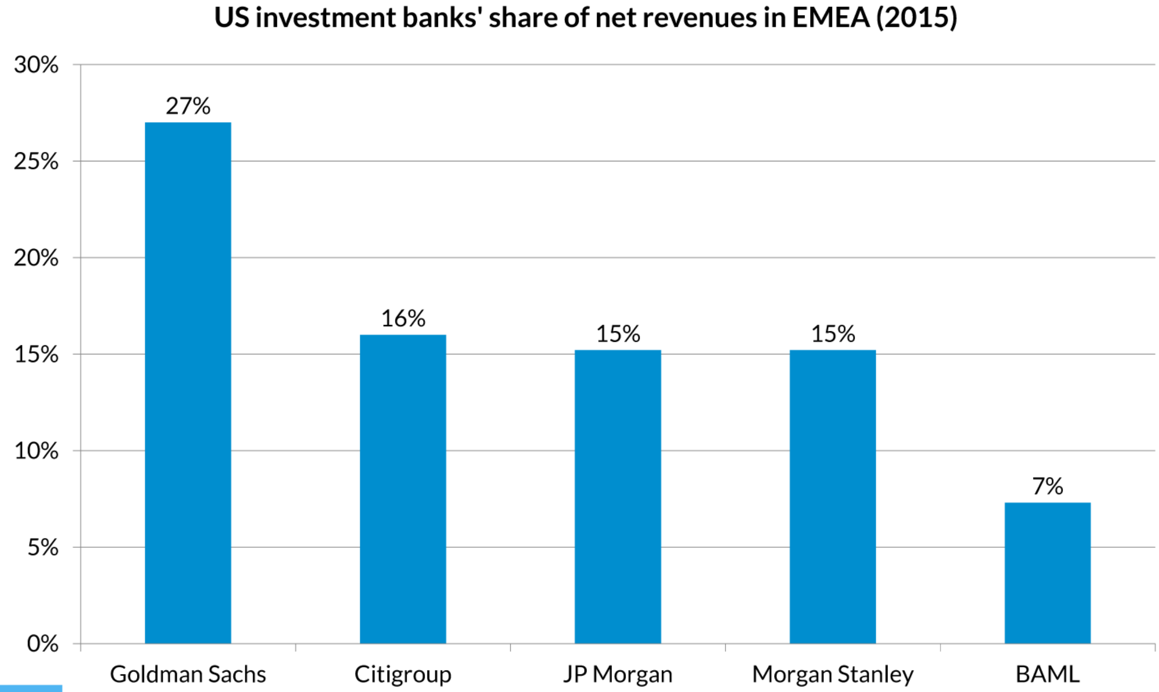
Directive	Outbound	Inbound
Capital Requirements Directive IV (CRD IV)	102	552
Markets in Financial Instruments Directive (MiFID)	2,250	988

Part of the reason for this is that the 'passporting' regime also incentivises non-EU firms to establish in one EU member state on the basis that this allows them to freely provide services across the EU from that base.[26] This helped the UK to establish itself as an entry point for banking into the EU's single market with many foreign banks headquartering their European subsidiaries in London and then using the passport system to operate branches and business across the rest of the EU. As AFME has noted, this has allowed firms (both EU and non-EU) to "centralise their provision of capital market services in a single hub location in the EU."[27] For example, there are currently over 1,400 financial services firms in the UK that are majority foreign-owned, from around 80 countries.[28]

One of the prime examples of foreign firms using the UK as an entry point to the single market is that of the large US investment banks. As was made clear during the referendum, they are vocal advocates of the EU largely due to the financial services passport.

[25] See the letter from FCA Chief Executive Andrew Bailey to the Rt Hon Andrew Tyrie MP, Chairman of the House of Commons' Treasury Select Committee, 17 August 2016: http://www.parliament.uk/documents/commons-committees/treasury/Correspondence/AJB-to-Andrew-Tyrie-Passporting.PDF
[26] Cooke et al, 'Financial Services and the City', in Regent's University London, 'UK and the EU: costs, benefits, options', October 2013, p58.
[27] AFME and Clifford Chance, The UK Referendum – challenges for Europe's capital markets: a legal and regulatory assessment', 21 March 2016: https://www.cliffordchance.com/briefings/2016/03/the_uk_referendumchallengesforeurope.html
[28] City of London, 'An indispensable industry: Financial services in the UK', 2013: www.cityoflondon.gov.uk/about-the-city/what-we-do/Documents/an-indispensable-industry.pdf

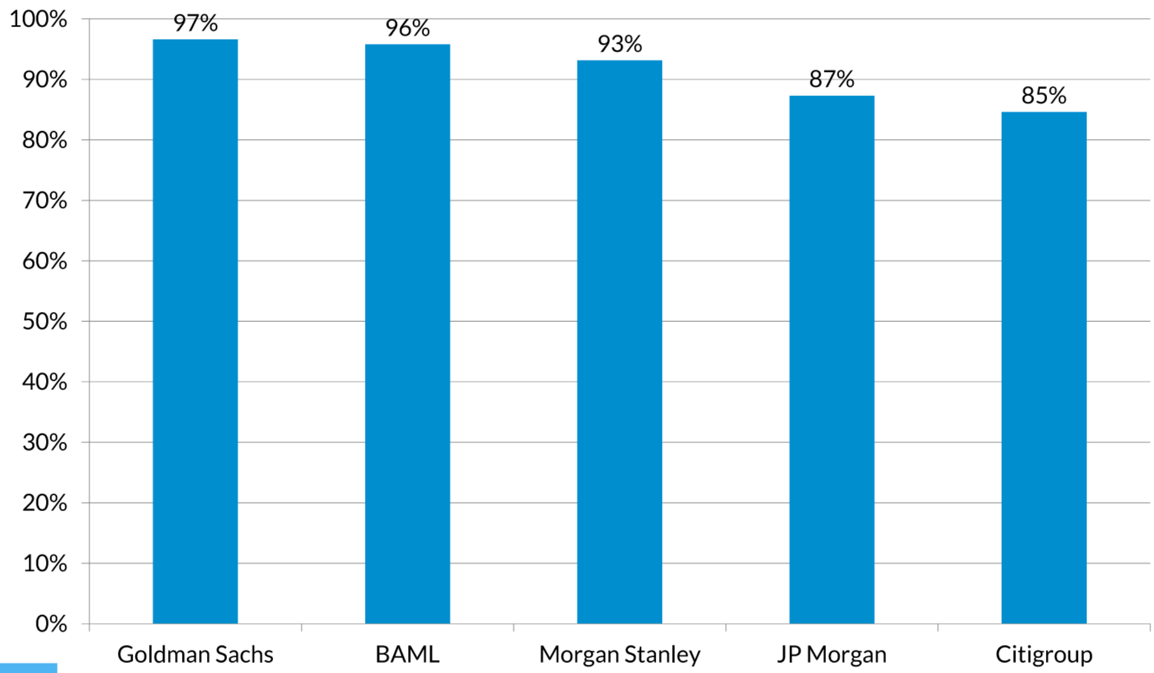
But just how important is it to them? As the chart below shows, five of the largest US investment banks make anywhere between 7% and 27% of their net revenues in Europe, the Middle East and Africa. On average these big five investment banks make 16% of their revenue in EMEA.



Source: Company reports and SEC filings

The large majority of these revenues run through London. As the chart below highlights, the bulk of turnover in EMEA for these large US investment banks is booked through their European headquarters in London.[29] Combining the two, we can see that, on average, around 14.5% of their revenue is booked through their London subsidiary – hence this is the maximum amount that could potentially be reliant on passporting.

[29] For further details, see Charles Goodhart and Dirk Schoenmaker, 'The United States dominates global investment banking: does it matter for Europe?', LSE financial markets group paper series, March 2016: http://www.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/SP243.pdf



Source: Goodhart & Schoenmaker

However, EU market access is not the only reason for the UK's success. Other factors include a large skilled workforce, broad and liquid capital markets and a stable regulatory environment.

Furthermore, as previously discussed, the passport is not a one-way street. A number of European banks utilise it to provide services into the UK which, as a global financial centre, remains a large market in its own right. For example, Deutsche Bank generated 19% of its revenue in the UK last year,[30] while French bank Société Générale also has a large UK operation which generates around 6% of total firm revenues.[31]

According to the EBA's Credit Institution register, currently 76 banks from EEA countries have branches in the UK (and therefore make use of the passport).[32] This compares to 214 full CRD registered banks and 79 non-EEA banks which have branches in the UK. Overall, the FCA has said that 8,008 EEA firms are currently using a total of 23,532 passports to provide financial services in the UK.

[30] See Bloomberg, 'Deutsche Bank set for investor scrutiny as short-sellers circle', 24 July 2016: http://www.bloomberg.com/news/articles/2016-07-24/deutsche-bank-set-for-investor-scrutiny-as-short-sellers-circle
[31] See Société Générale, 'Group results – Q2 and H1 2016', 3 August 2016: 'https://www.societegenerale.com/sites/default/files/documents/R%C3%A9sultats%20financiers/2016_EN/T2/Presentation_Q2_2016.pdf
[32] European Banking Authority, Credit Institution Register, accessed on 12 September 2016: https://eportal.eba.europa.eu/cir/faces/publicDisclaimer.xhtml#no-back-button

It is worth noting, however, that retail banking remains largely domestic, particularly in the UK. As the European Commission pointed out in a recent consultation paper,

> "The current level of direct cross-border transactions in retail financial services is limited, with consumers largely purchasing these products in their domestic market and firms overwhelmingly serving markets in which they are physically established."[33]

The Commission also cited a Eurobarometer survey released in March 2012 showing that less than 3% of respondents said they had already purchased products such as credit cards or current accounts from banks located in another EU member state.[34] The Commission further noted that cross-border loans within the Eurozone amount to less than 1% of total household loans in the area.[35]

2.2 Non-banks

The non-bank sector is diverse and encompasses a number of players including, among others: asset managers, Money Market Funds, hedge funds, private equity, and venture capital.

For these sectors, passporting is introduced largely through the Alternative Investment Fund Managers Directive (AIFMD) and the Undertakings for Collective Investment in Transferable Securities (UCITS). In theory, it allows asset managers to market their services in all EU member states, opening up a huge potential market. This also increases the choice for consumers of such services, boosting competition.

UCITS funds are profitable and imitated globally. Between 2009 (when the EU adopted the passport for UCITS funds) and 2013, almost every EU member state has seen a rather substantial increase in the number of registrations of UCITS funds. In the UK, the number of registrations of UCITS funds jumped from 3,482 in 2009 to 5,144 in 2013 – a 48% increase over the period. Under the passport, these funds can be marketed and sold to investors across the EU.

The AIFMD covers managers of all types of investment funds – hedge funds, private equity funds, real estate funds, etc. – that are not covered by the UCITS Directive.

[33] European Commission, 'Green paper on retail financial services', 10 December 2015, p6: http://ec.europa.eu/finance/consultations/2015/retail-financial-services/docs/green-paper_en.pdf
[34] European Commission, 'Special Eurobarometer 373 – Retail financial services', March 2012: http://ec.europa.eu/internal_market/finservices-retail/docs/policy/eb_special_373-report_en.pdf
[35] Data cited in European Commission, 'Green paper on retail financial services', 10 December 2015, p6.

It applies to any fund manager who manages total assets worth €100 million or more.[36] The AIFMD creates a 'passport system' for EU-based managers of alternative investment funds, mirroring the one introduced by the UCITS IV Directive.[37] Managers authorised by the national regulator of one EU member state can market their funds to professional investors in any other EU member state. It also allows, in certain cases, the marketing of non-EU AIFs to professional investors in other EU states.

Under both these regulations there are two different kinds of passport. There is a 'management passport', which allows asset managers based in one EU member state to provide their services to funds domiciled anywhere in the EU. And there is a 'marketing passport', which allows EU-domiciled funds to be marketed to clients across the bloc.

When they come into force, MiFID II/MiFIR will also allow investment firms to provide cross-border investment services (such as advice on shares and collective investment schemes), establish branches and have remote access to market infrastructure.[38]

Overall, at least in theory, combined the various regulations and passports should allow funds to be managed in the UK but marketed and sold across the EU. The table below details how many firms hold at least one passport with regards to UCITS or AIFMD, both in terms of passporting in to and out of the UK.

Directive	Outbound	Inbound
UCITS Directive	32	94
Alternative Investment Fund Managers Directive (AIFMD)	212	45

However, in reality, the passport is less complete than in banking and therefore is of less value. While services can be offered in other countries, the actual marketing of funds is subject to various national frameworks, thereby often creating other barriers.[39] Various national regulators, for instance, charge fees on fund managers based in other EU member states – in some cases for the mere processing of their passport notification. This can make it quite expensive to passport funds into multiple host countries, especially for smaller asset managers.

[36] The threshold is raised to €500 million if the funds are not leveraged and investors have no redemption rights for at least five years since the initial investment in each fund.
[37] Directive 2009/65/EC: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF
[38] See FCA, 'Passporting', last updated on 25 May 2016: https://www.fca.org.uk/firms/passporting
[39] EU regulation in this area also looks out of step with the global approach to the industry. Regulation is often poorly targeted and subject to one-size-fits-all (be it cross country, across financial services or across different sized firms).

In addition, these supervisory fees usually apply to individual funds – something which drives the cost further up because it means a manager has to pay multiple times if it wants to passport multiple funds.

In a previous paper with the New City Initiative (NCI), we estimated that a UK-based fund manager marketing and distributing in all the other 27 EU member states plus Switzerland would face total initial costs of over €1.5 million. Total on-going maintenance costs – allowing for the continuation of cross-border marketing – could be near €1.4 million per year.[40]

In a recent assessment of the passport under the AIFMD, ESMA itself raised a number of concerns,

> "These issues include: i) divergent approaches with respect to marketing rules, including heterogeneity of fees charged by the NCAs where the AIFs are marketed and the definition of what constitutes a "professional investor"; ii) varying interpretations of what activities constitute "marketing" and "material changes" under the AIFMD passport in the different Member States."[41]

Nonetheless, it ultimately concluded that the AIFMD framework still functions well and are used by parts of the industry.[42]

This is borne out by the data. According to the latest survey published by the Investment Association (IA), £1.2 trillion of assets were managed from the UK for European clients in 2015 – meaning slightly over a fifth (21%) of total assets managed by IA members last year (£5.7 trillion) were tied to European clients. On the flip side, 9% of assets in the UK were managed by European headquartered funds.

However, the same report also notes that there is an estimated £800 billion of assets whose management is delegated to UK-based asset managers for funds domiciled in Dublin and Luxembourg.[43]

---

[40] For further details, see Open Europe and New City Initiative, 'Asset management in Europe: The case for reform', July 2015: http://openeurope.org.uk/intelligence/economic-policy-and-trade/asset-management-in-europe-the-case-for-reform/

[41] ESMA, 'Opinion to the European Parliament, Council and Commission, and responses to the call for evidence on the functioning of the AIFMD EU passport and of the National Private Placement Regimes', 30 July 2015, p16: https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1235_opinion_to_ep-council-com_on_aifmd_passport_for_publication.pdf

[42] There also remain some protectionist elements within these regulations. For example, under AIFMD, while funds can be managed from a single EU location the deposits relating to the fund must be kept in the same member states as where the fund is located. So while a UK based asset manager may be managing a French fund from London, the deposits relating to that fund must be kept in France. For further details, see Matheson, 'AIFMD factsheet - Depositaries', May 2016: http://www.matheson.com/images/uploads/publications/AIFMD_Factsheet_Depositaries.pdf

As we will explain in further detail in Section 3, the delegation of portfolio management functions is also possible towards third countries – provided certain conditions are met. Therefore, this appears to suggest only a small fraction of total assets under management – a maximum of £400 billion, or 7% – would be affected by potential disruptions from the loss of the AIFMD and UCITS management passports after Brexit.[44]

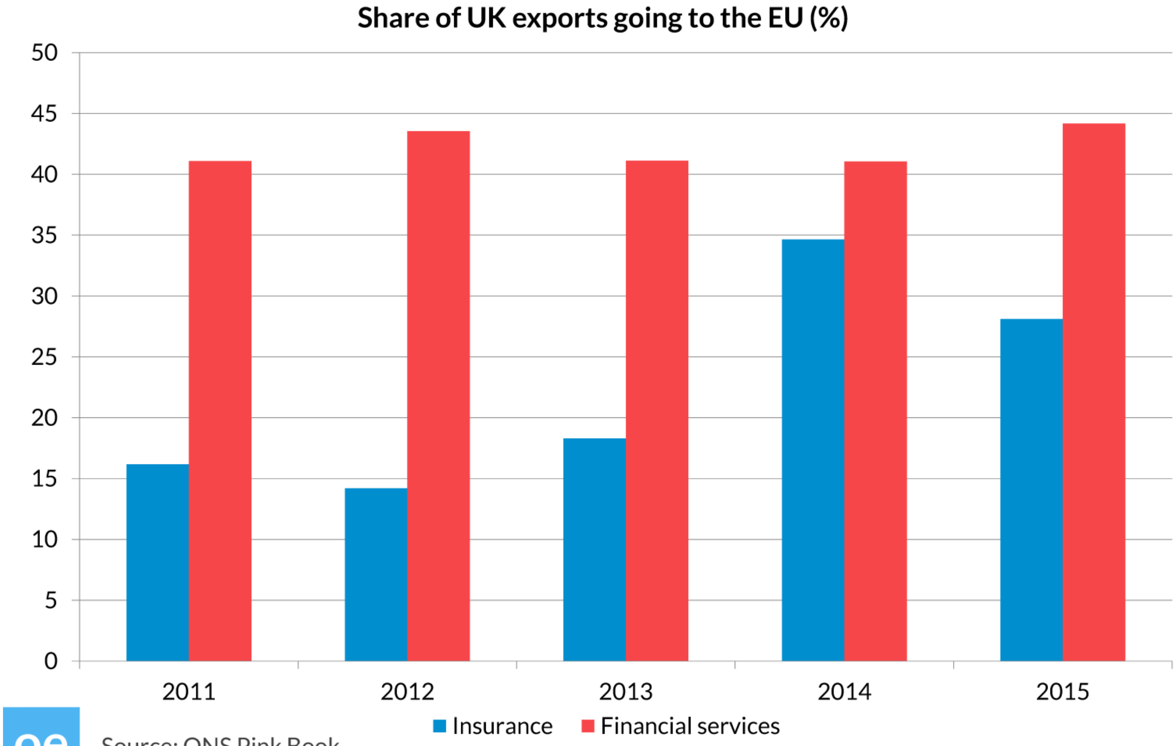
It is also worth bearing in mind that, while the UK is a leading hub for asset management, it is currently not Europe's preferred domicile for funds. In 2015, for instance, the UK was only the fifth largest centre in Europe in terms of domiciled funds – behind Luxembourg, Ireland, Germany and France.[45]

2.3 Insurance

The UK insurance industry is the largest in the EU, the third largest in the world and one of the UK's export strengths. However, UK insurance is a globally diversified business. In 2015, the EU accounted for 28% of the UK's total insurance and pension exports, although since 2012 it has averaged around 22% (increasing in the last two years).[46] This compares to 44% in 2015 for the rest of financial services.

This is confirmed by the recent Oliver Wyman study we cited at the beginning of Section 2. The sectoral breakdown shows that the share of revenue tied to EU business is much lower for the insurance industry – only between 8% and 12% of last year's total revenue.

[43] Investment Association, 'Asset management survey 2015-2016', September 2016, p15: http://www.theinvestmentassociation.org/investment-industry-information/research-and-publications/asset-management-survey/download-the-survey.html
[44] This £400m if calculated by taking the £800m domiciled in Dublin and Luxembourg from the total £1.2 trillion in funds managed in the UK for European clients. This is an upper bound as some of this £400m may well be domiciled in other parts of the EU with management delegated to the UK, rather than domiciled and managed in the UK for European clients.
[45] Data from the European Fund and Asset Management Association (EFAMA), cited by Investment Association, 'Asset management survey 2015-2016', September 2016, p74.
[46] Data from ONS, 'UK balance of payments – The Pink Book 2016', released on 29 July 2016: https://www.ons.gov.uk/releases/unitedkingdombalanceofpaymentsthepinkbook2016



Source: ONS Pink Book

As for the financial services sector more broadly, the strength of the UK as an insurance centre relies on a number of factors: access to a large pool of capital, skilled support industries such as accountancy and legal services and human capital and knowhow built up over many decades. These will likely naturally continue to exist outside of the EU.

The UK industry operates through brokers and subsidiaries worldwide and domestically for products such as life, motor and home insurance. The industry is highly regulated in both the selling of products and in the nature of the risks it takes on – as well as the amount of capital insurance firms need to hold as a result. Although many insurance rules are coordinated at a global level by the International Association for Insurance Supervisors (IAIS), these regulations are largely implemented via the EU and include (but are not limited to):

- Solvency II – governing the amount of capital insurance companies need to hold.
- MiFID II (Markets in Financial Instruments Directive II), PRIIPs (Packaged Retail Investment and Insurance Products) and IMD II (Insurance Mediation Directive II) – governing selling, disclosure and investments.[47]
- The Insurance Distribution Directive – due to be fully implemented in early 2018.

[47] For further details, see Ernst & Young, '2016 European insurance outlook', 2016: http://www.ey.com/Publication/vwLUAssets/EY-2016-european-insurance-outlook/$FILE/EY-2016-european-insurance-outlook.pdf

As with CRD IV and MiFID in the case of banks, and AIFMD and UCITS in the case of non-banks, these regulations allow UK insurance firms to passport into the EU. As in other sectors, this largely takes two forms: the freedom of providing cross-border services, whereby insurance services can be provided directly from London to any client around the EU; and the freedom of establishment, where firms have the right to establish branches in other EU states and provide services to local customers. The main regulation through which the passport is operated is now Solvency II. This covers all types of insurance from life through to maritime. The table below highlights the number of firms which have at least one passport under the relevant EU legislation.

Under EU rules, any insurer utilising the passport is not required to hold deposits or trust funds in other EU states, they can keep their deposits in a single pool such as the UK if they see fit.

Directive	Outbound	Inbound
Solvency II Directive	220	726
Insurance Mediation Directive (IMD)[48]	2,758	5,727

Further evidence suggests that the passport for actually providing insurance services is not widely used by the insurance industry. Of the cross border insurance business provided across the EU, 13% is done via branches (i.e. utilising the passport) while 87% is done via subsidiaries (not using the passport).[49]

There are a number of potential reasons behind this, but one highlighted by Bruegel is that insurance firms are keen to keep risks separate and isolated – meaning that a separately capitalised subsidiary makes sense.[50] This is particularly true for retail insurance services, where a presence on the ground and local knowledge are paramount, therefore are often offered via subsidiaries.

Insurers themselves confirm that the passport is not effective for insurance firms. For example, Mark Wilson, CEO of Aviva Plc the UK's second largest insurance firm, said recently,

> "The reality is that London is home for insurance, so for us it [Brexit] doesn't make much difference…In the EU there is not one single insurance market. It's no easier for me to do business in France than Singapore or China." [51]

[48] A huge number of firms have access to the insurance mediation passport – essentially intermediary firms who help to provide assistance to customers to make sure insurance contracts are fulfilled. Clearly, this is not limited to insurance firms but all kinds of financial firms.
[49] See Schoenmaker and Sass, 'Cross-border insurance in Europe: Challenges for supervision', The Geneva papers on risk and insurance, July 2016, Volume 41 Issue 3, pp351-377: http://link.springer.com/article/10.1057%2Fgpp.2015.35
[50] For further details, see Bruegel, 'Losing the EU passport would damage the City of London', 28 June 2016: http://bruegel.org/2016/06/losing-eu-passport-would-damage-city-of-london/
[51] Quoted by Bloomberg, 'City of London needs Brexit timetable certainty, Aviva CEO says', 9 September 2016: http://www.bloomberg.com/news/articles/2016-09-09/city-of-london-needs-

The IMF came to a similar conclusion in its financial sector assessment in June ahead of the EU referendum, saying,

> "UK insurance companies would be relatively insulated from the effects of Brexit, even in the case of exit from the EEA. Many UK insurers already operate in other EU countries via subsidiaries, with the notable exception of Lloyd's. So even if the UK did not obtain EEA membership, they would not incur costs of subsidiarising branch networks or be significantly affected by loss of 'passporting', although they would be impacted by the regulatory uncertainty post-exit. However, the impact on Lloyd's and the London insurance market could be significant absent cross-border supervisory recognition."[52]

As the IMF points out, the Lloyd's of London insurance market (a global centre of commercial insurance) must be considered separately to other insurance firms. The market brings together business (policyholders) and capital (members, both corporate and non-corporate) with a pool of underwriters.[53] Unlike in some countries, the EU recognises the Lloyds market as a more conventionally organised insurance institution. This allows the underwriters who form Lloyd's to write business for other EU markets, either directly via cross-border services or via branches in other states.

In 2015, the EU/EEA accounted for £2.9bn or 11% of Lloyd's Gross Written Premium. According to Hampden Group, that £2.9bn is made up of:

- £1.1bn Reinsurance
- £557m Marine, Aviation and Transport (MAT)
- £400m is non-MAT business currently underwritten by local cover-holders under Lloyd's branch licences
- £800m is the balance (undefined)

The final £800m is the part which is reportedly likely to be most directly impacted by the passport as it is provided via cross-border services.[54] This suggests that only 3% of Lloyd's Gross Written Premium is very closely tied to the passport, out of the 11% which relates to business in the EU/EEA.

---

brexit-timetable-certainty-aviva-ceo-says. Similarly, the UK's largest insurer, Legal & General, said before the vote that Brexit would have "little direct impact" given that the firm is heavily UK-focused. See The Daily Telegraph, 'Legal & General says Brexit would have little impact on its business', 1 March 2016: http://www.telegraph.co.uk/business/2016/03/01/legal-and-general-says-brexit-would-have-little-impact-on-its-bu/

[52] IMF, 'United Kingdom – Financial sector assessment programme/Financial system stability assessment', IMF Country Report No 16/167, June 2016, p43: https://www.imf.org/external/pubs/ft/scr/2016/cr16167.pdf

[53] For further details, see Lloyd's, 'What is Lloyd's?', retrieved on 19 September 2016: https://www.lloyds.com/lloyds/about-us/what-is-lloyds

[54] This has been confirmed by reports of speeches given by Lloyd's leadership to market participants. See, for instance, Lloyd's List, 'Lloyd's in talks to maintain EU licences on Brexit', 1 July 2016: https://www.lloydslist.com/ll/sector/insurance/article529493.ece

This is supported by recent comments from Lloyd's of London Chief Executive Inga Beale, who suggested that around 4% of revenues are tied to the passport.[55]

Therefore, while the passport is important in allowing Lloyd's of London to provide services across the EU, it also remains a globally diverse business – the company's Chairman John Nelson has expressed disappointment at the result but said it is not "a life-threatening issue" for the market.

Unlike banking and non-banking, there is some precedent for a third country having access to the insurance sector passport – namely Switzerland. However, the agreement between Switzerland and the EU is very narrow and specific.

The EU-Swiss agreement on direct insurance other than life insurance

In October 1989, the EU and Switzerland sealed a bilateral agreement on direct insurance other than life insurance – which then came into effect on 1 January 1993.[56]

Under the agreement, Swiss and EU insurance companies are granted freedom of establishment within the territory of the other contracting party. In other words, Swiss insurance companies are allowed to open branches across the EU subject to prior authorisation from the national supervisor of the host member state – and vice versa. Once established, these branches must be granted equal access and operating conditions by the host country.

The agreement can be terminated by either contracting party by one year's notice. It would continue to apply during that year, while the EU and Switzerland would aim to "jointly agree on rules governing the situation" of insurance firms authorised to open branches on their respective territories. If no deal can be struck by the end of the one-year transition period, those branches would become subject to the standard third-country regimes of the EU or Switzerland – but could not be automatically withdrawn authorisation.[57]

The EU-Swiss agreement is relatively narrow in scope. It does not cover life insurance, re-insurance or social insurance. Nor does it apply to cross-border services that are not provided through branches – meaning that the insurance companies wanting to take advantage of the agreement must have personnel based in the host country.

Nonetheless, the EU-Swiss insurance agreement shows that in principle the UK could try and negotiate bilateral arrangements with the EU to secure greater market access than it is currently envisaged under equivalence.

[55] Cited by BBC, 'Lloyd's of London considers setting up EU subsidiary', 22 September 2016: http://www.bbc.co.uk/news/business-37437732
[56] For further details, see the website of the Swiss Financial Market Supervisory Authority (FINMA): https://www.finma.ch/en/documentation/legal-basis/international-treaties/
[57] See Article 42 of the EU-Swiss agreement: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:21991A0727(01)&from=EN

History of the financial services passport

While the concept of free movement of services has existed since the Treaty of Rome in 1957, in reality the single market in services and financial services only became truly enforceable and more than just ad hoc measures with the Single European Act in 1987 and then the Maastricht Treaty in 1992. This legislation began the process of breaking down barriers in the single market, while the period saw the introduction of the concept of 'mutual recognition'.

Specifically in terms of financial services, the European Commission published a White Paper in 1985 which laid out the initial framework for a single banking licence and mutual recognition. This was then formally turned into law with the Second Banking Directive in 1989, which essentially created the first banking passport by allowing banks to operate branches in other EU states largely under 'home state' supervision. Similarly, the original UCITS Directive was introduced in 1985 but didn't include what would be considered a 'passport'. It was not until the Directive was updated in 1998, eventually implemented in 2001/2 in the form of UCITS III, that the passport began to resemble what we now have in force.

In 1999, another big step forward was taken in terms of the passport and the single market in financial services in terms of the Financial Services Action Plan (FSAP). Up until this point, financial services integration had focused largely on banking, insurance and some limited fund management – the FSAP also sought to expand to securities and other investment products. For example, the Prospectus Directive was introduced in 2003 aimed at providing a 'single passport' for issuers of debt and equity so that they can be sold across the EU once they have met the requirements in a single state. This was also supported by the Investment Services Directive aimed at creating a single securities market. Overall, the FSAP comprised 42 measures aimed at developing the single market in financial services – not all legislative – and included areas such as prudential supervision. However, more progress was made in some areas (such as integration of wholesale financial markets) than others (such as comprehensive and joined-up prudential supervision and retail banking).

The next big leap came with the regulatory push after the 2008 financial crisis. However, as might be expected, this was more focused on effective supervision and regulation than necessarily on deepening the passporting or services integration aspects of the single market in financial services. Between 2008 and 2014, the Commission tabled 30 proposals in this area.[58] There was also the creation of the European Supervisory Authorities. Alongside this came the creation of the 'single rulebook' focused on stronger prudential regulation as well as clearer mechanisms for bank recovery and resolution. This also went hand-in-hand with greater regulation of areas that had previously not been under the spotlight – such as clearing, central counterparties, and OTC derivatives. This period also saw the wider introduction of the 'equivalence' procedure into a number of regulations which standardised third country access in some sectors.

Why is all this important? What we can see is that the passport and its components as we know them now have not always existed. Mutual recognition in banking has a history stretching back to the start of the 1990s, and while elements of asset management and insurance passports were introduced over the following decade, they did not begin to properly resemble what we would now regard as 'passports' until the beginning of the 2000s. The big liberalisation in terms of securities and derivatives has only really happened in the past decade.

[58] See European Commission, 'A comprehensive EU response to the financial crisis: substantial progress towards a strong financial framework for Europe and a banking union for the Eurozone', 28 March 2014: http://europa.eu/rapid/press-release_MEMO-14-244_en.htm

Furthermore, a number of areas have only recently been brought under EU regulation and supervision. All this highlights that passports have been in place in some sectors longer than others and have had more say in dictating the structure and growth of certain industries (e.g. wholesale banking) over the past decades than others.

3. Potential alternatives to passporting

When the UK leaves the EU, it will need to consider how to ensure that London remains a global hub for financial services. This paper assumes that the UK will not remain part of the EEA, and therefore a new deal will be needed for financial services access. Broadly, there are three options open to Government and financial services firms that could, at least to an extent, help preserve the way financial services business is provided across the EU from London.

1. Bespoke agreements – negotiate specific agreements, similar to the Swiss insurance agreement, to preserve certain passports or levels of access.
2. 'Equivalence' – utilising a regime for third country access under certain EU regulations.
3. Local arrangements – set up local branches, subject to local requirements, not eligible to passport across the bloc. Set up subsidiaries, subject to licences and capital costs, but able to passport across the bloc.

Numbers 1 and 2 would be negotiated at the Government level, while 3 involves decisions taken at the firm level to try and mitigate the impact of losing the passport. Similarly, 1 would be an entirely fresh approach, while 2 and 3 build on existing options open to other third countries.

This section examines the equivalence process in detail and then looks at all the options for a number of different sectors and regulations.

3.1 Equivalence – What is it and how does it work?

Certain EU financial regulations allow for third countries outside the EU to be granted 'equivalence', and consequently gain access to some of the advantages of membership of the single market. In some cases, gaining 'equivalence' can provide passport-like rights for firms based in the third party country. A country can be granted equivalence if the Commission recognises that the legal, regulatory and/or supervisory regime of a third country is equivalent to the corresponding EU framework.

As such, equivalence has been widely cited as a potential alternative which the UK could fall back if it does not negotiate full access to the single market.

However, equivalence cannot replace membership of the single market. At best, it is a partial solution for certain parts of the industry.

Equivalence is not granted to individual firms but to countries. Crucially, it applies regulation by regulation. While some offer passport-like rights – e.g. MiFIR – others offer no equivalence at all – e.g. CRD IV. Therefore, even if the UK is granted equivalence across all possible areas, it would do nothing to support access for wholesale banking, for example. The table below summarises which legislation offers equivalence across the main financial service sectors:

Industry	Main EU law	Is EU equivalence available?	Passport-like rights?
Banking	MiFIR (investment banking)	Yes	Yes
	CRD IV (deposit-taking, lending, etc.)	No	No
Insurance	Solvency II	Yes (re-insurance)	Yes
		No (direct insurance)	No
Asset management	AIFMD (professional clients)	No	Indirectly via MiFIR
	UCITS V (retail clients)	No	No

Importantly, the EU grants equivalence on specific aspects of individual regulations. There are currently nearly 40 equivalence requirements in place in total. For example, there are three separate areas for evaluation under Solvency II (calculation of capital requirements, group supervision and reinsurance) – meaning that equivalence in all of them is needed in order for a third country's regulatory regime for insurers to be considered as fully equivalent to the EU's. To date, only Switzerland and Bermuda have achieved full equivalence under Solvency II.[59] Other third countries have gained partial equivalence – which is, however, limited in time. Japan, for instance, has been granted equivalence for calculation of capital requirements and reinsurance – for ten and five years respectively.[60] A summarising table of all the equivalence decisions granted by the EU to date is provided in Annex 3.

Negotiating equivalence is a political process. The European Commission's Directorate General for Financial Services (DG FISMA) is responsible for carrying out technical assessments of equivalence. These are usually based on advice from the three pan-EU financial supervisors – EBA, ESMA and EIOPA. Only after such an assessment is successfully concluded can the Commission make a formal decision to grant equivalence.

A third-country firm is only allowed to operate throughout the EU for as long as the regulatory and supervisory framework of the country where the firm is based is deemed equivalent by the Commission.

[59] European Commission, 'Equivalence decisions taken as at 19 September 2016': http://ec.europa.eu/finance/general-policy/docs/global/equivalence-table_en.pdf
[60] See Commission Delegated Decision (EU) 2016/310 of 26 November 2015: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016D0310&from=EN

In fact, regulations often make it clear that a firm may lose the right to provide its services across the EU if the Commission decides to withdraw equivalence to its home country.[61]

What does an equivalence decision look like? Implementing acts vs delegated acts

Equivalence decisions can take the form of an implementing or a delegated act – depending on what the relevant piece of EU legislation establishes. Both are non-legislative acts, although delegated acts are generally seen as closer to law-making – while implementing acts are more procedural.

In the case of delegated acts, the European Parliament and the Council of Ministers (acting by qualified majority) can object to their entry into force and even withdraw the delegated powers from the Commission at any point in time.[62]

In the case of implementing acts, oversight is left to the competent representatives of national governments organised in committees – which, incidentally, has given rise to the word 'comitology'. The Commission needs a positive opinion from the relevant committee before it can adopt an implementing act.[63]

In theory, having been a member of the EU, the UK would have no problem obtaining equivalence on day one after Brexit. However, if EU regulations change over time the UK would have to adapt its own legislation to maintain continued market access for its financial services sector. This could become increasingly challenging if in future, with the UK no longer involved in the law-making process, the EU takes a more protectionist approach to financial regulation. Although in that scenario being able to diverge from onerous regulations may in fact prove a competitive advantage for the UK, even if access is lost.

That said, it is worth noting that the European Commission has never actually withdrawn an equivalence decision due to divergence of regulation. While it is a relatively new concept, this is still important. It has, however, withheld the granting of equivalence for both technical and political reasons (more on this below).

[61] See Article 47(4) of Regulation (EU) No 600/2014. Furthermore, the AIFMD does envisage the possibility of extending the passport to non-EU fund managers - based on "positive advice" from ESMA. However, in a letter to the European Commission on 30 July 2015, ESMA argued, "ESMA has assessed six non-EU countries thus far. However, it has produced definitive views on only three of them [...] In some cases, the advice cannot be considered 'positive' in the sense of Article 67(4) of the AIFMD. The European Council, Parliament and Commission to which this advice is submitted pursuant to Article 67 of the AIFMD may wish to consider whether to wait until ESMA has delivered positive advice on a sufficient number of non-EU countries before triggering the legislative procedures foreseen by Articles 67(5) and (6)." The full letter is available here: https://www.esma.europa.eu/press-news/esma-news/esma-publishes-letter-european-commission-aifmd-passport
[62] See Article 290 TFEU.
[63] See Article 5 of Regulation (EU) No 182/2011: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011R0182&from=en

Overall, equivalence is therefore a far more piecemeal approach than the passport:

- Equivalence does not currently cover the whole range of EU financial regulation, particularly when it comes to retail financial services;

- The level of market access third-country firms can obtain via equivalence varies depending on the relevant piece of EU legislation. While equivalence under MiFIR essentially offers passport-like rights to third-country firms providing investment services to professional clients, equivalence under Solvency II does so only for re-insurance services;

- Equivalence is granted at the behest of the Commission, and is therefore part of a political process.

How long for a positive equivalence decision?

The timeline to obtain equivalence is another crucial issue. Experience so far shows that the amount of time needed to get to a positive equivalence decision can vary significantly – as the Commission does not work on fixed deadlines and is therefore under no time pressure to deliver its decisions. Decisions can also be delayed for political reasons. Ultimately, from the UK's perspective, relying on equivalence means to a large extent relying on the goodwill of the Commission.

The European Market Infrastructure Regulation (EMIR) entered into force in August 2012. A number of countries immediately sought equivalence to reduce the cost of clearing transactions between EU entities. The Commission then adopted equivalence decisions with regard to the regulatory regimes for Central Counterparties (CCPs) under EMIR for four non-EU countries in October 2014 and a further five in November 2015.[64] The table below highlights how long it took a number of states to gain equivalence.[65]

[64] European Commission press release, 'EU Commission adopts equivalence decisions for CCPs in Canada, Switzerland, South Africa, Mexico and the Republic of Korea', 13 November 2015: http://europa.eu/rapid/press-release_IP-15-6075_en.htm

[65] In most cases the two to three year timeline is likely to be a lower bound given that it only accounts the period from when the Commission tasked ESMA with giving a technical assessment of equivalence to when equivalence came into force. In some cases, a sizeable period of time may have elapsed between the country asking for equivalence and the Commission tasking ESMA with making and assessment.

Time take for CCPs equivalence under EMIR	
Country	Years
Australia	2
Canada	3
Hong Kong	2
Japan	2
South Korea	3
Mexico	3
Singapore	2
South Africa	3
Switzerland	3
US	4

The Swiss experience in this case is worth exploring in more detail. ESMA published its technical advice on equivalence for Swiss CCPs under EMIR on 1 September 2013, concluding that "CCPs authorised in Switzerland are subject to effective supervision and enforcement on an on-going basis and that the legal framework of Switzerland provides for an effective equivalent system for the recognition of CCPs authorised under third-country legal regimes." In spite of ESMA's positive advice, the Commission adopted a positive equivalence decision only in November 2015 – more than two years later. One rumoured explanation for the delay is the referendum Switzerland held in February 2014, won by supporters of reintroducing immigration quotas for nationals of EU member states.

As former EU Financial Services Commissioner Lord Hill pointed out in a recent speech at the LSE, negotiations with the US Commodity Futures Trading Commission (CFTC) went on for four years before the Commission was able to adopt a positive equivalence decision on CCPs – which are ultimately only one aspect of EMIR.[66] The US obtained equivalence for CCPs in March 2016.[67]

The Solvency II Directive setting out capital requirements for insurers was adopted in 2009, although it only came into effect on 1 January 2016. The Commission adopted the first equivalence decisions under Solvency II in June 2015.[68]

---

[66] Lord Hill's speech at the London School of Economics, 22 May 2016: https://ec.europa.eu/unitedkingdom/news/lord-hills-speech-london-school-economics_en

[67] European Commission press release, 'European Commission adopts equivalence decision for CCPs in USA', 15 March 2016: http://europa.eu/rapid/press-release_IP-16-807_en.htm

[68] European Commission press release, 'Insurance: European Commission adopts a first package of third-country equivalence decisions under Solvency II', 5 June 2015: http://europa.eu/rapid/press-release_IP-15-5126_en.htm

The case for 'pre-emptive' equivalence

One option the UK should consider is to seek 'pre-emptive' equivalence on financial services regulation as part of the upcoming exit talks with the EU. This means the EU would treat the UK's regulatory and supervisory framework as equivalent from the moment the withdrawal agreement concluded under Article 50 TEU enters into force – that is, from day one of Brexit. This would help minimise uncertainty, at least with regard to those pieces of EU law that make provisions for third-country access.

Admittedly, such an arrangement would likely involve a liberal interpretation of the existing equivalence process. The UK will not become a 'third country' until the entry into force of its withdrawal agreement with the EU – or until the two-year deadline set out by Article 50 TEU expires. Therefore, in principle the UK should not be able to apply for equivalence until then.

However, there is a precedent for this kind of 'pre-emptive' equivalence – albeit in slightly different circumstances. The European Commission adopted a first package of positive equivalence decisions under Solvency II in June 2015, with the new rules due to come into effect six months later.[69] There will remain a question around whether ESMA can begin assessing a state before it is fully a third country and the UK will likely have to lay out its regulatory regime in detail so that it can be assessed (or just promise to keep things as they are). However, if the decision is forward-looking and does not come into force until after the UK leaves, this is less of an issue.

Alternatively, the UK could seek interim equivalence – broadly mirroring what happens in some cases with the provisional application of free trade deals between the EU and third countries. Essentially, the EU would grant the UK provisional equivalence on day one of Brexit – pending confirmation from the European Commission and the relevant pan-EU financial watchdog (ESMA, EIOPA or EBA). By logic, such an arrangement should be fully possible given that the UK has so far been applying EU financial services regulation as a member of the bloc.

3.2 Investment banking (MiFID II and MiFIR)

Third country firms providing certain types of investment services and activities will have their access to the EU market governed by the new Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR). Both pieces of legislation are due to come into effect on 3 January 2018.[70] The definition of 'investment services and activities' under MiFID II/MiFIR includes, among others, portfolio management, investment advice and the execution of trading orders on behalf of clients.[71] MiFIR in particular has been widely cited as providing a potential route for recovering some version of the passport and allowing the services provided to continue.

[69] European Commission press release, 'Insurance: European Commission adopts a first package of third country equivalence decisions under Solvency II', 5 June 2015: http://europa.eu/rapid/press-release_IP-15-5126_en.htm?locale=en
[70] Council of the European Union, 'Markets in financial instrument: one-year delay enacted', 17 June 2016: http://www.consilium.europa.eu/en/press/press-releases/2016/06/17-markets-in-financial-instruments/
[71] For the full list, see Annex I (Section A) to Directive 2014/65/EU: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN

MiFIR deals with investment services/investment activities provided to eligible counterparties and professional clients. If equivalence is granted,[72] firms can operate anywhere in the EU without establishing a branch – i.e. very similar to the current passport.[73]

MiFID II deals with investment services/investment activities provided to retail clients and 'elective' professional clients – that is, retail clients that have chosen to be treated as professional. It establishes that a member state may require that a third-country firm establish a branch in its territory in order to provide these services.[74] In other words, MiFID II allows individual member states to continue applying their existing national regulatory regimes.[75] These in turn may or not require the establishment of a branch. However, in cases where the national law of a member state does envisage the opening of a branch, the latter needs to comply with MiFID II requirements. Compliance with MiFID II does not mean that the said branch can provide its services across the EU – meaning one might have to open branches in any member state you wish to provide services in.[76]

Therefore, MiFIR appears to guarantee passport-like rights to third-country firms via equivalence – while MiFID II does not.

	Scope	Does it require opening a branch?	Does it guarantee passport-like rights?
MiFID II	Investment services and investment activities to retail clients and clients who request to be treated as professional	Depending on the national legislation of the host EU member state	No
MiFIR	Investment services and investment activities to eligible counterparties and professional clients	No, provided equivalence with EU regulation is achieved	Yes, provided equivalence with EU regulation is achieved

[72] The European Securities and Markets Authority (ESMA), the pan-EU financial markets watchdog, is in charge of keeping a register of all third-country firms that apply to operate throughout the EU.
[73] Without equivalence firms can operate in single member states via national regulatory regimes and requirements. MiFIR also allows for a three year transition once equivalence is granted, which would allow firms to continue to operate via national regimes. However, after the three year period they must register with ESMA and fully adopt the EU rules. See Article 46 of Regulation (EU) No 600/2014: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN
[74] See Article 39 of Directive 2014/65/EU: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN
[75] HM Treasury, 'Transposition of the Markets in Financial Instruments Directive II', March 2015, page 10: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/418281/PU_1750_MiFID_II_26.03.15.pdf
[76] In this regard, it is worth stressing that, legally speaking, a branch is different from a subsidiary. The latter is a separate legal entity from the parent company, while the former is a fixed site through which the parent company operates in a given territory.

Professional vs retail investors under EU law

MiFID II defines a professional client as "a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs."[77] The definition includes:

- Entities that need to be authorised or regulated to operate in the financial markets (e.g. credit institutions, investment firms, insurance companies, pension funds, collective investment schemes, etc.);
- Large undertakings;[78]
- National and regional governments, central banks and international institutions (e.g. World Bank, IMF, EIB, etc.);
- Other institutional investors.

Given the broad and detailed definition of professional clients, it is clear that the large majority of services provided will involve such clients rather than pure retail clients. Furthermore, as we have already noted, retail financial services are very rarely provided across borders.

Recommendations

1. The UK should push for equivalence under MiFIR. It offers passport-like rights for the services provided by investment banks. In theory, this approach would likely prove sufficient for much of the business which large foreign investment banks (notably those from the US) conduct through their European headquarters in London. The FCA register demonstrates that for the most part these firms utilise the MiFID passport to provide services cross-border and occasionally via branches. These services will mostly be to large professional clients, not to retail clients (who are not covered by MiFIR). Of course, MiFIR has yet to come into effect. As such, its equivalence regime remains untested, meaning it is hard to know at this stage how easy (or difficult) it will be to make it work in practice.

3.3 Wholesale banking (CRD IV)

While investment banking activities are covered by MiFIR, the large majority of other banking services – such as deposit taking and lending – fall within the scope of the Capital Requirements Directive (CRD IV) passport.[79] Crucially, CRD IV does not have any provisions for third-country access to EU markets.

[77] See Annex II of Directive 2014/65/EU.
[78] Undertakings that meet at least two of the following criteria (on a company basis): total balance sheet of at least €20 million; net turnover of at least €40 million; own funds of at least €2 million.
[79] These activities are regulated by separate pieces of EU law (e.g. the Mortgage Credit Directive, the Payment Services Directive, the Consumer Credit Directive, etc.) but are provided across the EU under the CRD IV passport.

Equivalence is available under the Capital Requirements Regulation (CRR) – which completes the CRD IV package alongside the Directive. However, CRR equivalence is limited to the prudential treatment of certain types of exposures to entities located in non-EU countries. It allows EU-based credit institutions to apply preferential risk weights, comparable to those applied to similar exposures within the EU, to the relevant exposures in third countries whose prudential supervisory and regulatory requirements are deemed equivalent to the EU's by the European Commission.[80]

In other words, CRR equivalence is irrelevant in terms of EU market access for third-country operators. This means that, once the CRD IV passport is lost, UK-based banks would no longer be able to provide these services to retail clients across the EU.

As we demonstrated in Section 2, the CRD IV passport is used extensively when it comes to the provision of wholesale finance – deposit taking and lending between financial institutions and to large entities. The loss of this access would cause significant disruption to the current business model of banks based in the UK and would likely raise their cost of doing business.

However, as we also noted in section 1, the large pool of capital and competitive industry found in London means that the European corporates that come to London for financing or services are able to access them on favourable terms. Furthermore, the wholesale banking business is a two-way street, with a number of large banks passporting into the UK to provide services to firms headquartered here. Therefore, the loss of the passport would impose costs on European banks as well as UK based ones. Since very little retail banking is provided across borders the loss of the passport would have a very minimal impact on this part of the business.

Recommendations

This means that, to retain anything close to the current access and protect the business currently done from London, the UK will need to negotiate some form of bespoke deal. The size of the sector – it accounts for around 30% of total financial services revenue in the UK – and the lack of existing alternatives, mean our recommendations in this section need to be particularly detailed.

[80] See European Commission, 'Implementing Act on equivalence under Regulation (EU) No 575/2013 - Frequently Asked Questions', 12 December 2014: http://europa.eu/rapid/press-release_MEMO-14-2625_en.htm?locale=en

EU FTAs and financial services – the case of CETA

With a bespoke deal in mind, it is worth looking at what the EU has offered in this format to other countries. The Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada is perhaps the best benchmark to get a sense of how far EU FTAs have gone on liberalising trade in financial services to date. Hailed as the most ambitious and comprehensive FTA concluded by the EU to date, which it is, CETA does however maintain a number of market access restrictions when it comes to financial services.

In principle, CETA allows trade in financial services between the EU and Canada under all the four 'modes' envisaged by the WTO's General Agreement on Trade in Services (GATS): cross-border supply, consumption abroad, commercial presence, and presence of natural persons. However, the agreement establishes that "a Party may impose terms, conditions, and procedures for the authorisation of the establishment and expansion of a commercial presence."[81] It also specifies that the EU is not required to allow Canadian cross-border suppliers to "do business or solicit in its territory" – and vice versa.[82]

This essentially means Canadian firms that want to either sell their services to European customers on a cross-border basis or establish a commercial presence in the EU need to comply with EU rules. In other words, CETA does not appear to grant Canadian companies greater market access than they might already be able to achieve via equivalence under existing EU financial services regulation.[83]

1. The best case would be for the UK to seek to negotiate a bespoke deal which maintains the main elements of the current passport for banking services. This could take the form of a specific bilateral agreement – similar to the Swiss agreement on insurance which we explained in Section 2 – or it could form part of a specific chapter in a comprehensive FTA between the UK and EU.[84] This would undoubtedly be an ambitious undertaking, but there is some reason to believe it is not entirely out of the question. As we have explained, this passport runs both ways, with a number of EU banks making significant revenue in the UK. Furthermore, the prospect of mutual recognition or passporting of banking services has been around for much longer than nearly all the other passports for various financial services. As such, the principle and the business built around it have been long established. There is also the added fact that the bulk of these rules are built off of international standards via the Basel Committee on Banking Supervision.

[81] See Article 6(3a) of CETA's financial services chapter.
[82] See Article 7(6) of CETA's financial services chapter.
[83] For further details, see Patrick Leblond, 'CETA and financial services – what to expect?', CIGI Papers No 91, February 2016: https://www.cigionline.org/sites/default/files/cigi_paper_no.91_web.pdf
[84] Having cited the Swiss insurance agreement as a model, we should also reiterate that this agreement is specific and limited. An agreement on banking services would be far wider. However, even here there is scope to apply some sensible limitations. For example, it could be limited to wholesale services rather than retail services. Similar to the Swiss agreement it could only include freedom of establishment not full freedom of services, meaning that the UK would still need to operate branches where it wanted to provide banking services and these would have to be licensed by the respect host member states.

While the EU's CRD IV does diverge notably from this in parts, the UK is unlikely to deviate from the globally agreed best practice significantly.

2. The UK will need to commit to comprehensive regulatory and supervisory cooperation. Any agreement on a banking passport would require deep and total cooperation on prudential banking policy and supervision. The latter will be less of an issue given that the UK is already outside of the Eurozone's single supervisory mechanism, meaning that mechanisms already exist for close cooperation between the UK supervisors and the ECB as well as other states supervisors. These relationships should be replicated as closely as possible. Similar links and cooperation will have to be formally established with the ESAs – namely ESMA and the EBA. While these already exist, they do so from the perspective of the UK as an EU member not as a third country. The big concern around equivalence is whether regulation on either side could diverge over time. The best way to address this would be to establish financial regulatory committees which meet regularly and cooperate closely. The EU has already taken tentative steps in this direction by establishing Financial Markets Regulatory Dialogue (FMDR) with the US and Japan. The US group meets twice a year. However, cooperation between the UK and EU would likely have to be more comprehensive – either the committee should be in place permanently or should come together regularly, at least every quarter. These discussions should be wide-ranging covering 'big picture' issues such as future paths of overarching regulation to more technical issues such as the prudential requirements for branches and subsidiaries in each country.

3. Applying and gaining equivalence under CRR would also help, by going some way to assuaging concerns about each side's respective supervision and prudential regulation.

If a wide-ranging agreement cannot be struck, there would be a couple of fall-back options for the UK:

1. First, the banks could set up subsidiaries in another EU member state, which could then still access the passport.[85] This usually involves additional costs (see the box on pages 33-34). The subsidiary needs to be established as a separate legal entity and therefore capitalised separately, has to comply with EU and local regulation, and would be taxed on profits locally. Furthermore, it would almost certainly require some staff moving from the UK to another EU state. For some foreign banks this may raise questions about the size of their long-term presence in London.

[85] See, for instance, Allen & Overy, 'Financial services regulation – what impact will Brexit have on regulated firms established in the UK, Europe and third country jurisdictions?', February 2016: http://www.allenovery.com/SiteCollectionDocuments/Brexit%20-%20Impact%20for%20financial%20services.pdf

Both would likely have some negative knock-on impacts on the UK economy.

2. Alternatively, the banks could continue to operate deposit-taking branches but via local authorisation in one or more EU state.[86] This would mean that branches in any EU state would have to meet whatever the local requirements are laid out by the respective national supervisors. These can be onerous, either in prudential terms but also in conduct terms – this can refer to where certain staff need to be located and what the qualification or certification requirements are for certain employees. These branches would not have the ability to passport services, so would need to be established in any state where the bank wanted to do business.

3. Finally, the UK and large banks to push for the inclusion of equivalence for banking services in CRD V – the next version of the EU's bank capital rules. However, this is likely to be some way off and will probably be reliant on a new round of global discussions around Basel IV. Furthermore, the decision and formulation on any equivalence procedure would be up to the remaining EU members, making the UK a bit of a hostage to fortune.

In reality, the outcome could well be a combination of a bespoke deal and operating via subsidiaries or localised branches.

Setting up bank subsidiaries is not a cost-free exercise

In a recently published study, the Boston Consulting Group (BCG) estimates "the incremental additional capital required to convert existing German branches into UK subsidiaries to be approximately €10 billion…If we expand this analysis to all European banks…we estimate that up to an additional €30 billion to €40 billion in incremental capital could be required."[87]

The report also estimates that establishing independent subsidiaries across the EU could mean an increase in annual operating costs of between 8% and 22% for individual investment banks. The BCG works on the assumption of "a WTO outcome" to UK-EU negotiations – that is, the UK having to fall back on WTO rules after leaving the EU – and of "an operationally independent EU subsidiary as a prerequisite to serve European clients."

The study considers two scenarios:

- A "globally diversified bank", which already holds banking licences and has functioning hubs in a number of EU countries, would generally face lower costs.

[86] While under a Swiss type deal branches might still need to be set up, there would be much less scope for local requirements to be punitively high. Under a bespoke Swiss style agreement, the EU rules would set the basic requirements for operating the branches, not the local regulators.
[87] Philippe Morel et al, 'Global capital markets 2016: The value migration (Part 2) – Assessing the impact of Brexit', The Boston Consulting Group, July 2016: http://image-src.bcg.com/BCG_COM/BCG-Impact-of-Brexit-on-Capital-Markets-July-2016_tcm9-38972.pdf

However, it would still incur additional headcount and infrastructure costs – potentially alongside higher compensation and relocation benefits as staff are relocated away from London. Overall, the BCG estimates that such a scenario would translate into an increase in European operating costs of 8% per year.

- A "concentrated bank", which has "a large London presence but limited near-shore locations within Europe", would incur "significantly amplified" cost increases – as it would essentially need to build up new operations from scratch and would therefore "further incur duplicative costs for infrastructure, IT maintenance, and corporate functions." This explains the increase of up to 22% in annual operating costs estimated by the BCG.

Similarly, PwC noted in a study published ahead of the UK's EU referendum, "In the case of UK financial institutions who currently operate via branches in EU member states, they may be required to convert their branches into subsidiaries, and/or face additional regulatory requirements by the host regulator in order to address local systemic risks, such as capital, liquidity and reporting requirements that currently apply to non-EU banking entities. The above requirements are likely to vary to some degree across member states, meaning that banks face a patchwork of different regulatory requirements across the member states within which they operate. This increases the cost and complexity of providing services across borders."[88]

The cost of setting up a subsidiary can be mitigated by the fact that firms can simply reallocate capital from one entity to another. Since part of the business and balance sheet will also move, the overall amount of capital the firm would need to hold may not increase significantly. However, this is only likely in the longer term, since in the short term it will be hard to demonstrate to regulators that the capital can be moved until it is clear what business lines have been moved to the new subsidiary.

3.4 Asset management (UCITS and AIFMD)

3.4.1 UCITS (Undertakings for Collective Investment in Transferable Securities)

UCITS funds are mainly targeted at retail investors and therefore are mostly not covered by MiFIR, despite it covering some investment services. Furthermore, the current EU regulatory framework for UCITS includes no 'third-country regime'. This means that any UK funds marketed in the EU and any EU funds in the UK would have to meet the national requirements or restrictions of each country.

But more importantly, UCITS funds must be domiciled within the EU/EEA and be managed by a company which is also located in the EU/EEA – although the management company and the UCITS fund can be based in two different EU countries.

[88] PwC, 'Leaving the EU: Implications for the UK financial services sector', April 2016, p30-31: https://www.pwc.co.uk/financial-services/assets/Leaving-the-EU-implications-for-the-UK-FS-sector.pdf

As a result, unless the UK opts to remain a member of the EEA after Brexit, UK-based asset management companies look set to lose direct access to the UCITS passport.[89]

Nonetheless, EU rules do envisage the possibility for UCITS management companies to delegate portfolio management functions to undertakings located outside the EU/EEA – provided that the national law of the home member state of the management company allows for it and that cooperation agreements with the national supervisor of the third country concerned are in place. The UCITS Directive makes it clear, however, that "the management company shall not delegate its functions to the extent that it becomes a letter-box entity."[90]

In other words, there is no getting around the fact that both the UCITS fund and the management company must be based in the EU. However, it is possible for asset managers in a non-EU/EEA country to operate as 'delegated' managers of EU-domiciled UCITS funds – a move that essentially allows them to keep indirect access to the UCITS passport. This type of structure is already being used by US fund managers, for instance.[91]

It would involve additional costs and an extra administrative burden, though. It would ultimately boil down to a UK-based UCITS management company having to duplicate (at least part of) its operations in another EU member state. While large investment groups would most likely not have any big problems adopting this business model, smaller asset managers could find it too expensive to set up 'parallel' companies abroad. In particular, small and medium sized asset managers from outside the UK and EU, who currently use the UK as their EU domicile, could face a tough choice over whether to stay in the UK or to move elsewhere in the EU.

That said, this is quite a particular group and as we noted in Section 2, the use of the passport by small and medium sized asset managers is much more limited. Furthermore, as we explained in Section 2.2, one possible mitigating factor for UK-based asset managers is the fact that many of them already operate via two separate vehicles – one domiciled in the UK and another one located in a different European hub (usually Ireland or Luxembourg).[92]

---

[89] For further details, see Eversheds Consulting, 'Navigating regulatory compliance – Investment management update', 18 July 2016: http://www.eversheds.com/documents/sectors/financial_institutions/Investment_Management_Update_July.pdf
[90] Article 13(2) of Directive 2009/65/EC: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02009L0065-20140917&from=EN
[91] See Paul Ellison, partner in Macfarlanes' Financial Services Group, 'Post-Brexit regulatory landscape – radical departure or business as usual?', 29 June 2016: https://www.law.ox.ac.uk/business-law-blog/blog/2016/06/post-brexit-regulatory-landscape-radical-departure-or-business-usual
[92] See PwC, 'Being better informed – Financial services regulatory, accounting and audit bulletin', August 2016: https://www.pwc.co.uk/assets/pdf/bbi-aug2016.pdf

According to the IA survey that we cited in Section 2.2, of the £1.2 trillion of assets managed in the UK for European clients, at least £800m is organised in this fashion. In practice, this means UK-based asset managers would be able to retain indirect access to the passport via their EU-based operations since they could, as we explained above, delegate portfolio management to the UK.

3.4.2 AIFMD (Alternative Investment Fund Managers Directive)

The Alternative Investment Fund Managers Directive (AIFMD) includes provisions for potentially extending the passport to non-EU managers wanting to market across the EU funds domiciled either inside or outside the bloc. This would happen by means of a delegated act adopted by the European Commission, subject to a prior opinion from ESMA that there are "no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk, impeding the application of the passport" to non-EU fund managers. This is known as 'switching on' the third country access.

If this were switched on, then there would be passport-like rights for UK-based Alternative Investment Funds (AIFs) and they could be marketed freely across the EU – or at least as freely as they are now.

ESMA published its advice covering twelve non-EU countries in July, where it argued that for some of them – including Japan, Canada and Switzerland – there were "no significant obstacles impeding the application of the AIFMD passport."[93] However, the work of ESMA is far from complete. In fact, the July report suggests ESMA will continue assessing other third countries not covered so far. In other words, there is no clear timeline as to when the Commission might make its final decision on the extension of the AIFMD passport to non-EU fund managers.

As a result, absent decisive progress on this front in the meantime, after Brexit UK-based fund managers would need to fall back on one of the following options:

- ***Delegation*** – Similar to what we have seen with regard to the UCITS Directive, the AIFMD makes it possible to delegate portfolio management functions to undertakings located in a third country – subject to prior approval from the national authorities of the home EU member state and provided that cooperation with the national supervisor of the third country concerned is ensured.[94]

[93] ESMA, 'Advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs', 18 July 2016: https://www.esma.europa.eu/press-news/esma-news/esma-advises-extension-funds-passport-12-non-eu-countries

[94] See Article 20 of Directive 2011/61/EU: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011L0061&from=EN

This includes the requirement of having an entity in the EU to delegate outwards.

- ***MiFIR*** – It has also been noted that, since AIFs are mainly targeted at professional clients, UK-based fund managers could make use of the passport-like rights envisaged by MiFIR once it enters into force – and provided that the UK is granted equivalence by the EU.[95] As we have seen in Section 2, portfolio management is indeed one of the investment services covered by MiFIR. Some elements of uncertainty remain, however. It is unclear, for instance, whether undertakings that are already registered with ESMA as AIFMs could also register as MiFIR firms. Furthermore, the AIFMD and MiFID II do not cover exactly the same range of services.[96]

- ***Private placement*** – After Brexit, UK-based fund managers would still be able to rely on the various national private placement regimes of EU member states. This involves registration in every EU country where fund managers are planning to market their funds, bearing in mind that the AIFMD allows national supervisors to impose stricter requirements on third-country fund managers operating via private placement.[97] Most importantly, private placement rules change from one EU country to another – and in some member states private placement is forbidden altogether.[98]

- ***Reverse solicitation*** – Another alternative would be the so-called 'passive marketing' or 'reverse solicitation' – which is not covered by the AIFMD. This means EU-based clients can approach third-country managers and invest in funds domiciled outside the EU.[99] In this regard, the main challenge is that the boundaries of what constitutes 'passive' or 'active' marketing are far from clear. Again, different national supervisors have taken different views as to what exactly constitutes 'marketing'.

---

[95] See, for instance, this paper published by the Swiss government, 'Situation analysis and areas of action in market access', 2014, p12: http://www.news.admin.ch/NSBSubscriber/message/attachments/37605.pdf

[96] For further details, see Eversheds, 'MiFID II and the AIFMD: Is an onshore model for third country asset managers inevitable?', 1 October 2014: http://www.eversheds.com/global/en/what/articles/index.page?ArticleID=en/Financial_institutions/MiFID_II_and_the_AIFMD-is_an_onshore_model_for_third_country_asset_managers_inevitable

[97] See, in particular, Article 42(2) of Directive 2011/61/EU.

[98] For further details see, for instance, Eversheds, 'AIFMD: Private placement update', 24 April 2014: http://www.eversheds.com/global/en/what/articles/index.page?ArticleID=en/Financial_institutions/AIFMD_private_placement_update

[99] See, for instance, Norton Rose Fulbright, 'AIFM Directive – The impact on non-EU fund managers of non-EU funds', August 2012: http://www.nortonrosefulbright.com/files/aifm-directive-the-impact-on-non-eu-fund-managers-of-non-eu-funds-60540.pdf

Recommendations

1. While neither the AIFMD nor the UCITS Directive make provisions for third country equivalence, UK-based asset managers should make full use of the delegation of portfolio management functions laid down in both. This would mitigate the impact of losing access to both the AIFMD and the UCITS management passport.

2. Albeit far from ideal, UK-based asset managers should still try and make the most of private placement as an alternative route into EU markets. This path could also be followed by UCITS managers, should they opt to start marketing their funds as AIFs.

3. UK-based AIFMs should also explore the possibility of using third-country market access under MiFIR – which would cover, among other things, portfolio management and investment advice to professional clients. This would involve the UK Government pushing for equivalence under MiFIR.

4. The UK should continue to push for the extension of the AIFMD passport to third countries. Similarly, it should pull its weight behind a similar extension for UCITS funds – ideally as part of the next iteration of the UCITS Directive. In doing so, the UK would most likely be able to rely on the backing of other non-EU countries.

3.5 Insurance (Solvency II)

As previously discussed insurance is perhaps the sector that would be least affected by the loss of the passport.

However the EU's Solvency II Directive does allow for third countries to have their regulatory regimes for insurers judged as 'equivalent' by the European Commission. The impact of a positive equivalence decision by the Commission depends on which elements are deemed equivalent:

- If a third country's solvency regime is deemed equivalent under Article 172 of the Solvency II Directive, then reinsurance contracts concluded with firms headquartered in that third country must be treated in the same manner as reinsurance contracts concluded with EU-based firms;

- If a third country's solvency regime is deemed equivalent under Article 227 of the Solvency II Directive, then EU insurance groups can carry out their EU prudential reporting for a subsidiary in that third country under local rules; [100]

[100] Provided that they are authorised to use deduction and aggregation as the method of consolidation of group accounts, see for instance: http://ec.europa.eu/transparency/regdoc/rep/3/2015/EN/3-2015-8147-EN-F1-1.PDF

- If a third country's prudential regime is deemed equivalent under Article 260 of the Solvency II Directive, then the country's insurance groups that are active in the EU are exempted from some aspects of group supervision in the EU.

However, equivalence does not guarantee the same level of market access as the Solvency II passport. The latter allows an insurance undertaking authorised by one member state to operate throughout the EU either via branches or on a cross-border basis. Conversely, equivalence under Solvency II allows only re-insurers to operate within the EU/EEA on a cross-border basis. Direct insurance companies based in third countries can have no access to customers in the EU/EEA unless they set up a local branch or subsidiary – even if their home country's regulatory regime is deemed equivalent by the EU.[101]

In this regard, the difference we explained earlier with regard to banks also applies to insurers. A third-country branch can only serve customers in the host EU member state, but cannot 'passport' its services across the bloc. A subsidiary would be treated as a separate legal entity from the parent company. As such, it would be capitalised separately and would be able to apply for the passport.

Sean McGovern, Chief Risk Officer at Lloyd's, said in a speech in February,

> "An equivalence finding under Solvency II does not provide a solution. The UK would, under EU parlance, be a 'third country' and whilst it may be found to have a regulatory regime that is equivalent to Solvency II – that does not confer a right to access the EU market either on a cross border or on a branch basis."[102]

However, as we noted in Section 2, the insurance industry appears to rely on the passport significantly less than the banking sector. This suggests any disruption deriving from the loss of the EU passport could ultimately be fairly limited for the insurance sector. Subsidiaries are often already in place and hold a separate licence – meaning that they can make use of the passport on their own right, if they so wish. In fact, 87% of insurance firms providing services across borders in the EU, do so via subsidiaries.

[101] For a more detailed discussion, see, for instance, Shearman & Sterling, 'Brexit: Implications for the insurance and re-insurance industry', 19 July 2016: http://www.shearman.com/~/media/Files/NewsInsights/Publications/2016/07/Brexit-Implications-for-the-Insurance-and-Reinsurance-Industry-INS-071916.pdf
[102] Sean McGovern, 'The implications of Brexit for the London insurance market', speech delivered at the Insurance Institute of London on 10 February 2016: https://www.lloyds.com/news-and-insight/press-centre/speeches/2016/02/the-implications-of-brexit-for-the-london-insurance-market

Recommendations

As in other areas, the best approach will probably be a mixed one. A number of firms already operate subsidiaries and may well expand them or set up new ones.

1. The UK should pursue equivalence via Solvency II, which will allow for reinsurance to continue to be provided in a way similar to the current passport. Direct insurance will not be covered, but then this is more likely to be provided by local subsidiaries in any case. The European Commission has said cross-border retail insurance services account for only around 3% of total gross written premiums in the EU.[103] Of course, this means that there is unlikely to be any scrapping of the Solvency II rules in the UK. While some may see this as a missed opportunity, for the most part the industry has largely implemented the rules and has little desire to massively overhaul Solvency II for a new, yet to be defined, system.

2. Lloyd's of London could well require a bespoke agreement. This is likely to be a tricky area of negotiation due to the very particular and unique nature of the market. The best case would be, similar to what we recommended for CRD IV and similar to the Swiss situation, to negotiate a specific agreement which recognises the Lloyds of London insurance market and allows it to continue to provide specific services across borders. Whether or not this is reached, it will be important for the EU to continue to recognise and treat Lloyd's as a single insurer. This would make the process of opening up a branch or subsidiary in the EU post-Brexit easier. It is also worth noting that Lloyd's does have offices in 17 EU/EEA states already, some with local permissions to transact business – although more often these tend to provide administrative and management services to those operating in the London market.[104] As noted in Section 2.3, 38% of Lloyd's total written premium in the EEA comes from reinsurance – which could be covered via Solvency II equivalence.[105] Switzerland and Bermuda, seen as the main competitors in this area, have already received equivalence under Solvency II.

[103] Data cited in European Commission, 'Green paper on retail financial services', 10 December 2015, p6.
[104] For further details, see the Lloyd's website, 'Lloyd's global offices', retrieved on 19 September 2016: https://www.lloyds.com/lloyds/offices. See also Lloyd's, 'EEA: Determining freedom of services and establishment transactions', 18 August 2014: https://www.lloyds.com/the-market/communications/regulatory-communications-homepage/regulatory-communications/regulatory-news-articles/2014/08/eea-determining-freedom-of-services-and-establishment-transactions
[105] For further details, see Hampden Group, 'Brexit – Implications for Lloyd's', HUR Bulletin No 8/2016, 1 July 2016.

3. The UK should quickly tie up its position in the WTO and reaffirm its commitment to the General Agreement on Trading Services (GATS) as some types of insurance – marine, aviation and transport – are protected under WTO rules. For example, these account for 19% of Lloyd's of London Gross Written Premium in the EEA.

Overall, the approach should be a mix of equivalence, local branches and subsidiaries. This can apply to Lloyds as well as the sector more broadly, although negotiating a bespoke agreement for the Lloyds market specifically should be considered.

4. Reciprocity

The equivalence process also often involves the concept of 'reciprocity'. This is the idea that if the EU judges a country's regulation as equivalent and therefore opens up market access (as far as allowed by the EU regulations) then similar opening should be reciprocated by the other country for EU firms. This is important from the UK's perspective for two reasons.

Firstly, if the UK is judged to be equivalent in any of the areas mentioned it will likely be contingent on the UK offering similar openings to EU firms in the UK as it receives for UK firms in the EU. This is unlikely to be a huge problem since the UK has traditionally been an open economy and particularly open in financial services. Moreover, access to the UK's market should be a point of leverage in the negotiations with the EU. Therefore, the UK should make quick progress on establishing an equivalence regime and the criteria as well as the institutional capacity for taking equivalence decisions.

Secondly, the UK system is seen as equivalent via reciprocity by a number of non-EU states. However, this is based on EU membership and therefore would not be guaranteed to continue once the UK left the EU. As such, any arrangements would have to be renegotiated based on the UK's new independent regulatory system. For example, any arrangements between the UK and the US currently, would be based on the premise the UK is a member of the EU. Therefore, these would have to be renegotiated separately on both sides post-Brexit. For context, this is not that dissimilar to the situation the UK finds itself in with the free trade agreements it currently has via the EU. To aid with this approach the UK should move quickly to set up the infrastructure necessary to allow for swift equivalence negotiations and discussions with third countries. It should also aim to pin down its regulatory regime for financial services quite quickly – this may in fact support the view that, for the time being, from a regulatory standpoint, things should be kept quite similar to the current approach.

Indeed, if the UK seeks to gain equivalence with the EU in a number of areas or to maintain a similar regulatory system, there should be few disputes in terms of maintaining access to non-EU markets on a reciprocal basis (provided the UK keeps its market open to these countries as well). Still, this is something which will have to be smoothed out.

5. Timeline – quick progress needed in a fluid industry

Our analysis in Section 3 raises a number of questions, but a crucial one will be the timeline under which all this has to happen. This is, of course, a big question with regards to the entire negotiation. But it is particularly important when it comes to financial services, given the fluid nature of the industry and the level of uncertainty around future market access and passporting.

There are two facets to this concern. The first is that the negotiations will take longer than the two years allotted under Article 50 and therefore the UK could fall back on WTO rules (which say little on financial services) in the interim. This is the same concern harboured more broadly with regards to the negotiations. The second is more specific to financial services – that the industry will need time to implement whatever is agreed. There is a concern that things may be unclear for some time and then settled and implemented immediately. The sector would therefore have little time to respond and adjust.

Furthermore, during our background discussion for this paper, one point that was raised is that banks will need to have a clear idea where things are heading up to a year before the UK actually leaves the EU – if not longer. This is essentially the last 'point of no return'. If, with a year left, it is not clear what kind of new relationship there will be in financial services, banks will be forced to start making decisions regarding setting up subsidiaries or local branches and shifting certain business to other parts of the EU or elsewhere.[106]

Some firms may well start implementing their contingency plans even earlier than that. Lloyd's of London Chairman John Nelson recently told a conference,

> "If there is going to be a long period of uncertainty, unfortunately what will happen is people will execute their contingency plans quite quickly, during the course of, probably, the first half of 2017."[107]

[106] Oliver Wyman suggests this process could actually take between three and five years in terms of getting all licencing and approvals from local and EU regulators as well as getting infrastructure in place. However, this process may be expedited by regulators given the nature of the situation.
[107] Quoted by Reuters, 'Getting best Brexit deal for banks "absolute priority" – UK minister', 11 October 2016: http://uk.reuters.com/article/uk-britain-eu-banks-idUKKCN12B0VM

All this highlights the importance of the 'pre-emptive equivalence' principle we outlined in Section 3.1. Furthermore, this process will need to begin early on in the negotiations, given that following the equivalence discussion under some regulations (EMIR and MiFIR specifically) firms will have to apply for recognition from ESMA which can take up to 180 days, based on time allotted under the regulations. Not only will discussions over equivalence have to begin early on, but also discussions over the type of bespoke agreements which could be sought for banking and the Lloyds of London insurance market.

Finally, this also highlights that the option for a transition or a grandfathering of access, particularly in financial services, should be maintained if the options outlined above cannot be tied up during the bulk of the negotiations.

6. Case study - Will the UK be able to keep euro clearing following Brexit?

Post-Brexit, there are areas where regulatory and political conflicts will merge. The clearing of euros in London is undoubtedly one of them – and therefore makes for a perfect in-depth case study, while also setting it apart from issues we have discussed before.

The UK recently won a case at the European Court of Justice (ECJ) against the ECB regarding the latter's attempts to move the clearing of euro-denominated products and securities inside the Eurozone (so called 'location policy').[108] However, post Brexit there is a renewed concern that the ECB may once again seek to move euro clearing back inside the Eurozone. Below, we examine how likely this is, how it could happen and what the impact might be. See Annex 2 for a full explanation and background on the case.

Could clearing move to the Eurozone?

The first point to note is that UK clearing could be impacted by Brexit even without a renewal of the 'location policy'. This is because the UK may no longer be part of the single market in financial services and the regulation of trades cleared in third countries under EU rules are different to those for countries inside the EU. As Article 25 of EMIR notes:

> "A CCP established in a third country may provide clearing services to clearing members or trading venues established in the Union only where that CCP is recognised by ESMA."

To be recognised by ESMA, an equivalence decision must be taken by the Commission. However, as we have already explained, this is not simply a technical but also a political process.

---

[108] See also Open Europe Blog, 'UK secures important victory at ECJ to preserve the single market', 4 March 2015: http://openeurope.org.uk/today/blog/uk-secures-important-victory-ecj-preserve-single-market/

So far, the European Commission has adopted equivalence decisions for the regulatory regimes for CCPs in Australia, Hong Kong, Japan, Singapore, Canada, Mexico, South Africa, Switzerland and the Republic of Korea, as well as recently the US (albeit only partially). Of course, on day one, the UK would still have the same regulation and supervision approach as it did inside the EU. The ultimate decision might also depend on what becomes of the 'cooperation' part of the agreement struck between the ECB and the BoE.

However, if the UK leaves the EU without being found to be equivalent, UK CCPs will face very high capital charges when providing clearing services to clearing members or EU trading venues, at least in the area of OTC derivatives to which EMIR applies.[109] It is possible such charges could be prohibitively high. In that sense, there could be an automatic disruption to the current clearing system. However, this is slightly different to what the ECB was trying to do with its location policy. In theory, even if the UK is not seen as equivalent under EMIR, it could still clear euro denominated trades between non EU trading venues and/or non-EU clearing members. It also seems possible that if the instruments are traded in London, even by EU parties, then it might still be able to have them cleared in London (this would seem to come down to the definition of an 'EU trading venue').

For this to be stopped, the ECB would have to relaunch its location policy push, to have all euro denominated trades happen inside the Eurozone (or even now, inside the EU). But, given the ECJ ruling on this case, it is not clear whether the ECB would be able to do this. The ECJ ruled that the ECB does not have competence over the issue of securities clearing and that its statute would have to be changed if it wanted such control. The ECB's statute could be changed by QMV to allow for this competence. The European Parliament would also have to approve the change.

Alternatively, the EU could pass legislation which lays out the points underlying the 'location policy' and limits on clearing of euros. While few states previously supported this, the situation could change post Brexit.

Therefore, it seems that, if and when the UK leaves the single market, some of the clearing abilities could lapse – at least pending an equivalence decision. This point has already been hinted at by industry figures calling for transition arrangements to be in place. For euro-denominated clearing to fully be moved to the Eurozone it would need a change to the ECB statute and a renewed location policy, or for the EU states to actively legislate on this.

[109] The ECB defines a clearing member as "a member of a clearing house that clears on its own behalf, on behalf
of its customers and on behalf of other market participants":
https://www.ecb.europa.eu/pub/pdf/other/glossaryrelatedtopaymentclearingandsettlementsystemsen.pdf

What would be the impact?

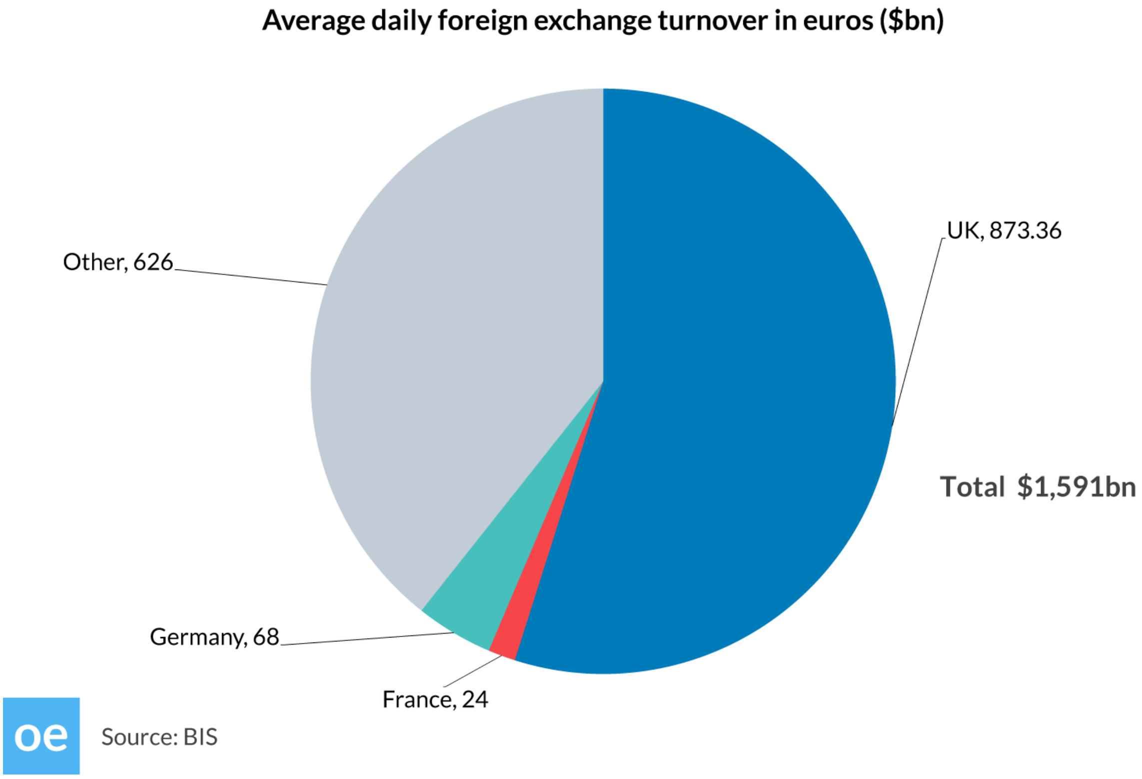
This is hard to say. The first point to make is that the direct hit may not be all that large. Clearing houses are not exactly profit centres in terms of the City of London. However, the indirect impacts could be significant.

There is a significant economy of scale to having a number of different types of instruments and currencies traded through a single clearing house. While this may create a locus of risk, it also creates efficiencies which save banks and brokers money. For example, by netting off margin on a number of different trades which run through a single central counterparty – this allows the overall amount of collateral posted to be significantly lower. This means that the trades and clearing will often coalesce around single locations. As such, if certain trades or instruments can't be cleared in London, then not only might their trading and clearing move but other related trades and clearing might as well.

The main area which seems likely to be impacted will be OTC derivatives trades. The UK is a huge centre for euro related OTC derivatives trading – the average daily net gross turnover in euro denominated interest rate derivatives in the UK is $574bn. This compares to $101bn in France and accounts for the large majority of euro denominated derivatives trading.[110]

The situation in trading of bonds and equities is more even, with trading spread more evenly across Europe and depending more on where the debt was issued or where companies are listed. Under EMIR, these OTC derivatives trades must be cleared through CCPs. Doing the trading and clearing in separate places could increase the cost and reduce the efficiency of these trades – therefore if one moves, the other may move. It is worth noting, however, that the UK is also the main EU centre for the clearing of US Dollar-denominated instruments. This may be less likely to move and hence this could also affect decisions on where to locate trades based on economies of scale and the various products which firms trade in. On this point, the UK is currently also a significant centre for euro foreign exchange trading, accounting for around 55% of euro-denominated daily foreign exchange turnover.

[110] BIS, 'Triennial central bank survey of foreign exchange and OTC derivatives markets in 2016', updated to 1 September 2016: https://www.bis.org/publ/rpfx16.htm



All that said, we should not forget that the costs of moving are not insignificant. Firstly, the infrastructure may not be as up to date as in the City of London. Secondly, getting all the licences and approvals for a new or expanded subsidiary can take time. Thirdly, there are reasons why the derivatives trade became located in London – notably that OTC derivatives tend to be issued under UK law and investors like having the UK legal system to ensure their interests are protected. Fourthly, if the moves start to involve moving staff or setting up new offices then other costs need to be taken into account (rent, taxation, etc.) which may offset any of the gains from moving from London.

It should also not be forgotten that moving euro clearing inside the EU would not just impact the UK but also the US and other third country jurisdictions. For example, the euro is the second most actively traded currency in the US and was on one side of 31% of all currency trades in the US market. The US is not alone. More euros are traded in each of Switzerland, Singapore and Japan than in Germany.[111]

Furthermore, this would harm the aims of the euro in terms of becoming an international currency, traded globally, and also a reserve currency rivalling the US Dollar.

[111] The graph is based on 2013 data, as BIS will only publish the full breakdown for 2016 at the end of the year.

There will also be questions around clearing of foreign currencies inside the EU/Eurozone. Currently Eurozone clearing houses clear dozens of currencies from around the world without direct access to central bank liquidity. Would this now be seen as a potential financial risk? Could other countries retaliate in terms of restricting clearing?

What options would the UK have to respond?

- As with other areas, the UK should push for pre-emptive equivalence for UK central counterparties under EMIR to allow for a smooth transition. It should also beef up the cooperation agreement between the BoE and the ECB to ensure sufficient supervision and reiterate the existence of the swap lines. An important part of this will be making progress on joint rules for the recovery and resolution of central counterparties, at the moment there is little agreement or clarity over how to deal with a failure of one of these large institutions.

- If the EU decides to reignite its push to move all euro denominated clearing back inside the EU/Eurozone it will be harder for the UK to fight. The best approach would be to team up with other large financial centres US, Japan, Switzerland, Singapore and Hong Kong for example and try to create a united push back against such action. If the move is to shift euro clearing inside the Eurozone, not just the EU, then the UK and others could seek to team up with an non-Euro EU state such as Sweden to fight the legislation both politically and at the ECJ.

7. What steps can the UK take to maintain London as a global financial centre?

Mitigating any potential impact of Brexit on UK financial services and the City of London will go beyond just finding agreements with the EU. It will also mean the UK using the policy levers it has (greater flexibility in which might have been gained by leaving the EU) to make the UK as attractive a place as possible for financial service firms to do business.[112]

7.1 Bank Levy

The bank levy was originally introduced in 2010 at a rate of 0.05% on UK based banks' balance sheets and gradually rose to 0.21%. It was aimed at ensuring a "fair contribution" of the banking system to the UK economy in the wake of the financial crisis.

[112] In Annex 1 we look at the approaches other Global Financial Centres take to make themselves attractive to business and investment, some of which has informed the discussion in this section.

In July 2015, the then Chancellor of the Exchequer George Osborne unveiled plans to halve the main bank levy rate from 0.21% to 0.1% by 2021 and the reduced rate from 0.105% to 0.05%. The proposed changes were then adopted as part of the Summer Finance Act 2015.

There have been growing concerns regarding the impact of the bank levy on UK banks subsidiaries overseas, despite promises that they would be excluded from the impact from January 2021 onwards.[113]

Recommendations

- An ambitious option would be for the UK Government to scrap the bank levy altogether. A significant amount of time has elapsed since the financial crisis and banks now face significantly more oversight and regulation. There might be concerns over the fiscal impact of this move. However, with the Government moving away from the promise of a budget surplus by 2020, this is less pressing. Furthermore, the bank levy has, on average over the past five years, generated £2.3bn per year in revenue.[114] This pales in comparison to the overall tax revenue from the banking sector. As such, if reducing the levy helps to dissuade any banks from moving certain staff or operations elsewhere, the fiscal impact could well prove lower than expected.
- This may prove politically unpalatable to the Government. Alternative moves include: speeding up the reduction in the levy; frontloading cuts to allow for reductions in the immediate aftermath of Brexit; or adjusting the levy to help exclude subsidiaries of UK banks abroad and subsidiaries of foreign banks in the UK. The latter point may be seen as unfair on UK banks if they don't also get some reductions, but it would have the advantage of appealing to the big foreign banks with large subsidiaries in the UK – potentially the most mobile group.

7.2 Corporation tax surcharge

The introduction of a new bank corporation tax surcharge was also announced in the summer of 2015, alongside the gradual reduction in the bank levy. The measure entered into force on 1 January 2016 and imposes a surcharge of 8% on the profits of banking companies (on top of the standard 20%), calculated on the same basis as for the corporation tax.[115]

[113] See for example the British Bankers Association (BBA)
[114] See, HMRC National Statistics, 'Corporation Tax, Bank Levy and Bank Surcharge net receipts 1999-00 to 2015-16': https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/547336/table11-1A_Aug16.pdf
[115] See HM Revenue & Customs, 'Bank corporation tax surcharge', 8 July 2015: https://www.gov.uk/government/publications/bank-corporation-tax-surcharge/bank-corporation-tax-surcharge

The surcharge does not apply to the first £25 million of profit of a banking group, or to an individual banking company where the latter is not part of any group.

The Government published its estimates of the combined impact on the Exchequer of the surcharge and the bank levy reduction, shown below.

	2016 to 2017	2017 to 2018	2018 to 2019	2019 to 2020	2020 to 2021
Exchequer impact (£m)	+415	+555	+365	+225	+105

However, concerns have been raised – both by politicians and the industry – over the potential impact of the surcharge on smaller banks – and therefore on competition in the banking sector more broadly.[116]

Recommendations

- Similar to the bank levy, the most effective measure would be to scrap the corporation tax surcharge entirely. Alternatively, it could be reduced to allow for a smaller surcharge, certain exemptions for smaller banks could be incorporated and/or its introduction could be delayed further to allow for adjustment time in the wake of Brexit.
- More broadly, the removal or shifting of the surcharge could tie in with the reduction of corporation tax. While the Government has suggested it will not follow through with previous promises to cut corporation tax to 15%, it does look set to follow through with gradual cuts to 17%.[117] Again, the timeline for these cuts could be moved forward.

There are also a huge number of other policy issues which will help to determine whether the UK looks attractive to financial services and business investment more widely. For example, as we explained in our pre-referendum Brexit reports, adopting an open and liberal approach to immigration will be crucial. We will explore further how this can be married with the clear democratic concern around immigration in a forthcoming paper.

[116] See Reuters, 'UK lawmaker asks regulator to review effect of new bank tax', 8 October 2015: http://www.reuters.com/article/banks-tax-regulator-idUSL8N1283ED20151008. See also BBA, 'Banks pay additional £40 billion in taxes', 14 July 2015: https://www.bba.org.uk/news/press-releases/banks-pay-additional-40-billion-in-taxes/#.V-UGPNgVCM8

[117] See HM Revenue & Customs, 'Corporation Tax to 17% in 2020', policy paper, 16 March 2016: https://www.gov.uk/government/publications/corporation-tax-to-17-in-2020

8. Conclusions and Recommendations

8.1 Conclusions

The financial services 'passport' is not a single thing. There is no one passport. 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, that is not to say it has no value. There are areas where it will be important to try to retain a similar relationship to the one the UK has now.

Banking

The passport works best for the banking sector. Around a fifth of the UK banking sector's annual revenue (between £23bn and £27bn according to Oliver Wyman) is estimated to be built on the access afforded by the passport. Our analysis suggests that, via their London bases, an absolute maximum of 14.5% of the US investment banks revenues can be linked to the passport. The banking passport relies on two key pieces of EU legislation – CRD IV and MiFID. CRD IV allows banks to provide deposit taking, lending and payment services, while MiFID allows them to provide advisory services, investment services and portfolio management across the EU from a base in London. Essentially, wholesale banking is done via CRD IV and investment banking via MiFID. As it stands, the CRD IV legislation does not allow for equivalence, or meaningful third party access. Therefore without a bespoke agreement, giving passport-like access, UK banks and the London-based US investment banks could see significant disruption to their business lines across Europe.

Asset management

The story for non-banks, namely asset managers, is a bit different. The key regulations, UCITS and AIFMD, theoretically provide passports to allow funds to be marketed across the EU and managed from a single base, but in reality a number of technical barriers remain. Supervisory and legal fees, as well as different national definitions of 'marketing', make it particularly challenging for small or medium-sized asset managers to expand into other markets in Europe. Meanwhile, many of the larger funds already choose to operate European subsidiaries, rather than relying on a passport. A recent industry survey by the Investment Association suggests that 21% of assets managed in the UK are tied to EU clients. Under certain conditions, the UCITS and the AIFM directives envisage the possibility of delegating portfolio management functions outside the EU – meaning that in future UK-based asset managers might be able to keep providing portfolio management services for funds domiciled within the EU/EEA. This would ultimately amount to keeping indirect access to the passport, built on existing regulations.

Under such a scenario, only around 7% of total assets managed in the UK would be under direct threat from the loss of the passports in this sector.

Insurance

For insurance, the story is again completely different. The industry is less reliant on the European markets – in 2015, 28% of insurance exports went to the EU, compared to 44% for other financial services. This is not surprising, because fundamentally there is no real single market in insurance in the EU. The large majority of services provided in other countries are done so via subsidiaries rather than via a passport – up to 87% of insurers operating across borders in the EU do so via subsidiaries rather than branches. 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. But even this only accounts for 11% of the market's gross written premium, £2.9bn, (with possibly as little £800m directly reliant on the passport). Therefore, from an insurance perspective, the loss of the passport is not likely to be life or death for the industry.

What are the alternatives that the UK could negotiate?

If the UK loses its financial services passport, there are three broad options to retain access to the European markets: under certain EU regulations, the Government can apply for 'equivalence'; the Governments of both sides could negotiate a bespoke EU-UK agreement; or finally individual firms can make use of existing local arrangements to set up branches or subsidiaries.

Equivalence

Many cite 'equivalence' as an alternative to the passport. In some cases, this can offer access to the single market when a country is judged by the EU to have a broadly equivalent regulatory regime. However, it is, at best, a partial solution. Whether or not equivalence is available varies regulation by regulation, and while some do offer passport-like rights for third countries – MiFIR for example – others offer no equivalence at all – e.g. CRD IV. Granting equivalence is also a political decision, requiring a judgment from the Commission, and can take many years to be granted. Moreover, if regulation diverges over time then it can be in jeopardy – though, so far, equivalence has never been revoked. All that said, the UK also starts from the basis of having the exact same regulation, something no other country has done – which should make equivalence easier to achieve.

Bespoke agreements

The limitations of equivalence mean that the UK will want to try and negotiate bespoke agreements to protect certain markets. 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 – although not via cross-border services. Clearly, it is a very specific agreement, but nonetheless it provides an interesting precedent.

Local arrangements
Financial firms can set up local branches if they wish to continue to provide services in certain member states. These branches would be subject to local requirements and authorisations. However, they would not be eligible to passport into other states, and as such, a branch would need to be set up in every state in which the firm wished to operate. Alternatively, firms could set up a subsidiary in an EU member state which could then provide services across the bloc. However, this would require significant investment in terms of capital, staff and infrastructure.

8.2 Recommendations

The UK should prioritise negotiating a new deal for the sectors that depend on passport access, and where the alternatives are limited. The approach should look to a mixture of Government-negotiated specific bilateral agreements and equivalence, as well as individual firms establishing local branches and subsidiaries where necessary.

1. The Government's primary objective, with regards to financial services, should be attempting to keep the CRD IV passport in place, given the importance of banking, and the lack of equivalence. This could take the form of a specific bilateral agreement (similar to the EU-Swiss deal on insurance) or it could be 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 – which already exists to an extent between the BoE and the ECB, but will need to take account of the UK outside of the European Supervisory Authorities. The UK should also seek equivalence under MiFIR, which will allow many of the investment banking services provided by the passport (including those by foreign firms) to continue.

2. For asset managers there is less urgency for new arrangements, as the regulations (theoretically) allow for funds to be managed outside the EU – provided they have some presence in the EU. Many UK-based asset managers already operate via two separate vehicles – one domiciled in the UK and another one located in a different European hub (often Dublin or Luxembourg). Achieving equivalence under MiFIR will also give asset managers a chance to retain a passport for some of the services they offer to professional investors.

3. Insurers are unlikely to be as concerned about the loss of the passport, given the industry's global nature and tendency to operate via subsidiaries. Nonetheless, the UK should seek equivalence under Solvency II to help smooth the transition, and a bespoke agreement will be important for Lloyd's of London.

Again, this could be a specific bilateral agreement allowing it to continue to be treated as a single entity and provide services across the bloc, provided it adheres to the relevant EU regulation. Steps 2 and 3 will be particularly important. 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) are also more likely to maintain the bulk of their operations in London.

4. 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.

5. Since equivalence can be a time-consuming and complicated political process, 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.

6. 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.

7. The UK should offer reciprocal access to its markets to EU firms, and maintain the current access offered to third countries (currently granted through EU equivalence). This will mean creating and establishing the UK's 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).

8. 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.

ANNEX 1: What can the UK learn from other Global Financial Centres?

Hong Kong

Hong Kong ranked fourth in the Global Financial Centres Index (GFCI) for 2016 – in which it was pushed off the podium by Singapore.[118] A wide range of financial activities take place in Hong Kong. Around 70 of the top 100 global banks have a presence there. The Hong Kong stock market is the third-largest in Asia and the sixth-largest in the world. Hong Kong is also a leading fund management hub – with over 70% of the assets of non-real estate funds sourced from overseas investors. Most importantly, Hong Kong has established itself as the premier offshore hub for financial activities denominated in renminbi – the Chinese currency.[119]

Among the strengths of Hong Kong is certainly its simple and advantageous tax system. The tax rate for corporate profits is 16.5%, while personal income is taxed at a flat rate of 15%.[120] There is no sales tax, no capital gains tax, no withholding tax on dividends and interest, and even no VAT.[121] Hong Kong has also put in place over time a network of Comprehensive Double Taxation Agreements (CDTAs) to make sure foreign investors who want to do business there do not face double taxation. There are 35 CDTAs currently in place – including twelve of Hong Kong's top 20 trading partners.[122]

Under the so-called 'one country, two systems' principle, Hong Kong has managed to preserve a high degree of autonomy after the reunification with mainland China in 1997. Crucially, this means Hong Kong has kept its legal framework based on English common law – another reason behind its success as a global financial centre. English has been retained as one of Hong Kong's official languages, on equal footing with Chinese.[123] Hong Kong also benefits from a favourable time zone (GMT +8), which in practice means foreign exchange dealings can go on for 24 hours a day by linking to the American and European markets.

[118] Global Financial Centres Index No 19, 'The overall rankings', March 2016: http://www.longfinance.net/global-financial-centre-index-19/976-gfci-19-the-overall-rankings.html

[119] For further details, see Hong Kong Monetary Authority, 'Hong Kong: The global offshore renminbi business hub', January 2016: http://www.hkma.gov.hk/media/eng/doc/key-functions/monetary-stability/rmb-business-in-hong-kong/hkma-rmb-booklet.pdf

[120] Government of Hong Kong, 'Tax rates of profits tax', retrieved on 8 August 2016: http://www.gov.hk/en/residents/taxes/taxfiling/taxrates/profitsrates.htm

[121] See Government of Hong Kong, 'Hong Kong: China's global financial centre', November 2013, p4: http://www.fstb.gov.hk/fsb/topical/doc/pitchbook_brochure(Nov%202013)_e.pdf

[122] Updated to April 2016, see Government of Hong Kong 'Comprehensive agreements for avoidance of double taxation': http://www.fstb.gov.hk/tb/en/comprehensive-agreement-for-avoidance-of-double-taxation.htm

[123] Government of Hong Kong, 'Hong Kong – The facts', retrieved on 8 August 2016: http://www.gov.hk/en/about/abouthk/facts.htm

Switzerland

Financial services and activities in Switzerland are spread across five hubs: Zurich, Geneva, Basel, Ticino, and Lausanne/Vaud. Only Zurich and Geneva currently feature in the GFCI, and were ranked sixth and fifteenth respectively in the 2016 edition.

Banking is arguably the key pillar of Switzerland's financial services sector. There are around 280 banks authorised by Finma – the Swiss financial supervisor. Approximately a third of them have their head office in the Zurich region.[124] In turn, wealth management represents the core of Swiss banking activities. At the end of 2013, Swiss banks managed assets totalling nearly CHF 5.2 trillion – of which almost 55% belonged to foreign clients.

Insurance is the second largest financial industry in Switzerland. In 2010, 66% of Swiss insurers' global premium income for private insurance and re-insurance was generated abroad – which can be seen as an indication of the high level of internationalisation of the sector. Over time, Swiss insurance firms have become increasingly specialised in re-insurance services – making Switzerland the world's fourth-largest hub for re-insurance.[125] Along with Bermuda, Switzerland is currently the only third country to have been granted full equivalence under Solvency II by the European Commission.

Other important activities across the Swiss financial centres include currency trading, commodity trading and hedge fund management.

A number of factors contribute to making Switzerland an attractive location for financial services professionals: stable and broadly predictable politics; a healthy economy; moderate taxation and double taxation agreements with the country's main economic partners;[126] a flexible labour market; a generally very high quality of life.

---

[124] As of 2013, see Canton of Zurich, 'The Zurich banking centre – Facts and figures', 2015/2016 edition: http://www.awa.zh.ch/internet/volkswirtschaftsdirektion/awa/en/standortfoerderung/cluster/finanzdienstleistungen/_jcr_content/contentPar/downloadlist/downloaditems/the_zurich_banking_c.spooler.download.1422016794873.pdf/leporello_zurichbanking_centre_2015_2016_e.pdf

[125] Michael Mainelli and Chiara von Gunten, 'How do the Swiss financial centres compare to the rest of the world?', Swiss Banking Yearbook, April 2013: http://www.longfinance.net/images/zyen_SBY2013.pdf

[126] Only a limited portion of tax is levied at the confederal level, meaning that the final tax rate – both for personal income and corporate profits – can vary from one Swiss canton to another. The high level of tax autonomy is generally seen as fostering tax competition among cantons. For further details, see Swiss Federal Department of Finance, 'The Swiss tax system', retrieved on 11 August 2016: https://www.efd.admin.ch/efd/en/home/themen/steuern/steuern-national/the-swiss-tax-system/fb-schweizer-steuersystem.html

Singapore

Singapore took the third spot from Hong Kong in the GFCI for 2016. Its success as a global financial hub mainly lies with: its strategic location at the heart of the Asia-Pacific region; a strong economy with high growth potential; a robust regulatory and supervisory framework; a legal system based on English common law; a pro-business environment and favourable tax regime; high-quality infrastructure; and an international pool of highly skilled finance professionals.

The total asset size of Singapore's banking sector neared USD 2 trillion at the end of 2013. According to the Monetary Authority of Singapore (MAS), over 200 banks have established a presence in Singapore and a growing number have chosen to locate their operational headquarters there to service their activities across the Asia-Pacific region.[127]

Over the past decade, Singapore's fund management industry has experienced exceptional growth. At the end of 2014, there were 591 fund managers registered and licensed with the MAS, and total assets under management stood at nearly SGD 2.4 trillion – double the amount in 2009. 81% of these assets were sourced from outside Singapore (54% from the Asia-Pacific region, 19% from Europe, and 18% from North America) – which goes to show the international breadth of the sector.[128] The Resident Fund Scheme introduced in 2006 played an important role in driving this expansion. It constitutes an incentive for fund managers to locate their fund vehicles in Singapore, as it essentially gives Singapore-based funds the same tax exemptions traditionally granted to qualifying offshore funds.[129]

Singapore is also a leading hub for foreign exchange (FX) and over-the-counter (OTC) derivatives trading. The triennial survey of the Bank for International Settlements (BIS) showed that the average daily FX turnover volume in Singapore was USD 383 billion in April 2013 – making Singapore the largest FX centre in the Asia-Pacific region and the third-largest globally.[130]

[127] Monetary Authority of Singapore, 'The Singapore financial centre – Banking sector', retrieved on 16 August 2016: http://www.mas.gov.sg/Singapore-Financial-Centre/Overview/Asian-Dollar-Market.aspx
[128] Monetary Authority of Singapore, '2014 Singapore asset management survey', August 2015: http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Surveys/Asset%20Management/2014%20AM%20Survey%20Report.pdf
[129] For further details, see PwC, 'Singapore fund management incentives', March 2014: https://www.pwc.com/sg/en/tax/assets/sgfundmgtincentives.pdf
[130] Monetary Authority of Singapore, 'The Singapore financial centre – Capital Markets', retrieved on 16 August 2016: http://www.mas.gov.sg/Singapore-Financial-Centre/Overview/Capital-Markets.aspx. The full data from the new triennial survey is due for publication in December 2016, see BIS, '2016 triennial central bank survey of foreign exchange and OTC derivatives markets', 30 March 2016: http://www.bis.org/press/p160330.htm

Singapore has recently been looking to boost its role as an offshore renminbi centre. At the beginning of 2013, as part of the China-Singapore free trade deal, the Chinese central bank appointed the Singapore branch of the Industrial and Commercial Bank of China (ICBC) as the official renminbi clearing bank in Singapore.[131] Nonetheless, the gap with Hong Kong remains huge on this front. Data published by the Society for Worldwide Interbank Financial Telecommunication (SWIFT) at the end of April 2016 showed that Hong Kong was processing 72.5% of all renminbi payments, followed at long distance by the UK (6.3%) and Singapore (4.6%).[132]

ANNEX 2: UK vs ECB on euro clearing

What was the case about?

On the 5 July 2011, the ECB published its Eurosystem Oversight Policy Framework, which argued that clearing houses based in the UK or other non-Eurozone countries would have to move inside the Eurozone to continue to do business in euros. It said,

> "As a matter of principle, infrastructures that settle euro-denominated payment transactions should settle these transactions in central bank money and be legally incorporated in the euro area with full managerial and operational control and responsibility over all core functions for processing euro denominated transaction exercised from within the euro area."[133]

In that paper and future opinions, the ECB has stressed that it would not provide central bank liquidity to clearing houses outside the Eurozone but that all such institutions should have access to it.

The UK quickly challenged the policy in September 2011, calling for the ECB's policies to be annulled, and launched two further challenges at the ECJ, in which it updated its list of complaints, the key points of which were:

- The ECB lacks powers to dictate the location of business, especially since it did not include the plans in a regulation to be adopted by the Council or by the ECB itself, simply decreed it in a policy paper and opinion.

[131] Monetary Authority of Singapore, 'The Singapore financial centre – Regional gateway for RMB', retrieved on 16 August 2016: http://www.mas.gov.sg/Singapore-Financial-Centre/Overview/Regional-Gateway-for-RMB.aspx

[132] SWIFT, 'UK jumps ahead of Singapore as the second-largest offshore RMB clearing centre', 28 April 2016: https://www.swift.com/insights/press-releases/uk-jumps-ahead-of-singapore-as-the-second-largest-offshore-rmb-clearing-centre

[133] See also Open Europe Blog, 'UK secures important victory at ECJ to preserve the single market', 4 March 2015.

- 'De jure' or 'de facto' the rules will impose a residence requirement on clearing houses which want to clear euros, meaning existing clearing houses will face a choice of moving within the Eurozone or changing their business approach.
- The rules offend the principle of equality in the single market since firms incorporated in different EU member states will be viewed differently and the rules will not apply equally.
- There are less onerous methods for achieving the security of the financial system.

How did the Court rule and what did it say?
The ECJ's General Court fully supported the UK's request for the Eurosystem Oversight Policy Framework to be annulled. The press release said:

> "The General Court annuls the European Oversight Policy Framework published by the ECB in so far as it sets a requirement for CCPs involved in the clearing of securities to be located within the Eurozone."
>
> "The General Court holds that the ECB lacks the competence necessary to regulate the activity of securities clearing systems as its competence is limited to payment systems alone by Article 127(2) of the TFEU."

The Court added that, if the ECB felt that its role in managing payment systems required the oversight of securities clearing, it would need to request a change to its statute so that the relevant article includes explicit reference to this point.

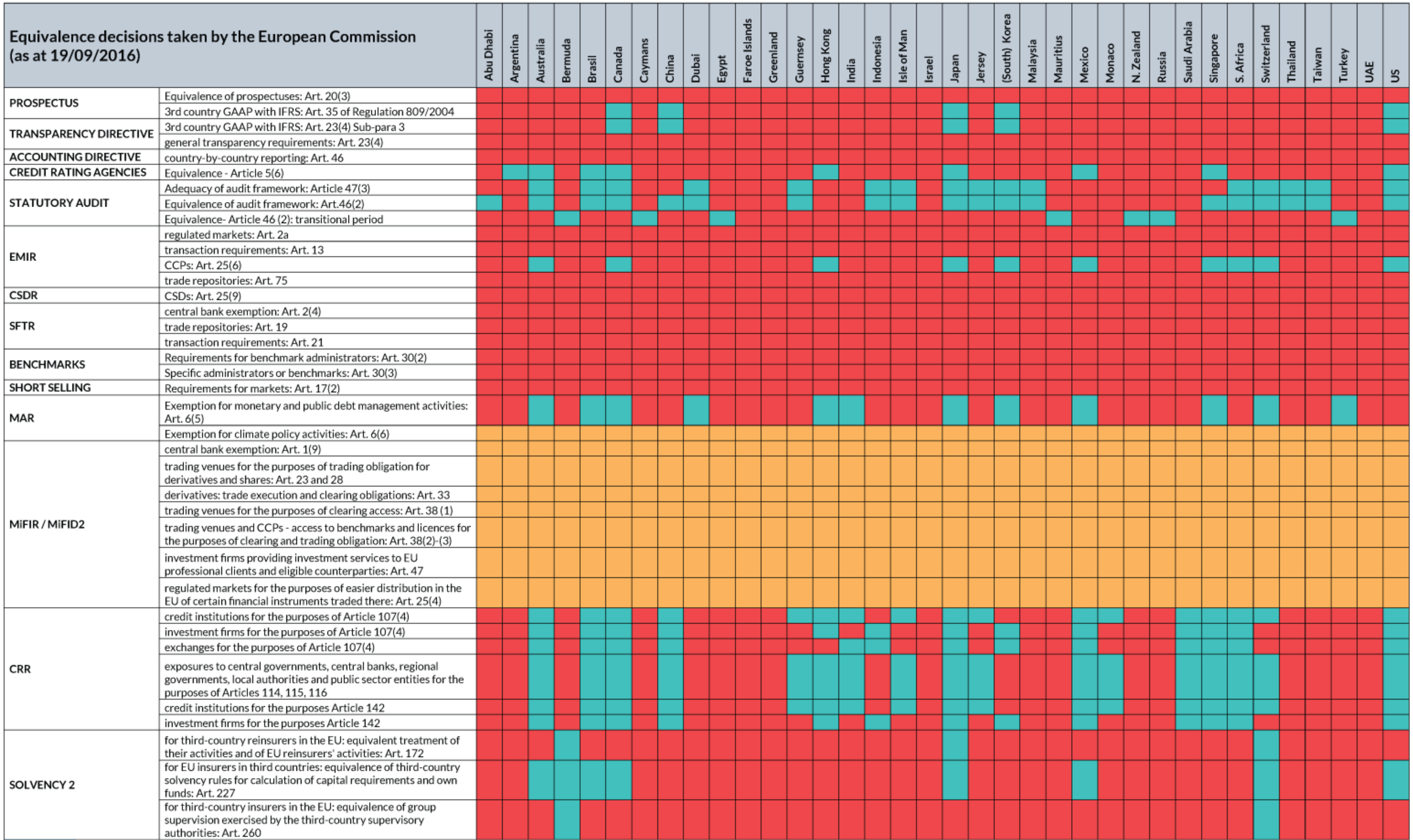
What was agreed?
Following the ECJ's ruling, the UK dropped all of its legal cases on the issue and agreed to a EUR/GBP swap line between the ECB and the Bank of England, to ensure there is always sufficient liquidity available in both currencies. The two central banks also agreed on "enhanced arrangements for information exchange and cooperation regarding UK Central Counterparties (CCPs) with significant euro-denominated business."[134]

As we have always said, this was a logical answer to the questions and concerns raised. The ECB did have some validity in its point about financial stability. There is no doubt that more and more transactions are being directed on to exchanges and through central counterparties (clearing houses) therefore it makes sense for them to have access to sufficient liquidity. The swap lines help tackle this concern.

Most importantly, Brexit does not change any of these economic or financial considerations. If the swap line was adequate beforehand, then it should continue to be. As such, the only reason for the ECB or others to try and move euro clearing back inside the Eurozone would be political.

[134] See Bank of England, 'European Central Bank and Bank of England announce measures to enhance financial stability in relation to centrally cleared markets in the EU', 29 March 2015: http://www.bankofengland.co.uk/publications/Pages/news/2015/044.aspx

Annex 3: EU equivalence decisions granted so far



Source: European Commission

Equivalence granted | No equivalence | Regulation not in force yet

Open Europe
Staying ahead
of the game

www.openeurope.org.uk
@openeurope

Offices

Open Europe
7 Tufton Street
London
SW1P 3QN
+44 (0)20 7197 2333
www.openeurope.org.uk
info@openeurope.org.uk
@OpenEurope

Open Europe Brussels
113-115 rue du Trône
B-1050
Brussels
+32 (2) 540 86 25

Open Europe Berlin
Oranienburger Straße 27
10117 Berlin
Germany
+49 (0)30 2758 1365
info@openeuropeberlin.de
www.openeuropeberlin.de